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THE PROSPECTUS DEFENSE: DEFEATING IT AS A MATTER OF FACT AND LAW

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INTRODUCTION

One of the issues that has become prominent in recent securities litigation and arbitration is the role written risk disclosures play in a prospectus that contradict a broker's oral representations, and how they bear on an investor's ability to recover damages. There is confusion whether written risk disclosures bar – as matter of law – an investor's claims for damages based on contrary oral representations without regard as to whether such claims are grounded in section 12(a)(2) of the Securities Act of 1933, Rule 10b-5 of the Securities Exchange Act of 1934, state securities acts – also known as blue-sky laws, common law fraud, or solely involve the issue of when the appropriate statute of limitations begins to run. Also lost in the confusion are various regulatory agencies, including the Financial Industry Regulatory Authority (FINRA), formerly known as the National Association of Securities Dealers (NASD), and the U.S. Securities Exchange Commission (SEC).

The writers of this article believe that investors can and should defeat what is commonly known as the "prospectus defense" *as a matter of fact* in Rule 10b-5 and common law securities fraud cases through a multi-part factual balancing test.[2] Investors also can and should defeat the prospectus defense *as a matter of law* in section 12(a)(2) and companion state securities act cases – also known as blue-sky laws.[3] In fact, there is no credible argument that the prospectus defense applies to statutory claims based on section 12(a)(2), the vast majority of companion state blue-sky statutory claims, or breach of fiduciary duty claims,[4] because these causes of action do not require reliance as an element. Similarly, regulatory agencies take the position that risk disclosures in a prospectus – as a matter of law – do not

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2. *See infra* Part III.
3. *See infra* Parts V, VI.
4. *See infra* Part IV.

insulate brokers from responsibility for making oral representations that contradict written risk disclosures.[5] Contrariwise, Rule 10b-5 and companion common law fraud causes of action require reliance as an element, and therefore, the prospectus defense may – under narrow circumstances – bar investors from recovering damages.

Whether the prospectus defense bars investors' claims in Rule 10b-5 and companion state statutory and common law securities fraud cases depends on whether investors justifiably relied on their brokers' oral misrepresentations. In determining whether reliance was justified, the majority of federal and state courts use a multi-part factual balancing test. Under this balancing test, courts examine the following factors: (1) the plaintiff's sophistication and expertise in financial and security matters; (2) whether a long standing business or personal relationships exist between the plaintiff and the defendant; (3) the plaintiff's access to relevant information; (4) whether the defendant owed a fiduciary relationship to the plaintiff; (5) whether the defendant concealed the fraud; (6) the plaintiff's opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

I. REGULATORY AGENCIES AND ENFORCEMENT DECISIONS DO NOT SUPPORT THE PROSPECTUS DEFENSE

According to the U.S. Securities and Exchange Commission (SEC), delivery of a prospectus[6] does not absolve a broker of liability for misleading oral statements.[7] As an independent United States governmental agency, the SEC is responsible for enforcing federal securities laws and regulating the securities industry.[8] Within this enforcement context, the SEC has held that, "a registered representative may be found in violation of the NASD's rules and federal securities laws for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to

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5. *See infra* Part II.

6. Section 2(10) of the 1933 Securities Act broadly defines "prospectus" to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . . ." 15 U.S.C. § 77b(a)(10) (2009); *see also* Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 574-75 (1995).

7. *See* In re Ross Secs., Inc., 41 S.E.C. 509, 510 (1963).

8. *See* http://www.sec.gov/about/whatwedo.shtml (last visited July 31, 2009).

the customers."[9] In fact, the SEC – in its commitment to protecting investors – has long held that information in prospectuses "furnishes the background against which the salesman's representations may be tested," and that "those who sell securities by means of representations inconsistent with it do so at their peril."[10] As early 1963, in a case in which a registered broker-dealer made false and misleading statements in the offer and sale of securities, the SEC commission stated:

> At the expense of restating the obvious, we emphasize that compliance with these requirements for delivery of a prospectus or offering circular does not, however, license broker-dealers or their salesmen to indulge in false or fanciful oral representations to their customers. The anti-fraud provisions of the Securities Act and the Securities Exchange Act apply to all representations whether made orally or in writing, during or after the distribution. We have repeatedly held that the making of representations in the sale of securities unsupported by a reasonable basis is contrary to the obligation of fair dealing imposed on broker-dealers and their salesmen by the securities laws. This obligation is not diminished because a prospectus or offering circular containing information specified by the Act and our rules has been or is to be delivered. Such information furnishes the background against which the salesman's representations may be tested. Those who sell securities by means of representations inconsistent with it do so at their peril.[11]

With the SEC's position in mind, brokerage firms and their representatives must do more than merely deliver a prospectus to a client that discloses the risks of a securities transaction. A brokerage firm has an affirmative duty to educate clients about the risks associated with a particular recommendation, and to ensure that their customers understand the true risks involved in a securities transaction.[12] Therefore, a firm cannot use written

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9. *See* Dep't. of Enforcement v. Reynolds, 2001 NASD Discip. LEXIS 17, at *35 (June 25, 2001); *see also* In re Klein, 52 S.E.C. 1030, 1036 (1996) (holding that broker's delivery of a prospectus to an investor did not excuse broker's failure to inform the investor fully of the risks of the investment package the broker proposed); In re Foster, 51 S.E.C. 1211, 1213 n.2 (1994) ("Notwithstanding [broker]Foster's distribution of the prospectuses, he is liable for making untrue statements of material facts and omitting to state material facts.").

10. *See Ross Secs., Inc.*, 41 S.E.C. at 510.

11. *Id.*

12. *See* In re Dep't. of Enforcement v. Chase, 2001 WL 963788, at *5 (NASD Aug. 15, 2001); *see also* In re Keel, 51 S.E.C. 282, 286 (1993) (noting that a broker must determine that the recommendation is suitable for the customer).

disclosures in a prospectus to shield itself from liability. In fact, the SEC has consistently rejected this argument, holding that, "the fact that an unsophisticated customer receives a prospectus disclosing the nature of the product is no defense to allegations of misrepresentation or unsuitability."[13]

The Financial Industry Regulatory Authority (FINRA),[14] formerly known as the National Association of Securities Dealers (NASD),[15] also adheres to this principle. As the largest self-regulatory organization for all securities firms in the United States, FINRA regulates firms by adopting and enforcing rules and regulations.[16] In publishing *Regulatory Notices*, FINRA provides brokerage firms with timely information on a variety of issues, such as notice of recently approved rules and amendments, proposed rules on which FINRA solicits comment, and legal interpretations and guidance relating to existing rules.[17] A review of these notices reveals that FINRA has taken the position that risk disclosures in a prospectus do not insulate brokers from responsibility for making oral representations that contradict written risk disclosures.

For instance – in a notice released in 1994 – FINRA reminded firms of mutual fund sales practice obligations, stating in relevant part:

> Members and their associated persons must ensure that their communications with customers (both oral and written) are accurate and complete regarding disclosure of material information.
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> . . . .
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> Members are also advised that, although the prospectus and sales material of a fund include disclosures on many matters, oral representations by sales personnel that contradict the disclosures in the prospectus or sale literature may nullify the effect of the written

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13. *See Reynolds*, 2001 NASD Discip. LEXIS, at *36 (citing Dist. Bus. Conduct Comm. for Dist. No. 8 v. Cruz, 1997 NASD Discip. LEXIS 62 (Oct. 31, 1997).

14. On July 26, 2007, the U.S. Securities and Exchange Commission (SEC), approved the merger between the enforcement and arbitration functions of the New York Stock Exchange and NASD, creating "[FINRA], a single watchdog for brokers from Wall Street to Main Street." *See* Carrie Johnson, *SEC Approves One Watchdog for Brokers Big and Small*, Washington Post, July 27, 2007, at D02.

15. In July 2007, the NASD officially changed its name to FINRA, and also changed its internet domain from www.nasd.com to www.finra.org. *See* http://www.finra.org/Newsroom/NewsReleases/2007/p036329.

16. *See* http://www.finra.org/AboutFINRA/index.htm (last visited July 31, 2009).

17. *See* FINRA's Regulatory Notices*, available at* http://www.finra.org/Industry/Regulation/Notices/2009/index.htm.

> disclosures and may make the member liable for rule violations and civil damages to the customers that result from such oral representations.[18]

FINRA has also warned firms about procedures to follow when selling hedge funds to investors.[19] With concern that firms were not fulfilling their sales practice obligations when selling hedge funds – especially to retail customers – FINRA released a notice, which with respect to written discourses, stated in relevant part:

> Sales material and oral presentations that promote hedge funds (or funds of hedge funds) raise particular investor protection concerns. NASD reminds its members that the promotion of hedge funds must be balanced by a fair presentation of the risks and potential disadvantages of hedge fund investing.
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> . . . .
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> Members must also provide investors with a prospectus or other disclosure document of the hedge fund (or fund of hedge funds). Members should bear in mind, however, that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations."[20]

Likewise, FINRA has warned firms about procedures to follow when selling non-conventional investments (NCIs), such as asset-backed securities, distressed debt, and derivative products.[21] In a notice released in 2003, FINRA stressed the importance of providing a fair and balanced representation – both through written sales materials and oral presentations – stating:

> Sales materials and oral presentations regarding NCIs must present a fair and balanced picture regarding both the risks and benefits of investing in these products. For example, members may not claim that certain NCI products, such as asset-backed securities, distressed debt, derivative contracts, or other products, offer protection against declining markets or protection of invested capital unless these statements are fair and accurate. Moreover, when promoting the advantages of NCIs, it is critical that members balance

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18. NASD Notice to Members 94-16, *NASD Reminds Members Of Mutual Fund Sales Practice Obligations* (Mar. 1994).

19. NASD Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds*, at 49 (Feb. 2003).

20. *Id*.

21. NASD Notice to Members 03-71, *NASD Reminds Members of Obligations When Selling Non-Conventional Investments*, at 765 (Nov. 2003).

> their promotional materials with disclosures of the corresponding risks and limitations of the product discussed above in the "Due Diligence/Reasonable Basis Suitability" section of this Notice.[22]

This same principle is echoed in a FINRA notice reminding firms of sales practice obligations when selling bonds and bond fund investments.[23] With concern that many investors were not fully appreciating the risks associated with such products, FINRA reminded firms that it is the firm's responsibility to take appropriate steps to ensure that their registered representatives understand and inform their customers about the risks of the products they offer and recommend.[24] In doing so, FINRA required firms offering bonds and bond funds to provide investors with a prospectus and other disclosure material provided by the issuer or sponsor.[25] However, FINRA was careful to advise firms "that simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer."[26]

In addition to publishing *Regulatory Notices*, FINRA publishes rules, such as FINRA Rule 2210 prohibiting misleading statements to the public, which explains the underlying principle behind the lack of support for the prospectus defense. Specifically, FINRA Rule 2210 requires that:

> (A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.
>
> (B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or

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22. *Id*. at 768.

23. NASD Notice to Members 04-30, *NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds,* at 339 (Apr. 2004).

24. *Id*.

25. *Id*. at 342.

26. *Id*.

misleading.[27]

Finally, to hold that investors must read and understand prospectuses to ensure that their brokers' oral representations are in line with the risk disclosures in the prospectus is at odds with what happens in the real world. According to the "Mandatory Disclosure Documents Telephone Survey," commissioned by the SEC's office of Investor Education and Advocacy,[28] "nearly two-thirds of investors who receive mutual fund prospectuses said they rarely (28%), very rarely (14%) or never (21%) read prospectuses when they received them."[29] From the relatively small number of investors who review mutual fund prospectuses, only 4% look for information concerning risks.[30] The same poll also reveals that 72% of those who review prospectuses find the language used somewhat or very difficult to understand.[31] In fact, as difficult as regular mutual fund prospectuses can be to understand, variable annuity prospectuses are virtually incomprehensible.[32] Thus, ordinary investors should not be required to read and understand prospectuses to make sure that their brokers are not deceiving them, because this imposes an unrealistic burden on clients.

II. THE PROSPECTUS DEFENSE SHOULD NOT BAR INVESTORS' CLAIMS UNDER RULE 10b-5 OF THE SECURITIES EXCHANGE ACT OF 1934 AS A MATTER OF LAW

Determining whether a written prospectus disclosing risks bars claims based on contradictory oral representations depends on whether an investor brings a claim under section 12(a)(2) of the Securities Act of 1933[33] or Rule 10b-5 of the Securities Exchange Act of 1934.[34] This is because claims

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27. FINRA Rule 2210, "Communications with the Public," *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=10467&element_id=3617&highlight=2210#r10467.

28. Mandatory Disclosure Documents Telephone Survey, Abt. SRBI, July 30, 2008, *available at* www.sec.gov/pdf/disclosuredocs.pdf (last visited July 31, 2009).

29. *Id*. at 56.

30. *Id.* at 61.

31. *Id*. at 72.

32. *See* Walter Updegrave, *One (Small) Cheer for Variable Annuities*, MONEY MAGAZINE, Jan. 1, 2000 (stating how variable annuities are "brain-numbingly complicated").

33. *See infra* Part V for a discussion on section 12(a)(2) of the Securities Act of 1933.

34. 17 C.F.R. § 240.10b-5 (2009) (Rule 10b-5 provides that "it shall be

arising under Rule 10b-5 differ from those governing section 12(a)(2). Specifically, the language of Rule 10b-5 and the Exchange Act section 10(b) under which it was adopted, does not expressly create a private cause of action or require reliance as an element.[35]

In 1946 – despite the lack of an express private cause of action – the United States District Court for the Eastern District of Pennsylvania held that section 10(b) contained an implied private cause of action that allowed private citizens to bring civil claims for damages.[36] Twenty-five years later, the United States Supreme Court, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[37] confirmed that an implied private cause of action existed under Section 10(b).[38] The Court concluded that private individuals could bring a section 10(b) claim even though Congress did not expressly proscribe civil liability.[39] Currently, "through judicial interpretation and application, legislative acquiescence, and the passage of time," there is no doubt that an implied private cause of action exists for a section 10(b) and Rule 10b-5 violation.[40]

Since a Rule 10b-5 cause of action is implied, courts have had the responsibility of defining its elements.[41] In doing so, courts turned to the

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unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security").

35. *Id.*; *see also* 15 U.S.C. § 78j(b) (2000); Dunn v. Borta, 369 F.3d 421, 430 n.18 (4th Cir. 2004) ("Section 10(b) and Rule 10b-5 do not explicitly create a cause of action--they simply provide that certain sales of securities by deceptive means or material misrepresentations are unlawful.").

36. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946).

37. 404 U.S. 6 (1971).

38. *Id*. at 13 n.9.

39. *Id.*; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972).

40. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 230-31 (1988); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (noting that the existence of a private cause of action for Rule 10b-5 violations is well established).

41. *See* Dunn v. Borta, 369 F.3d 421, 430 (4th Cir. 2004) ("Such federal claims have no statutorily-defined elements; rather, they were judicially created. And because the causes of action under section 10(b) and Rule 10b-5 are implied, the responsibility of defining those claims rests with the courts.").

common law tort of fraud, which requires reliance as an element.[42] As a result, courts concluded that Rule 10b-5 – unlike a section 12(a)(2) cause of action – should require reliance as an element as well.[43] The courts reached this conclusion even though Rule 10b-5's language does not support a reliance requirement .[44]

With reliance as an element, a plaintiff must prove the following to establish a Rule 10b-5 claim: (1) the defendant made a material misrepresentation or omission[45] (2) with scienter (3) upon which the plaintiff justifiably relied (4) that proximately caused the plaintiff's damages.[46] Under this standard, whether the prospectus defense bars an investor's claim for damages in 10b-5 cases depends on whether the investor justifiably relied on the broker's contrary oral representations.[47] In turn, whether reliance is justified depends upon the specific factual situation.[48] Thus, since Rule 10b-5 claims are fact specific, disputes about the existence of their elements typically cannot be resolved as a matter of law.[49]

Accordingly, a case review from federal circuit courts indicates that under this fact based approach, the majority of courts use a multi-part factual balancing test when examining whether reliance is justified.[50] The Tenth

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42. *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

43. *See Basic*, 485 U.S at 243 (noting that reliance is an element of a Rule 10b-5 cause of action).

44. *See* 17 C.F.R. § 240.10b-5 (2009).

45. A broker's omission of a material fact is not discussed in this article since the scope of this article addresses the prospectus defense in the context of a broker's oral misrepresentation. S*ee* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972) (explaining that when deceit arises from nondisclosure in a Rule 10b-5 cases, positive proof of reliance is not a prerequisite to recovery).

46. Kennedy v. Josephthal & Co., 814 F.2d 798, 804 (1st Cir. 1987).

47. The majority of courts use a recklessness standard in determining whether an investor justifiably relied on a misrepresentation or omission. *See* Molecular Technology Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991) (citing Zobrist v. Coal-X, Inc*.,* 708 F.2d 1511, 1516 (10th Cir. 1983)); *see also* Wright v. Nat'l Warranty Co., 953 F.2d 256, 262 (6th Cir. 1992).

48. *Zobrist*, 708 F.2d. at 1516.

49. Cooke v. Manufactured Homes, Inc., 998 F.2d 1256, 1262 (4th Cir.1993)(citing United States Supreme Court's holdings in Basic, Inc. v. Levinson, 485 U.S. 224, 239-41 (1988) and TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976)).

50. *See*, *e.g.*, *Kennedy*, 814 F.2d at 804-05; Brown v. E.F. Hutton Group, Inc., 991 F.2d. 1020, 1032 (2d Cir. 1993); Myers v. Finkle, 950 F.2d 165, 168 (4th Cir. 1991); *Molecular Technology*, 925 F.2d at 918; Davidson v. Wilson, 973 F.2d 1391, 1400 (8th Cir. 1992); Atari Corp. v. Ernst & Whinney, 981 F.2d 1025, 1029 (9th Cir.

Circuit, in *Zobrist v. Coal-X Inc.*,[51] consolidated relevant factors previously used by circuit courts in determining whether reliance was justified into an eight-factor test.[52] While no single factor is controlling,[53] determinations of whether an investor's reliance was justified require the consideration of all relevant factors, which include: (1) the plaintiff's sophistication and expertise in financial and security matters; (2) whether a long standing business or personal relationships exist between the plaintiff and the defendant; (3) the plaintiff's access to relevant information; (4) whether the defendant owed a fiduciary relationship to the plaintiff; (5) whether the defendant concealed the fraud; (6) the plaintiff's opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.[54]

A. Broker-Dealers Cannot Escape Liability When Their Agents Tell Clients Not To Read A Prospectus

In a recent securities arbitration case, *Brezden v. Associated Securities, Corp.*,[55] the United States District Court for the Central District of California held that arbitrators did not act with manifest disregard of the law when they found that plaintiff investors justifiably relied on their broker's oral representations that contradicted written risk disclosures.[56] In *Brezden*, the arbitration panel issued and served a reasoned written decision awarding plaintiffs $8,858,596 in damages on March 29, 2009.[57] Thereafter, the defendants filed a petition to vacate the award in the district court, arguing that the arbitrators acted in manifest disregard of federal securities laws.[58]

1992); *Zobrist,* 708 F.2d. at 1516; Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989).

51. 708 F.2d 1511 (10th Cir. 1983).

52. *Id*. at 1516.; *see also* Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976); G.A. Thompson & Co., Inc. v. Partridge*,* 636 F.2d 945, 955 (5th Cir. 1981); Nye v. Blyth Eastman Dillon & Co., Inc., 588 F.2d 1189, 1197 (8th Cir. 1978*);* Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d 156, 176-77 (9th Cir. 1976), *cert. denied*, 429 U.S. 896 (1976).

53. *Zobrist*, 708 F.2d at 1516-17.

54. *Id.* at 1516.

55. Brezden v. Associated Secs., Corp., 2009 U.S. Dist. LEXIS 49557, at *10-11 (C.D. Cal. Jun. 1, 2009).

56. *Id*. at *10-11.

57. 2009 NASD Arb. LEXIS 259, at *11 (Mar. 24, 2009).

58. *Brezden,* 2009 U.S. Dist. LEXIS 49557, at *7; *see also* Luong v. Circuit City Stores, Inc., 368 F.3d 1109, 1112 (9th Cir. 2004) (explaining that an award

The district court disagreed and denied the defendants' petition to vacate.[59]

The plaintiffs in *Brezden* defeated the defendants' prospectus defense as a matter of fact. Plaintiffs had filed claims for federal securities fraud under Rule 10b-5 and common law fraud against defendant Associated Securities Corporation.[60] Plaintiffs were given a private placement memorandum and other disclosure documents that stated that the investment involved "a high degree of risk."[61] In addition, the subscription agreement provided that the investors should solely rely on the information contained in the written documents.[62] However, the plaintiffs alleged that their broker told them that the underlying investment was safe, secure, and liquid.[63] The plaintiffs' broker also told them that they did not need to read the prospectus themselves because he had read it and "that was what they were paying him for."[64] In fact, the only plaintiff who read the private placement memorandum and was aware of the various risk disclaimers that were inconsistent with what her broker said was told to ignore it as "legalese."[65]

In finding for the plaintiffs, the arbitration panel noted that while it was true that each of the investors had some sophistication and investment experience, it was equally apparent that the investors reasonably and justifiably relied on their broker for advice.[66] Specifically, the arbitration panel stated:

> None of the [Plaintiffs] had any experience in understanding about investing in options (with the possible exception of [one investor]), much less investing in an options trading fund. [The broker] held himself out as an expert in matters of this sort and that is precisely why [Plaintiffs] hired him as their financial advisor/planner. Indeed, when the [Plaintiffs] asked [the broker] about the contents of the PPM [Private Placement Memorandum] before they signed the [security] Subscription Agreements, he told them that they did not need to read it themselves because he had read it and "that was what they were

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exhibits a manifest disregard of the law where it is "clear from the record that arbitrators recognized the applicable law and then ignored it") (quoting Mich. Mut. Ins. Co. v. Unigard Sec. Ins. Co., 44 F.3d 826, 832 (9th Cir. 1995).

59. *Brezden*, 2009 U.S. Dist. LEXIS 49557, at *11.
60. *Id.* at *4-5.
61. *Id.* at *4.
62. *Id.*
63. *Id.*
64. *Id.* at *6.
65. *Id.*
66. 2009 NASD Arb. LEXIS 259, at *16-17 (Mar. 24, 2009).

> paying him for." The one claimant . . . who did in fact read the PPM and saw the various disclaimers about risk that were inconsistent with what [the broker] was touting about [the investment] was essentially told to ignore it as "legalese." [The broker] then went on to tell her that he rated the risk of investing in [the security] on a scale of 1 to 10 (with 1 being the "safest") as a 2 or 3 notwithstanding that options trading, especially naked options trading, as was done here, is probably a 9 or 10 on that same 10 point scale.
>
> At bottom, the evidence is undisputed that [Plaintiffs] put their faith and trust in [the broker]. They had every right to rely on [the broker's] purported expertise in matters of finance -- particularly here where they paid him substantial fees to look after their interests in such matters.[67]

Nevertheless, the defendants filed a petition to vacate the award in the district court, arguing that the arbitrators acted in manifest disregard of federal securities laws.[68] Specifically, the defendants argued that the arbitration panel ignored two federal securities law cases,[69] *Calvi v. Prudential Securities, Inc.*,[70] and *Carr v. Cigna Securities, Inc.*[71] The defendants argued that these cases "clearly state" that the "no justifiable reliance" defense, "absolutely bars [Plaintiffs'] securities and common law fraud claims as a matter of law."[72] The district court disagreed and distinguished *Calvi and Carr*, stating:

> The *Calvi* case primarily addresses when the statute of limitations begins to run on an investor's claim for fraud against a broker, and does not hold that claims like Plaintiffs' are barred as a matter of law. *Carr*, while more applicable to the issues in this case, explicitly limits it's holding, stating:
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> > We do not say that a written disclaimer provides a safe harbor in every fiduciary case. Not all principals of fiduciaries are competent adults; not all disclaimers are clear; and the relationship may involve such a degree of trust invited by and reasonably reposed in the fiduciary as to dispel any duty of self-protection by the principal.

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67. *Brezden*, 2009 U.S. Dist. LEXIS 49557, at *5-8.
68. *Id.* at *7.
69. *Id.* at *9.
70. 861 F. Supp. 69 (C.D. Cal. 1994).
71. 95 F.3d 544 (7th Cir. 1996).
72. *See Brezden,* 2009 U.S. Dist. LEXIS 49557, at *10.

> Here, the arbitrators could have found that the relationship between [the broker] and Plaintiffs involved "such a degree of trust invited by and reasonably reposed in the fiduciary as to dispel any duty of self-protection" by Plaintiffs. The arbitrators clearly emphasized the relationship between Plaintiffs and [the broker], including his statements that the investors did not need to read the investment documents and, if they did read the investment documents, were free to ignore their contents as mere legalese.[73]

Therefore, it appears that the district court in *Brezden* recognized that *Carr* "did not go so far as to hold that all alleged oral modifications of the written disclosure are barred as a matter of law, especially in cases where alleged misrepresentations can be proven with other evidence."[74] As a result, *Carr* can be read to imply that the existence of a fiduciary relationship or a long standing relationship with the broker will provide an investor with evidence to succeed in a 10b-5 claim despite the receipt of a prospectus that contradicts oral representations. *Carr* also implies that the mere receipt and possession of a prospectus that contradicts oral statements does not *per se* bar an investor's claim for recovery under 10b-5.

This notion is supported by *Zobrist*[75] in which the apparent absence of a fiduciary relationship, the investors' high level of sophistication,[76] and the lack of evidence of any long standing business or personal relationship tipped the scale in favor of the defendants. In fact, none of the relevant factors weighed in favor of the investors; however, the *Zobrist* court – like *Carr* – carefully limited its holding, stating:

> Of course, we do not imply that the defendants can disclaim responsibility for their misrepresentations simply by disclosing the risks in the memorandum and therein warning investors not to rely on representations not contained within the memorandum.
>
> . . . .
>
> . . . We do not say that such reliance might not be justified under *different factual circumstances*.[77]

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73. *Id*. at *10-11 (internal citations omitted).

74. *See* Baghdady v. Robbins Futures, Inc., 1999 U.S. Dist. LEXIS 3394, at *15 (N.D. Ill. Mar. 11, 1999).

75. 708 F.2d 1511 (10th Cir. 1983).

76. The investor in *Zobrist* was a sophisticated businessman with prior investing experience apparently involving the specific investment at issue. In contrast, the *Brezden* claimants, while sophisticated in general business affairs (i.e., doctors, businessmen and businesswomen), had no prior experience with options trading (i.e., hedge funds).

77. *Zobrist*, 708 F.2d at 1518-19 (emphasis added).

A year after *Zobrist*, the Tenth Circuit in *Wegerer v. First Commodity Corp. of Boston*[78] faced a different factual circumstance than in *Zobrist*. In *Wegerer*, the court appeared to limit its prior holding in *Zobrist* to impute knowledge of information contained in a prospectus to only *sophisticated* investors.[79] The court also noted that the investors were told not to read the prospectus.[80] Specifically – in distinguishing *Zobrist* – the *Wegerer* court stated:

> *Zobrist* involved an action brought by purchasers of stock against the sellers to recover for fraud. In *Zobrist* we held that the warnings and statements contained in a private placement memorandum could be imputed to a sophisticated investor even though he had not read them and that the investor could not justifiably rely on misrepresentations where the falsity of the misrepresentations is palpable. Such is not the case at hand.
>
> Neither of the Wegerers [investors] were sophisticated investors. *Furthermore, it is uncontested that the Wegerers were told not to read the materials sent to them; that Jones told the Wegerers the materials were sent by FCCB merely to comply with a legal requirement*; that the Wegerers were lied to repeatedly; and that the Wegerers were "badgered" by numerous telephone calls and pressured into investing.[81]

Moreover, in *Luksch v. Latham*,[82] investors brought an action against defendant investment advisor for a variety of claims, including federal securities fraud under Rule 10b-5.[83] The issue before the District Court for the Northern District of California was whether – as a matter of law – knowledge of the information contained in offering memoranda must be

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78. 744 F.2d 719 (10th Cir. 1984).

79. *Id.* at 723 (*Wegerer* distinguished *Zobrist* on the basis that *Zobrist* involved a sophisticated investor. The Tenth Circuit refused to impose the same duty on the *Wegerers*, who were not sophisticated investors) (emphasis added); *see also* Luksch v. Latham*,* 675 F. Supp. 1198, 1203 n.7 (N.D. Cal. 1987); Kelly v. Primeline Advisory, 889 P.2d 130, 138 (Kan. 1995) (distinguishing *Zobrist* and refusing to impute knowledge of the contents of a prospectus upon investors for purposes of running the statute of limitations).

80. *Wegerer*, 744 F.2d at 723.

81. *Id.* at 723 (emphasis added).

82. Luksch v. Latham*,* 675 F. Supp. 1198 (N.D. Cal. 1987).

83. *Id*. at 1999 (Although *Luksch* did not involve a 10b-5 claim, the court considered the *Zobrist* factors in determining whether to charge the investors with constructive knowledge for the purposes of commencing the running of the statute of limitations).

imputed to investors upon their receipt of such memoranda, for the purpose of determining when the investors were on constructive notice so as to start the running of the statute of limitations.[84] The district court denied the defendant's motion for summary judgment, holding that "the mere receipt of a prospectus containing information that contradicts material representations made orally to investors, standing alone, does not put such investors on constructive notice of section 10(b) and rule 10b-5 claims as a matter of law."[85]

The *Luksch* court also noted the force of Judge Holloway's dissent in *Zobrist*.[86] In arguing that "the federal policy of deterring intentional misconduct in securities dealings outweighs the policy of deterring negligent behavior by investors,"[87] Judge Holloway explained that:

> The majority's resolution of this issue defeats the main purpose of the securities law to protect from fraud and misrepresentation, unsoundly striking the balance in favor of the wrongdoers by penalizing a plaintiff for his neglect or recklessness in not discovering the defendants' intentional wrongs.
>
> . . . .
>
> . . . The defendants are instead exonerated by a theory of constructive knowledge imputed to the plaintiff of the defendants' exculpatory boilerplate. Fashioning such a rule favoring those found guilty of knowing misconduct frustrates the important policy of the securities law and the [10b-5] Rule.[88]

More importantly, Judge Holloway quoted an excerpt from the plaintiff investor's testimony that revealed the broker's misleading statements:

> I asked him, I said, "Am I supposed to read this?" And he said, "well, yes, you should." I said, "That is an all-night reading and I don't think I have the time or expertise." I said, "Tell me what I really ought to know about it." He said, "Well, I have really told you in the projections."
>
> Q. What about risks? Did he point out that document discusses risks involved in this venture?
>
> A. No, he didn't point that out.[89]

Judge Holloway went on to explain that "the projections referred to were

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84. *Id*. at 1198-99.
85. *Id.* at 1204.
86. *Id*. at 1203 n.7.
87. Zobrist v. Coal-X Inc., 708 F.2d 1511, 1522 (Holloway, J., dissenting).
88. *Id.* at 1520.
89. *Id.* at 1522-23.

two or three pages that painted a 'rosy picture' of the tax advantages and return that the defendants told [the investor] he could expect to receive from his investment.[90] As such, he concluded that "[the broker] made only the slightest effort to encourage [the investor] to read the prospectus."[91]

Furthermore, when courts determine that there is sufficient evidence to raise a genuine issue of material fact when considering the relevant *Zobrist* factors, courts have not – as a matter of law – barred an investor's 10b-5 claim based on lack of justifiable reliance.[92] For example, the Fourth Circuit, in *Myers v. Finkle*,[93] reviewed a case in which plaintiff investors brought claims against defendant accounting firm alleging securities fraud under Rule 10b-5 and companion state claims for fraud.[94] The United States District Court for the Eastern District of Virginia granted summary judgment in favor of defendant accounting firm.[95] On appeal, the Fourth Circuit reversed the district court's decision.[96] The Fourth Circuit held that summary judgment was inappropriate since the evidence raised material issues of fact regarding the investor's allegations.[97] In particular, the court stated:

> The evidence is also contradictory regarding the Myers' [investors] access to relevant information. The Myers allege that the subscription documents were sent to them for their signature in blank immediately prior to tax deadlines, thus precluding careful consideration of the information they contained. They additionally claim that they did not receive private placement memoranda for the offerings until several months after they signed the subscription documents and invested in the limited partnerships. [The broker] contends that the memoranda and other offering materials were provided to the [investors] prior to each investment and that financial projections were reviewed with the [investors] or their representative. While we express no opinion as to how these disputed factual issues will ultimately be resolved, *it would be improper to attribute knowledge of the memoranda to them prior to a determination of whether they had meaningful access to the documents*.[98]

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90. *Id*. at 1522.
91. *Id*.
92. *See* Myers v. Finkle, 950 F.2d 165, 168 (4th Cir. 1991).
93. 950 F.2d 165.
94. *Id.* at 166.
95. *Id*.
96. *Id.*
97. *Id.*
98. *Id*. at 168 (emphasis added).

Likewise, in *Brown v. Earthboard Sports USA, Inc.*,[99] an investor brought claims against a financial advisor and financial company alleging securities fraud under Rule 10b-5 of the Securities Exchange Act of 1934.[100] The United States District Court for the Eastern District of Kentucky granted summary judgment in favor of defendants.[101] On appeal, the Sixth Circuit reversed and remanded as to the claims against the advisor.[102] Specifically, in weighing the *Zobrist* factors, the court concluded that the investor did not act unreasonably – as a matter of law – in relying on the broker's misrepresentations.[103] The court held that the investor had introduced sufficient evidence to raise a genuine issue of material fact of reasonable reliance to withstand summary judgment.[104] Therefore, the court left the final determination of reliance to the trier of fact.[105]

Similarly, in *Bruschi v. Brown*,[106] plaintiffs appealed the United States District Court for the Southern District of Florida's decision granting defendant summary judgment with regard to plaintiffs' 10b-5 claims.[107] On appeal, the Eleventh Circuit reversed, holding that the investor's reliance was not unjustified as a matter of law.[108] In particular, the Eleventh Circuit explained that it had " . . . never held that, regardless of the circumstances, an investor is always precluded from recovering under Rule 10b-5 if the misrepresentations upon which the investor relied were oral and conflict in some way with contemporaneous written representations available to the investor."[109] The court further stated that:

> It may be argued that the most prudent course for [the investor] to have taken would have been to read the disclosure documents before deciding whether to invest in [the security]. Under the circumstances, however, her failure to do so -- and thereby discover the inconsistencies between the alleged oral misrepresentations and the written representations -- does not make her reliance unjustified as a matter of law.[110]

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99. 481 F.3d 901 (6th Cir. 2007).
100. *Id*. at 905.
101. *Id*.
102. *Id*.
103. *Id*. at 921.
104. *Id.*
105. *Id.*
106. 876 F.2d 1526 (11th Cir. 1989).
107. *Id.* at 1527.
108. *Id*. at 1529.
109. *Id*.
110. *Id*.

In specifically weighing the *Zobrist* factors, the court stated:

> [The investor] was unsophisticated and inexperienced in financial matters; [The broker] was her investment advisor and was more knowledgeable as to the economic and tax risks of the investment; as [the investor's] offeree representative [the broker] undertook a fiduciary obligation to act in [the investors] best interests, [the investor] *did not read the disclosure documents because [the broker] advised her not to do so*; [the broker knew the misrepresentations were false; and [the broker] initiated the transaction. When all factors are considered, it cannot be held as a matter of law that [the investor's] reliance on the alleged oral misrepresentations was not justified.[111]

Accordingly, although no one factor from *Zobrist* is determinative on whether an investor's reliance is justifiable, it appears that the presence or absence of some type of fiduciary relationship, whether it be imposed by law or as a matter of fact based on a long standing relationship of trust and confidence, as well as the lack of sophistication of the investors in understanding the particular product recommended, are the key factors in the balancing test in cases involving 10b-5 claims.

III. THE PROSPECTUS DEFENSE SHOULD NOT APPLY TO BREACH OF FIDUCIARY CLAIMS

The prospectus defense should not apply to breach of fiduciary claims since a breach of fiduciary duty cause of action does not require reliance as an element. The elements of a cause of action for breach of fiduciary duty are: (1) the existence of a fiduciary duty; (2) the breach of the fiduciary duty; and (3) damage proximately caused by the breach.[112] In discussing a fiduciary obligation, one commentator has explained:

> This missing element of reliance is perhaps one of the more interesting and often misunderstood aspects of the fiduciary obligation. Although many cases discuss the question of whether a borrower actually relied on the lender, and, if so, whether such reliance was reasonable under the circumstances, the *fiduciary*

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111. *Id.* at 1530 (internal citations omitted) (emphasis added).

112. Stanley v. Richmond, 41 Cal. Rptr. 2d 768, 776 (Ct. App. 1995); *see also* Brown v. Brewer, 2009 U.S. Dist. LEXIS 47535, at *7-8 (C.D. Cal. May. 29, 2009); Malone v. Brincat, 722 A.2d 5, 12 (Del. 1993) (stating that causation is not an element of an action for breach of fiduciary duty of disclosure).

> *relation does not require reliance, reasonable or otherwise.* One scholar expressed this point quite clearly when he wrote, "*the law entitles the entrustor to rely on the fiduciary's trustworthiness. The entrustor is therefore not required to show that he actually relied on the fiduciary* and the fiduciary has the burden of justifying self-dealing transactions."[113]

IV. THE PROSPECTUS DEFENSE SHOULD NOT APPLY TO SECTION 12(a)(2) OF THE SECURITIES ACT OF 1933

The prospectus defense should always be defeated as a matter of law in section 12(a)(2) cases because section 12(a)(2) does not require reliance as an element. It is well settled that 12(a)(2) imposes liability without regard as to whether an investor relied on the misrepresentation or omission.[114] Specifically, section 12(a)(2) of the Securities Act of 1933 imposes civil liability on:

> [a]ny person who . . . offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a *prospectus or oral communication*, which includes an untrue statement of a material fact or omits to make the statements, in the light of the circumstances, under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . . .[115]

Thus, to prevail under section 12(a)(2), a plaintiff must demonstrate (1) an offer or sale of a security, (2) by means of a prospectus or oral communication, (3) that includes an untrue statement of material fact or omits to state a material fact that is necessary to make the statement not misleading.[116]

Since reliance is not an element of a section 12(a)(2) cause of action,[117]

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113. Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719, 731 (1994) (citing Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 824-25 (1983)) (emphasis added).

114. Sanders v. John Nuveen & Co., 619 F.2d 1222, 1225 (7th Cir. 1980).

115. 15 U.S.C. § 77l(a)(2) (2009) (emphasis added).

116. Wright v. Nat'l Warranty Co., 953 F.2d 256, 262 n.3 (6th Cir. 1992).

117. *See*, *e.g.*, Metromedia Co. v. Fugazy, 983 F.2d 350, 360 (2d Cir. 1992);

section 12(a)(2) clearly places a lesser burden on plaintiffs than Rule 10b-5.[118] Specifically, plaintiffs under section 12(a)(2) are not held to the same standard of care as plaintiffs under Rule 10b-5. As the Seventh Circuit explained, "section 12(a)(2) does not establish a graduated scale of duty depending upon the sophistication and access to information of the customer. A plaintiff under section 12(a)(2) is not required to prove due diligence. All that is required is ignorance of the untruth or omission."[119] Under section 12(a)(2), it is a firmly entrenched principle "that the availability elsewhere of truthful information cannot excuse untruths or misleading omissions by the seller."[120] As Professor Long, a leading commentator on blue-sky laws, explained:

> The investor has no due diligence obligation to make any investigation concerning the investment or to verify any information. The Securities Act was intended to reverse the age-old concept of caveat emptor and replace it with the concept of caveat venditor or seller beware. Therefore, the investor is not charged with information which he might have acquired or with constructive knowledge.[121]

With this in mind, federal and state courts have held that written risk disclosures do not bar investors' claims for damages based on contrary oral representations as a matter of law.[122] The Ninth Circuit, in *Casella v. Webb*,[123] held that constructive knowledge of the contents of written risk disclosures cannot bar a purchaser's recovery under section 12(a)(2).[124] In *Casella*, the investors did not read the offering memorandum which described the underlying investment as risky, and instead, relied on their broker's contrary oral representations.[125] The Ninth Circuit, in reversing the

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Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 689 (3d Cir. 1991); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 696 (5th Cir. 1971); *Wright*, 953 F.2d at 262; *Sanders*, 619 F.2d at 1229; Casella v. Webb, 883 F.2d 805, 808-09 (9th Cir. 1989); MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/American Exp., Inc., 886 F.2d 1249, 1256 (10th Cir. 1989); Currie v. Cayman Res., Corp., 835 F.2d 780, 782 (11th Cir. 1988).

118. *See supra* Part III for a discussion on Rule 10b-5.

119. *Sanders*, 619 F.2d at 1229 (internal citations omitted).

120. Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How it Compares with Rule 10b-5*, 13 HOUS. L. REV. 231, 267-68 (1976) (quoting Dale v. Rosenfeld, 229 F.2d 855, 858 (2d Cir. 1956)).

121. Joseph C. Long, 12A Blue Sky Law § 9:24.

122. *See* cases cited *supra* note 116.

123. 883 F.2d 805 (9th Cir. 1989).

124. *Id.* at 809.

125. *Id.*

district court's decision holding that the investors were presumed to know the information contained in the offering memorandum, and thus, could not rely on contrary oral statements, stated:

> Section 12(a)(2) on its face treats the state of mind of sellers and purchasers differently in this respect. Sellers are charged with constructive knowledge under section 12(a)(2), but purchasers are not. Sellers may defeat recovery only by proving they did not know and in the exercise of reasonable care could not have known of the untruth or omission; purchasers may recover unless they have actual knowledge of the untruth or omission. Sellers may be liable for misrepresentations they did not know were false if they should have known it; purchasers need only establish they did not know the statements were untrue. Constructive knowledge, which plaintiff might have acquired by exercising ordinary care, will not preclude him from recovery . . . . Contributory negligence has been rejected as a defense under section 12(a)(2).[126]

Despite the fact that section 12(a)(2) does not require investors to conduct due diligence, defendants often mistakenly cite to and rely on Rule 10b-5 cases as authority. However – as the Ninth Circuit explained – the line of demarcation between Rule 10b-5 and section 12(a)(2) claims is clear, and defendants reliance on cases construing Rule 10b-5 rather than section 12(a)(2) to avoid liability is a mistake.[127] But brokerage-firms are not the only ones who mistakenly confuse this critical difference between Rule 10b-5 and section 12(a)(2) cases. The Sixth Circuit, in *Wright v. National Warranty Co.*,[128] reversed the district court's decision granting defendants' summary judgment since the district court had incorrectly used reliance as an element.[129] In reversing the district court, the Sixth Circuit stated:

> Unlike a Rule 10b-5 claim, however, reliance on alleged misrepresentations or omissions is not an element of a section 12(a)(2) cause of action . . . section 12(a)(2), on the other hand, has no requirement of justifiable reliance on the part of a purchaser. Because of this, a purchaser's investment sophistication is immaterial to a section 12(a)(2) claim. A purchaser has no duty to investigate a seller's possible fraud and need not verify a statement's accuracy.[130]

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126. *Id.* (internal citations and quotations omitted).
127. *Id.* at n.9.
128. 953 F.2d 256 (6th Cir. 1992).
129. *Id.*
130. *Id.* at 262.

Likewise, the Eighth Circuit, in *Alton Box Board Co. v. Goldman*, *Sachs & Co.*,[131] explained that "the district court's conclusion that [the plaintiff] should have been aware from the public record of the financial condition of [the company in which he invested] and therefore was barred from recovery under section 12(2) . . . clearly is not the law."[132] In adhering to this principle, the Fifth Circuit, in *Haralson v. E.F. Hutton Group*, *Inc.*,[133] also reached the same conclusion, stating:

> We do not suggest that a purchaser has any duty to find out the truth under section 12(a)(2) . . . indeed, a purchaser who is actually ignorant that a seller's representation is inaccurate or incomplete may recover even though the full truth is apparent from materials in her possession. The concept of a plaintiff's constructive knowledge has no place in section 12(a)(2) actions.[134]

V. THE PROSPECTUS DEFENSE SHOULD NOT APPLY TO STATE SECURITIES STATUTES (BLUE SKY LAWS)

In claims brought under state securities laws, the prospectus defense should almost always be defeated as a matter of law since virtually all state securities acts do not require reliance as an element. The Uniform Securities Act was drafted by the National Conference of Commissioners on Uniform State laws, and approved and recommended for enactment in all the states.[135] Section 509(b) [formerly 410(a)(2)] of the Uniform Securities Act was modeled after section 12(a)(2) of the Securities Act of 1933.[136] Therefore – since section 12(a)(2) does not require reliance as an element – the language of Section 509(b) [formerly 410(a)(2)], which provides the civil remedy for misrepresentations and omissions, does not include an element of reliance as well.[137]

The primary draftsman of section 410(a)(2)[now section 509(b)] – Professor Loss – indicated that he did not think reliance was an element of

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131. 560 F.2d 916 (8th Cir. 1977).

132. *Id*. at 919 n.3.

133. 919 F.2d 1014 (5th Cir, 1990).

134. *Id*. at 1032-33 n.10 (internal citations omitted).

135. Uniform Securities Act (2002).

136. Official Comment to § 410(a), Clause (2), Loss, Commentary on the Uniform Securities Act 146 (1976).

137. Uniform Securities Act § 509(b) (2002), Official Comment 4 (2002); *see also* Kaufman v. I-Stat Corp., 754 A.2d 1188, 1197 (N.J. 2000); Gohler v. Wood, 919 P.2d 561, 566 (Utah 1996).

recovery under the section.[138] And official comment four of section 509(b) – reaffirms this position – stating: "Unlike the current standards on implied rights of action under Rule 10b-5, neither causation nor reliance has been held to be an element of a private cause of action under the precursor to Section 509(b)."[139]

In following the Uniform Securities Act, the overwhelming majority of states have enacted their own state securities laws, commonly known as blue-sky laws. These states thus, do not require reliance as an element.[140] For example, the Fourth Circuit, in *Dunn v. Borta*,[141] construed Virginia's state securities act not to include an element of reliance.[142] In doing so, the court explained how the construction of Virginia's securities act is "consistent with the manner in which other courts have construed similar statutes modeled on section 410(a) of the Uniform Securities Act."[143]

Likewise, in construing California's Blue Sky Act (known as Corporate Securities Law section 25000),[144] California courts have consistently concluded that reliance is not an element.[145] In *Bowden v. Robinson*,[146] the

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138. *See* Official Comment to § 410(a), Clause (2), Loss, Commentary on the Uniform Securities Act 147-48 (1976) ("The 'by means of' clause . . . is not intended as a requirement that the buyer prove reliance on the untrue statement or the omission. He must show only that he did not know of it.").

139 . Uniform Securities Act § 509(b) (2002), Official Comment 4.

140. *See*, *e.g.*, Murphy v. Stargate Def. Sys., Corp., 498 F.3d 386, 392 (6th Cir. 2007) ("Under Ohio's Blue Sky Law, [r]escission is available for intentional misrepresentation without a showing of reliance . . . ."); Carothers v. Rice, 633 F.2d 7, 14 (6th Cir. 1980) (explaining that the "The [Kentucky] blue sky act does not . . . require proof of reliance upon a misrepresentation"); Alton Box Board Co. v. Goldman, Sachs & Co., 560 F.2d 916, 924 (8th Cir. 1977) (construing Missouri blue sky act in conformity with section 12(2) of the Securities Act of 1933); Mirkin v. Wasserman, 858 P.2d 568, 580 (Cal. 1993); Bradley v. Hullander, 249 S.E.2d 486, 494 (S.C. 1978) (holding that the state statute should conform with the construction of section 12(2) of the Securities Act of 1933, which "does not require plaintiffs show reliance . . . .") (citing Hill York Corp. v. American Int'l Franchises, Inc. 448 F.2d 680, 696 (5th Cir. 1971); Gohler v. Wood, 919 P.2d 561, 563 (Utah 1996); Esser Distrib. Co v. Steidl, 437 N.W.2d 884, 886-87 (Wis. 1989) (distinguishing securities fraud from common law fraud in that reliance is not required by the relevant statutory provisions).

141. 369 F.3d 421 (4th Cir. 2004).

142. *Id.* at 428.

143. *Id.*

144. *See* Cal. Corp. Code §§ 25401, 25501 (West 2006).

145. *See*, *e.g.*, Mirkin v. Wasserman, 858 P.2d 568, 580 (Cal. 1993); Bowden v. Robinson, 136 Cal. Rptr. 871, 877-78 (Ct. App. 1977).

court stated that sections 25400 and 25500: "conspicuously avoid [] the requirement of 'actual reliance.' The legislature is again expressing its intention to afford the victims of securities fraud with a remedy without the formidable task of proving common law fraud [which requires reliance]."[147]

But not every state has reached the same conclusion. Although a substantial majority of states have enacted state securities acts modeled on section 410(a) of the Uniform Securities Act – such as Virginia and California – it appears that four states require proof of reliance in securities fraud cases pursuant to their blue-sky statutes. These states include: (1) Georgia; (2) Illinois; (3) Tennessee; and (4) Washington. However, a closer look reveals the fallacy of the approaches taken by Georgia, Tennessee and Washington. Specifically, these states have not followed the original language of section 410(a)(2), which does not require reliance as an element.[148] Instead, these states have relied on Rule 10b-5 as precedent in requiring reliance as an element.[149] In doing so, it appears these states have ignored a key difference –that civil liability under Rule 10b-5 is implied whereas liability under state securities acts is express.[150] Therefore, as Professor Joseph C. Long explained:

> [T]he language of the statutes, not comparable common law fraud as in Rule 10b-5 should provide the elements necessary for recover under the statute. In fact, neither the anti-fraud provisions nor the civil liability sections in these three states have any language suggesting that reliance ought to be an element. Without statutory language supporting the imposition of a reliance requirement, reading the statutes as written, there should not be a reliance requirement. Certainly, this is the conclusion unanimously reached by the other state courts when considering the language of the unmodified Uniform Securities Act, Section 410(a)(2).[151]

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146. 136 Cal. Rptr. 871.

147. *Id*. at 877-78 (quoting Walter G. Olson, *The California Corporate Securities Law of 1968*, 9 SANTA CLARA L. REV. 75, 98 (1968)) (discussing California Corporate Securities Law procedures and requirements).

148. *See* Loss, *supra* note 137.

149. *See* Joseph C. Long, 12A Blue Sky Law § 9:117.29.

150. *See supra* Part III for a discussion on Rule 10b-5 implied civil liability.

151. *See* Long, *supra* note 148.

VI. THE INQUIRY NOTICE STANDARD FOR PURPOSES OF TRIGGERING THE STATUTE OF LIMITATIONS

Section 13 of the Securities Act of 1933 provides a clear statute of limitations for section 12(a)(2): "within one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence."[152]

The statute of limitations governing Section 10(b) and Rule 10b-5 claims, however, was not clear for many years.[153] Neither provision contained any limitations period, which left courts without guidance. The United States Supreme Court in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* stepped in and ended this uncertainty, holding that causes of action under Rule 10b-5 must be brought within one year after the discovery of the facts constituting the violation and within three years after the violation actually occurred.[154] But In 2002, Congress modified *Lampf* by enacting the Sarbanes-Oxley Act of 2002, which extended the statute of limitations for private 10b-5 claims to the earlier of two years after the discovery of the facts constituting the violation or five years after such violation.[155]

Determining the "one-year after discovery" period in section 12(a)(2) and "two-year after discovery" period is complicated because "discovery of the facts constituting the violation" is a fluid concept. The majority of courts have held that a plaintiff does not need actual knowledge of the defendant's fraud for the discovery period to begin to run.[156] A plaintiff who knows or has discovered facts which would require a reasonable person to inquire further has an affirmative duty to make a diligent inquiry to discover fraud.[157] A plaintiff "cannot avoid the statute of limitations by possessing – but failing

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152. 15 U.S.C. § 77m (2009).

153. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION, 997 (2d ed. 1988).

154. *See* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 360, 364 (1991).

155. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 804(a), 116 Stat. 745, Title VIII, (2002).

156. *See* Kennedy v. Josephthal & Co., 814 F.2d 798, 802-03 (1st Cir. 1987); Dodds v. Cigna Secs., Inc., 12 F.3d 346, 353 (2d Cir. 1993); Jensen v. Snellings, 841 F.2d 600, 607 (5th Cir. 1988); DeBruyne v. Equitable Life Assurance Soc'y, 920 F.2d 457, 466 n.18 (7th Cir. 1990).

157. *See*, *e.g.*, Phillips v. Levie, 593 F.2d 459, 462 (2d Cir. 1979); Tregenza v. Great Am. Commc'ns Co., 12 F.3d 717, 718 (7th Cir. 1993).

to read – the documents that would put her on inquiry notice."[158] Thus, inquiry notice, rather than actual knowledge, appears to be the key in determining when the limitations begin to run.[159] And inquiry notice is often acquired through 'storm warnings' that would have alerted a reasonable investor to the possibility of fraudulent statements or omissions in his securities transaction.[160]

In *Luksch v. Latham*, however, the District Court for the Northern District of California held that the mere receipt of a prospectus containing information contradicting oral representations made to investors did not put investors on constructive notice of federal securities fraud claims for determining the commencement of statute of limitations.[161] The court first distinguished the First Circuit's decision in *Kennedy v. Josephthal*,[162] since the investors in *Kennedy* "apparently had actual as opposed to merely constructive knowledge of the contents of the offering materials."[163] Next, in considering the Ninth Circuit's decisions in *Rochelle v. Marine Midland Grace Trust Co. of New York*[164] and *Briskin v. Ernst & Ernst*,[165] the *Luksch* court concluded that the determination of when the statute of limitations begins to run is normally a question of fact, reserved to the jury.[166] In particular, the *Luksch* court stated:

> [E]ven if some cases do intend to hold that mere receipt of a contradictory prospectus necessarily starts the statute of limitations running, the Court does not believe that the Ninth Circuit would or should adopt such a broad vision of

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158. *DeBruyn*e, 920 F.2d at 466; *Dodds*, 12 F.3d at 353.

159. *See Tregenza*, 12 F.3d at 718 (explaining the difference between inquiry notice and actual knowledge is that inquiry notice occurs when the victim of the alleged fraud becomes aware of facts that would have led a reasonable person to investigate whether he might have a claim, and actual knowledge is when an investor actually becomes aware in fact that he was a victim of fraud, and thus has a claim).

160. *See*, *e.g.*, Cook v. Avien, Inc., 573 F.2d 685, 693 (1st Cir. 1978); In Re Nahc, Inc. Sec. Litig., 306 F.3d 1314, 1325-26 (3d Cir. 2002); Marks v. CDW Computer Ctrs., Inc., 122 F.3d 363, 368 (7th Cir. 1997); Great Rivers Cooperative v. Farmland Indus., Inc., 120 F.3d 893, 896 (8th Cir. 1997); Sterlin v. Biomune Sys., 154 F.3d 1191, 1201 (10th Cir. 1998).

161. Luksch v. Latham, 675 F. Supp. 1198, 1201 (N.D. Cal. 1987).

162. Kennedy v. Josephthal & Co., 814 F.2d 798, 802-03 (1st Cir. 1987) (holding that plaintiff's section 12(a)(2) claims were time barred since plaintiffs were on inquiry notice where oral representations were contradicted by the prospectus).

163. *Luksch*, 675 F. Supp. at 1201.

164. 535 F.2d 523 (9th Cir. 1976).

165. 589 F.2d 1363 (9th Cir. 1978).

166. *Luksch*, 675 F. Supp. at 1203.

> constructive notice. For example, in *Rochelle v. Marine Midland Grace Trust Co. of New York*, the Ninth Circuit refused to impute knowledge of proxy materials filed with the Securities and Exchange Commission ("SEC") to a company holding debentures, even though it was a sophisticated investor. In declining to do so, the *Rochelle* court explicitly invoked the fundamental policy considerations underlying the securities laws:
>
> We are mindful that the overriding purpose of Section 10(b) and Rule 10b-5 was to protect the purity of the securities market and that private claims for relief thereunder are a means to that end. We would impair the larger purpose if we were to expand the concept of constructive notice to defeat such claims.[167]

The *Luksch* court further stated:

> The Ninth Circuit generally views the question of when a reasonably diligent investor should have discovered a claim as one appropriate for the fact finder to determine after trial rather than on for a judge to decide as a matter of law on summary judgment. Thus, in *Briskin v. Ernst & Ernst*, the Ninth Circuit rejected imputation of knowledge of an SEC registration statement to plaintiffs who denied knowledge of the filing. Further, the court held that plaintiffs were not necessarily put on constructive notice as a matter of law by prospectuses and financial documents *even after reading them*. The court went on to find that:
>
>> Once again, the definition of investor reasonableness where calls for a review of the documents in question by a trier of fact in light of all the evidence. A trial judge should not assign conclusive legal effect to such documents at the summary judgment stage when there can be a genuine difference of opinion as to their impact on a reasonable person.[168]

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167. *Id.* at 1202 *(*quoting *Rochelle* in part*,* 535 F.2d at 532*)* (internal citations omitted).

168. *Id.* at 1201-02 (quoting *Briskin* in part, 589 F.2d at 1368) (internal citations omitted) (emphasis added).

The Supreme Court of Kansas has also reached the same conclusion. In *Kelly v. Primeline Advisory*,[169] the court refused to impute knowledge on investors – as a matter of law – for purposes of running the statute of limitations.[170] The Supreme Court reversed the district court's decision granting defendant's summary judgment on the grounds that the facts necessary to determine when appellants reasonably discovered the claim could not be decided as a matter of law for purposes of running the statute of limitations.[171] Specifically, the court stated:

> [T]he Kellys [investors] received prospectuses and other offering and subscription materials near the time of purchase of each investment. For most or all of the investments at issue, the prospectuses and offering documents contained provisions which explicitly warned of the risks of the investment. When purchasing each investment, the Kellys signed forms showing that they had read financial documents concerning the investment. The Kellys admit that they generally did not read the prospectuses, and if they did look at them, they did not go through them carefully and did not fully understand them.
>
> According to Primeline [defendants], the Kellys had a duty to read the information provided to them with respect to each investment. By certifying that they had read such information, Primeline contends, all of the information (i.e., descriptions, limitations, and warnings) they received should be imputed to them; in doing so, the Kellys must be deemed as a matter of law to have known that Baxter [their broker], as they claim, was misrepresenting or omitting material facts about each investment. Since the Kellys had all of the information for each investment in their possession more than three years before filing suit, Primeline asserts the Kellys' claims are time barred even if a discovery rule applies.[172]

In support of its argument, the defendants cited *Zobrist*[173] and *Kennedy*[174] for the proposition that the investors claims were time barred. In rejecting the defendants' argument, the court distinguished *Zobrist* and *Kennedy*, stating:

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169. 889 P.2d 130 (Kan. 1995).
170. *Id.* at 132.
171. *Id.*
172. *Kelly*, 889 P.2d at 138.
173. Zobrist v. Coal-X Inc., 708 F.2d 1511 (10th Cir. 1983).
174. *Kennedy*, 814 F.2d 798.

> As investors, the Kellys do not have the same level of sophistication as the plaintiffs in *Kennedy* and *Zobrist*. The Kellys' relationship with [their broker] was not long-term, but encompassed only the few years in which the Kellys gradually invested the money that Mr. Kelly had received upon retirement. The Kellys' situation is more like that in *Wegerer v. First Commodity Corp. of Boston*. *Wegerer* distinguished *Zobrist* on the basis that *Zobrist* involved a "sophisticated investor." The Tenth Circuit refused to impose the same duty on the *Wegerers*, who were not sophisticated investors.[175]

VII. CONCLUSION

There is no credible argument that the prospectus defense applies in cases alleging violations of section 12(a)(2) of the Securities Act of 1933, state securities acts (blue-sky laws), and breach of fiduciary duty cases. Cases alleging violations of Rule 10b-5 and related state common law fraud should not permit the prospectus defense to bar recovery – as a matter of law – in the common situation when a broker tells a client who is unsophisticated in the security recommended, and who has a relationship of trust and confidence that he or she need not read the prospectus, because the broker has or that the prospectus contains only "legalese." Otherwise, brokers would have a safe harbor for avoiding liability in cases when they make oral misrepresentations as long as the client received a stack of written disclosure documents. In fact, the regulators have taken this position in holding that it is not enough for brokers to deliver a prospectus to clients. Rather, brokers must provide a balanced and complete explanation of the risks of any recommended investment to their clients.

175. *Kelly*, 889 P.2d at 138 (internal citations omitted).

DEATH BY SUIT-ABILITY?

Frederick Rosenberg[1]

OVERVIEW

There's an old story about a country boy who traveled to the big city to buy his first suit to wear at his wedding. As fate would have it, he wandered into a men's store in a somewhat depressed area of town. The salesman, seeing an opportunity to move some dead inventory, measured the farmboy before handing him a garment to try on. "I've got just the thing for you," he said, handing the country boy a suit.

When the country boy complained that the right sleeve was way too short, the salesman explained that the sleeve was proper length and that all he needed to do was adjust his posture by lowering his left shoulder. Doing so caused the left sleeve to extend way beyond the boy's fingertips. When he again complained, the salesman insisted that the problem was with his posture and advised him to crook and extend his left elbow. With his right shoulder down and his left arm bent, a huge bulge popped up over the collar. Once again, the salesman attributed the improper fit to a posture problem and advised the boy to bend at the waist and twist a bit to his right. "Perfect!" the Salesman said.

The country boy paid for the suit and exited the store in his new duds, heading for the church, when he came across a young mother with her child. Upon seeing the young man the child turned to her mother and said, "Oh mama, look at that poor crippled man!" Whereupon the mother replied, "I see darling, but look how nicely his suit fits!"[2]

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1. Frederick Rosenberg obtained his JD from George Washington University in 1971 with an emphasis on business planning. He founded an NASD member firm in 1981 in Washington DC and was a Series 24 principal and Series 4 registered options principal. Today he has over 30 years business and legal experience as claimant's counsel, chief financial officer, private equity underwriter, foreclosed commercial real estate asset manager, and bank risk auditor. He has qualified as an expert in federal and state courts and in NASD arbitrations, has written chapters for PLI's arbitration course books and articles for the Piaba Bar Journal, and has been a speaker at the Piaba Annual Meeting and a faculty member of the Practicing Law Institute program on securities arbitration.

2. *Two years later*: In an arbitration brought by the country boy, the salesman argued 1) that his men's shop had four full-length mirrors and if the Claimant were really dissatisfied he surely did not complain, 2) that people buy clothes that don't fit

AN *UNEDUCATED* CONSUMER IS OUR BEST CUSTOMER.[3]

The securities analogy is palpable. Instead of tailoring the portfolio to the customer, too often it is the customer who is tailored to the portfolio, inveigled by advisers into strategies and investments that often are incapable of achieving objectives without extreme short-term risk. Virtually every recommendation, good or bad, is pitched and sold as a risk-appropriate strategy to achieve a customer's objective; rarely are they accidental. To the contrary, most disastrous recommendations are intentional, often based upon market-rationalized beliefs that equities and equity products can be configured to achieve every "objective" for every investor when in fact such customers should be advised that if the suit doesn't fit, don't buy it.

LEARNED PROFESSION, NOT!

The Department of Labor defines the term *Learned Professional*[4] as follows:

> To qualify for the learned professional exemption, an employee's primary duty must be the performance of work requiring advanced knowledge in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction.

This *primary duty test* includes three elements:

1. The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.
2. The advanced knowledge must be in a field of science or learning; and
3. The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.

Despite the wide spread industry hyperbole claiming professional status essentially for salesmen who've mastered relatively simple concepts of selling retail investment products to the public and who've passed the Series

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all the time, only to suffer buyer's remorse, 3) that the suit actually fit so long as the Claimant would contort himself to wear it, something he agreed to do during the fitting, and 4) the Claimant actually appears in a photograph at a movie theater showing "The Hunchback of Notre Dame" and admits to having a full length poster of Charles Laughton in his bedroom. The Panel dismissed the claim.

3. See *Syms*, A play on the advertising slogan of Syms, a well-known New York metropolitan clothes store, "An Educated Consumer is our Best Customer.

4. 29 CFR 541.301.

7 or Series 65 exams, *Registered Representative and RIA are not Learned Professions.* Neither is a Certified Financial Planning certificate the equivalent of an MBA or Chartered Financial Analyst designation.

THE SALES ENVIRONMENT

Financial advisers and brokerage firms do not make their money by buying, holding, or trading stocks for their own account as they advise their customers to do. They make their money by getting their customers to buy, hold or trade securities and then charging fees or commissions. Often, brokers promise returns that exceed even the growth rates and profitability of their own firms, ironically suggesting that the brokerage firm would be better off closing its sales offices and following its own recommendations.

Registered Representatives are salesmen specifically hired and trained to sell commission or fee-based products and services. They work in sales offices and survive if their gross commissions rank at or above a defined threshold. They are screened for their social skills, selling skills, access to clients, and perhaps their score on the [sic]"Greed Index", not by the cogency of their MBA dissertations, and certainly not by the performance of their recommendations.

Furthermore, the retail brokerage office is a high stress, highly competitive, income-driven environment. Higher gross commissions result in higher payout, a better desk location, an individual office, a more impressive title, an occasional trip, award or promotion and possibly an override. Every month each representative is ranked among peers by several sales metrics and those at the bottom are likely out the door.

Ask any branch manager about an individual broker and [s]he'll discuss the rep's gross commissions, office rankings, product breakdown (options, mutual funds, equities etc.), and even social skills. But, ask the branch manager how a certain representative's clients are faring, or better still, ask the branch manager to rank representatives by the market performance of their recommendations and you'll realize that firms maintain no metrics to determine the answer. Instead you'll often get guesstimates or market-related answers such as "the customers must be happy because no one's complained," or "the rep does a significant gross."

RATIFICATION OF ABUSE

Based upon recent awards, one might conclude there's a safe-harbor in arbitration for abuses committed against smart, experienced, or successful customers. If the broker has erred however, it should matter not a whit whether the customer is affluent or destitute, brilliant or half-witted, intuitive or dense, or even whether the customer agreed in good faith to the proposed strategy.

Furthermore, a customer cannot consent to fraud, and nothing that a customer does, is, signs, or agrees to can exonerate or ratify securities abuse. Neither can customers be held to the standards and experience of the supervisory people mandated to oversee their account and adviser. Agreeing to an adviser's recommendation does not presume contributory negligence, nor does it exonerate conduct that is actionable. Still, you'd be hard-pressed to conclude as much from arbitrator awards that deny recovery to claimants 55% of the time.

Many of my colleagues treat an unsuitable portfolio as a cause instead of a consequence of action. But, conflating unsuitability with negligence focuses attention only on what is self-evident -- the losses -- yet fails to explain to panels why recovery is justified. Inevitably the customer endures a withering cross-examination berating his spending habits and failures while declaiming his complicity in disaster simply for following the advice of his adviser.

Sadly, despite the fact that volatility is predictable and quantifiable, arbitration panels have often proven loath to hold brokers responsible for losses attributable to the "unpredictable" direction of the markets. As they say, "It ain't the insurance business."

Arbitration panels typically rule against claimants when claimant's counsel ignores causality to harangue about "unsuitable" portfolios. In point of fact, suitability counts only reinforce a "means test" or "sophistication threshold" as a predicate for recovery for broker misconduct. In any other area of consumer litigation, an aggrieved customer's education, sophistication, or use of the product is not a barrier to recovery. Yet in securities arbitration, the Claimant is cross-examined relentlessly as if by agreement he or she were actually responsible for the recommendations. Can we really be surprised after Claimant's counsel argues passionately that his client has been "financially contorted", that arbitration panels' response has often been the equivalent of "Yes, but look how nicely his suit fits."

WHAT'S THE RISK?

Every time I board an airplane, I take a risk; it's the same when I cross the street. In San Francisco there's a risk of an earthquake. There's a risk of death even when having a tooth filled under nitrous. Still, I'm willing to cross the street to catch a cab to the airport and fly round trip to San Francisco to get a root canal from my brother-in-law without a bit of concern for the collective risks. Succinctly stated, it is not the possibility but the probability of disaster that controls my decisions.

Customers hire full service brokers, planners, or advisers to reduce the probability not the possibility of disaster. Most aggrieved customers, however, are simply ill-equipped to disagree with adviser enthusiasm for equities and long-term growth. Unfortunately, most customers rarely understand their adviser's limitations in controlling risk. They do not understand rebalancing, or the impact of their adviser's stay-the-course strategy in periods of high volatility, or the corrosive impact of fees and costs over the long-term.

Importantly, most investors have little or no understanding of conflicts of interest that in any other learned profession would be unethical without complete disclosure. They do not understand the conflicts of interest and biases that motivate advisers to commit excessive dollars to "long-term growth" strategies utilizing high volatility equities and equity funds, and they do not understand their need for the advice of qualified counsel before signing agreements surrendering control of their life savings to a commission or fee driven adviser. As with any product, small font disclaimers are obscured by boldface promises!

Many advisers erroneously conflate money management with financial planning, but financial planning and money management are not synonymous. "Money management" is a recognized skill-set entirely different from financial planning. The CFP Board of Standards clearly distinguishes planners from "money managers" who actively manage portfolios on a *discretionary* basis[5]. While a financial plan may need revision once every 3 to 5 years, active management requires hands-on attention

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5. The CFP Board of Standards defines a Money Manager : "Money managers typically design a portfolio for clients (or work with a design developed by a financial planner) comprising individual securities, bonds, real estate or other financial assets and investments, *and manage the portfolio on a discretionary basis, usually for a fee that is a small percentage of the value of the assets under management*...".

every day the market is open.

In general, financial advisers fall into four broad and occasionally overlapping categories: 1) registered representative, 2) financial planner, 3) money manager, and 4) registered investment adviser (RIA).

Money managers actively manage assets day-to-day under discretion and pursuant to well-defined strategies and objectives. Their model performance is measured against identified correlated indices. Most money managers limit their energies to managing no more than three or four investment portfolios. Money managers generally have limited contact with retail customers except to explain their investment strategies and track record. Most rely on adviser referrals and fee splitting to bring money into their investment control.

Maintaining recommended portfolio allocations is the minimum expected from a money manager. Portfolio allocations inevitably shift from original recommendations and the manager owes a duty either to correct the imbalance or communicate to the client the reasons why the imbalance is now consistent with the original investment objectives.

Financial planners design portfolios based upon a client's financial profile, and review and report on the portfolio at periodic intervals. Financial planners rarely if ever take discretion. With dozens if not hundreds of clients they often have little time or ability to respond to daily market volatility or portfolio allocation shifts on a client-by-client basis. Financial planning, including the sending of regular statements, conducting periodic reviews, and adviser availability to answer customer questions in itself does not rise to the level of management, which is precisely why it is called financial planning and not portfolio management. In fact, apart from periodically producing a financial plan, a financial planner's responsibilities are virtually identical to those of ordinary stock brokers who aggressively disclaim managerial responsibility.

Registered representatives execute trades and may recommend securities approved by the firm when asked, but have little affirmative obligation to advise or manage at all.

Registered Investment Advisers (RIA) usually specialize either in active management, or financial planning, but rarely can they do both. Registered Investment Adviser licensure authorizes asset-based fees for RIAs without requiring any supervision by a broker/dealer. The trade-off for RIAs is that they assume the fiduciary risk and take on defined legal duties to the customer well beyond the responsibilities of a simple stockbroker[6].

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6. Chief Judge Benjamin Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), pertaining to a fiduciary's duty of loyalty . "Many

The principal duty owed by fiduciaries is the duty of loyalty, meaning that the interests of the client must always be put ahead of the adviser's. This duty of loyalty requires complete and full disclosure of conflicts of interest, disclosures typically lacking in cases of securities abuse. Ideally, clients want an adviser who'll be responsible for designing and actively managing individualized portfolios, but such an adviser is nearly impossible to find.

A BRIEF DIGRESSION INTO HISTORY

In the mid-1970s when I was a broker with a large wire house, not one client ever had more than ten to twenty percent of their liquid assets in the stock market. On average, less than six million shares traded daily on the New York Stock Exchange. Margin requirements were seventy percent. Affluent clients invested in bonds for safety. Most importantly, average workers and employees of large corporations were generally covered by defined benefit plans that assured a lifetime pension at retirement in addition to social security.

For better or worse, in the late 1980s through the 1990s, defined benefit plans were supplanted by defined contribution plans, like 401Ks, and suddenly people, who never before had been investors, were solely responsible for their investments and financial planning, something they were ill-equipped to understand. With limited alternatives for their money, billions of dollars flowed into the market from inexperienced investors seduced by the financial industry's love affair with and enthusiasm for technology and growth.

Despite "irrational exuberance" in the markets, Alan Greenspan's Federal Reserve dropped interest rates to historic lows further driving the market higher. Corporate consolidations left hundreds of thousands employees with lump-sum buy-outs targeted by their advisers for stock market investments, virtually the only marketplace capable of absorbing the influx of new money. Over the decade, the mutual fund industry and financial planning industry exploded.

Furthermore, executive compensation, driven by quarterly earnings and stock performance, fueled the fraudulent accounting scandals that led to the

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forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the **morals of the market place**. … Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

demise of Arthur Anderson & Co., Enron and Worldcom. Technology, which fueled the market bubble of the late 1990s, also enabled program trading, which contributed to sudden market corrections on more than one occasion. NYSE trading alone went from six million shares per day to two billion shares per day in 25 years, while 24/7 financial networks abounded on every cable or satellite system. During the late 1990s and early 2000s, market-cap weighted indexes like the S&P 500 saw their Standard Deviation increase by 140% from 15% to 21%, a rate normally considered highly aggressive, evidencing the considerable increased volatility even for clients advised to stay the course.

Finally, in the last two decades there has been a dramatic shift by corporations away from long-term, disciplined borrowing via debentures to equity financing that unburdened balance sheets from the debt and debt-covenants that hamstring public corporation during periods of stagnant or negative growth.

It is gross simplification to represent that the markets' risk in the 2000s can be measured by historical metrics. Over the last 15 years, the primary factors affecting the market prices of stocks have been driven primarily by short-term expectation, not long-term trends, as was the case through most of the last century. Furthermore, the financial industry well understands the catastrophic consequence of retail investors exiting the stock market *en mass*, leaving the institutions and mutual funds holding the bag. Consequently, investors have routinely been advised to stay the course even during periods of extreme short-term and quantifiable volatility. And without any non-marketbased alternative strategies ever being proposed or recommended, retail investors have found themselves continually channeled into long-term equities whose market value can collapse by ten to twenty percent overnight based upon missing earning targets by a penny or two.

DEATH TO SUITABILITY

Whether investments are suitable or not is more a question of opinion than fact, which is why prevailing in arbitration has been so difficult. "Suitability" is a term of art in the securities lexicon, one that most clients are unable to quantify; volatility, however, can easily be measured and quantified. Customers typically get into trouble, not because their portfolio is unsuitable, but because 1) they fundamentally misunderstand risk(volatility) and their adviser's professed ability to intervene in time to reduce the probability of substantial loss, and 2) they're often pressed to make decisions in a sales environment without the un-conflicted second opinion of

knowledgeable and independent counsel.

To paraphrase the late New York Senator, Daniel Patrick Moynahan, from a debate on the floor of the US Senate: "Advisers are indeed entitled to their own opinion but they are not entitled to their own facts". An adviser's opinion about suitability does not alter the discernable risk metrics one iota. Rather than litigate whether or not the portfolio is "suitable" as the basis of recovery, attorneys should focus their clients' claims on the sales environment and the representations, omissions, and presentation materials that induced customer agreement to the recommendations.

Most investors know instinctively that there is risk in market investments, which usually is their motivation to hire an adviser in the first place. What they do not understand is their probability of disaster, or that relying on long-term equities typically assures short-term volatility, or that the industry's "stay the course" bias against market timing effectively means there is no effective strategy to control the impact of short term market gyrations on long-term equities, gyrations that are becoming a fixture in present day stock markets.

CONCLUSION

Customers, often catastrophically, go unrepresented when signing over their assets to a fee-based or commission-compensated investment adviser, arguably one of the most important financial decisions they'll ever make. Ironically, the same clients are uniformly advised to obtain qualified counsel in every other financial dealing -from buying a house or getting a divorce to forming a business partnership or giving a loan. Rarely are customers ever advised to obtain an independent and un-conflicted second opinion on their adviser's recommendations or on the binding agreements they're asked to execute. This legal equation is simply out of balance.

The fact that an injured customer is persuaded to accept an adviser's recommendations is usually the predictable outcome of a sales presentation that ignored comprehensive risk disclosure, used half-truths or incomplete illustrations and overly simplified portfolio management. Without full disclosure there can be no customer agreement, only customer manipulation or fraud in the inducement, which brings us full circle. "A customer cannot consent to fraud, and nothing that a customer does, is, signs or agrees to can exonerate a financial adviser or ratify securities abuse."

AUCTION RATE SECURITIES[1]

Joe Prendergast[2], Craig McCann and Eddie O'Neal

Auction Rate Securities (ARS) were marketed by broker-dealers to investors, including individuals, corporations and charitable foundations as liquid, short-term, cash-equivalent investments similar to traditional commercial paper. The securities, however, were long-term floating rate bonds or preferred stock with floating rate coupons which gave them a superficial similarity to short-term investments.

ARS's liquidity and similarity to short-term investments were entirely dependent on the presence of sufficient orders to buy outstanding ARS at periodic auctions in which they were bought and sold subject to a contractual ceiling on the interest rate the issuer would have to pay. If the interest rate that would clear the market was greater than this maximum rate, the auctions "failed" and existing holders of the securities were forced to hold securities they wanted to sell and had previously thought were liquid.

If the demand for an ARS was too low to clear the market, broker dealers sponsoring the auction could place bids just below the maximum interest rate to clear the auction. The lower the public demand for an issue, the larger the quantity broker dealers had to buy to avoid a failed auction.

Participating broker dealers had better information than public investors about the creditworthiness of the ARS issuers and were the only parties with information about the broker dealers' holdings and inclination to abandon their support of the auctions. This severe asymmetry of information made public investors in ARS vulnerable to the brokerage firms' strategic behavior.

 The primary authors can be contacted at joeprendergast@slcg.com or 703-246-9382, craigmccann@slcg.com or 703-246-9381 and eddieoneal@slcg.com or (336) 655-8718. We received helpful comments from Guohua Li and Joshua Mallett.

2. Dr. Prendergast is currently a Principal at Securities Litigation and Consulting Group in Fairfax, Virginia. Prior to that, he was a Principal and Director of Mortgage Research at Smith Breeden Associates, an investment management company located in Durham, North Carolina. Dr. Prendergast received a Ph.D. in Finance from the University of Michigan Business School in 1996.

In this paper, we explain what auction rate securities were, how they evolved, how their auctions worked, and why their flaws caused them to become illiquid securities.

I. Introduction

Auction Rate Securities (ARS) were long-maturity floating rate securities issued by municipalities, closed-end mutual funds, structured finance trusts and corporations. Their coupon payments were determined within limits by supply and demand in periodic Dutch auctions held at intervals of 7, 14, 21, 28 or 35 days.[3] At each auction, buyers and sellers were constrained to pay par value for the securities but could bid on the interest rate that would be paid by the issuer until the next auction. When an auction cleared, buyers paid the par value of the bonds, and received the (auction) market clearing interest rate at the next auction if there were sufficient buyers.[4] As long as the ARS could be sold at the auctions, investors effectively held a short-term security.

ARS were marketed by broker-dealers as liquid investments, alternatives to money markets, and cash-equivalent investments, but the design of the securities exposed investors to significant liquidity risk. In particular, ARS did not have a "put" feature that granted investors an option to force the issuer to buy the bond back at par, as is the case with true short-term securities such as variable rate demand notes or tender option bonds. It was only the continued success of the periodic auctions that created the appearance that these long-term securities were short-term securities.[5]

In a successful auction, a single market clearing coupon rate was determined that equated the amount of securities participants were willing to buy to the amount of securities participants were willing to sell. If there were insufficient buyers to clear the market at any coupon rate below the "maximum rate" specified in the security's prospectus, the auction failed and the coupon was set to the maximum rate. This restriction on how high the coupon rate determined in the auction could be was economically equivalent

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3. In financial markets, Dutch auctions are also known as uniform-price or single-price auctions. In these auctions, each winning bid is filled at the lowest winning price (or highest winning yield). See Back and Zender (1993).

4. "Auction Rate Securities," California Debt and Investment Advisory Commission, August 2004.

5. Adrian D'Silva, Haley Gregg and David Marshall, "Explaining the Decline in the Auction Rate Securities Market," Chicago Fed Letter, November 2008.

to setting a floor on the price at which the bonds could trade. Moreover, the way the maximum rate was determined was often complex and opaque. Thus, many investors would not have been able to tell when market clearing coupon rates were getting close to the maximum rate and therefore when auctions were close to failing.

Prior to 2007, auction failures were infrequent. In August 2007, the market's assessment of the risk in auction rate securities increased and some auctions failed as the interest rate that would clear the auction exceeded the maximum rates issuers and underwriters agreed would be paid. In the last half of 2007, the financial condition of monoline bond insurance companies that had guaranteed subprime mortgage backed securities deteriorated. These insurers also guaranteed municipal bonds, many of which were issued in ARS form. With the capital adequacy of the monoline insurers in doubt, investors increased their assessment of credit risk in municipal ARS. In addition, as financial conditions worsened generally, investors increased the liquidity premium they required to hold all but the safest, most liquid securities. In February 2008 the auction market failed *en masse*. As a result, the majority of ARS investors were unable to liquidate their holdings when they needed cash and suffered sizeable damages.

The design of auction rate securities and the manipulated implementation of the auctions led to auction failures. The coupon rates determined in ARS auctions were limited to a maximum rate (or cap) defined in each security's prospectus. If the credit or liquidity risk of a particular ARS warranted a higher coupon rate than the maximum rate, the auction would fail. McConnell and Saretto (2008) found empirical evidence that auctions failed because of "maximum rates" that constrained the ARS coupons to be below what was required to compensate investors. Also, the broker-dealers that underwrote, distributed and remarketed ARS propped up auctions by bidding when the demand for particular ARS was too low to clear the auction at interest rates below the maximum rate allowed in the ARS's prospectus.[6] The repeated undisclosed involvement of the broker-dealers allowed auctions to clear that would have otherwise failed and gave ARS an artificial appearance of liquidity.

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6. In 2006, 15 broker-dealers settled with the SEC. The SEC found that the broker-dealers intervened in auctions to prevent auctions from failing without adequately disclosing their interventions, and that investors may have been unaware of the liquidity or credit risks associated with ARS because the broker-dealers prevented auctions from failing. See "15 Broker-Dealer Firms Settle SEC Charges Involving Violative Practices in the Auction Rate Securities Market," SEC Press Release 2006-83.

In late 2007 and early 2008, broker-dealers saw their inventories of auction rate securities increase dramatically as the brokerage firms had to buy more and more of the securities to keep the auctions from failing. When the brokerage firms ultimately withdrew their support for auctions there was a precipitous drop in liquidity for investors. If it were not for the brokerage firms' non-public and increasing intervention in the auctions, investors would have been able to observe the ARS gradually become riskier and illiquid.[7]

When auctions failed, some investors suffered significant damages. For example, investors missed valuable investment opportunities for lack of funding, paid penalties for reneging on existing agreements, or were forced to obtain financing at high interest rates. Investors experienced especially large losses on auction rate securities backed by risky Collateralized Debt Obligations (CDOs). Many of the CDOs that backed ARS were exposed to subprime mortgage backed securities. For these ARS, ARS investors still suffered losses even when auctions didn't fail.

The remainder of this paper proceeds as follows: First, the different types of ARS issuers are enumerated. Second, the auction process is described and illustrated. Third, a brief history of ARS markets is presented, and finally we explain why adverse incentives built into ARS and the auctions can easily explain the auction failures in 2007 and 2008.

II. Types of Auction Rate Securities

Auction rate securities are long-maturity floating rate securities issued in the form of bonds or preferred stock. The term "floating rate" means that the coupon rate (or dividend, in the case of preferred stock) varies over time. This is opposed to, for example, a fixed rate bond which promises a constant coupon payment over its life. What distinguished auction rate securities from other floating rate securities was how the coupon rate was determined. In most floating rate securities, coupon rates are specified as a fixed spread to or multiple of a benchmark or reference interest rate such as 1-month LIBOR[8] or a constant-maturity Treasury rate, and the price of the bond is

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7. In a Federal Reserve Board paper, Han and Li (2008) found that the withdrawal of support by broker-dealers resulted in the collapse of the ARS market and revealed the flawed design of the ARS product.

8. LIBOR (London Interbank Offered Rate) is the interest rate at which banks borrow from each other in the London interbank market. T-Bills are short-term obligations of the US Government. LIBOR rates are commonly used benchmarks

allowed to vary up or down to the extent the specified coupon rate over- or under-compensates for liquidity risk, credit risk and interest rate risk. In contrast, ARS prices were fixed at par and the spread to reference interest rates was allowed to vary subject to a cap to compensate for liquidity risk, credit risk and interest rate risk. The auction mechanism would have continued to clear the market except the coupon rates were not allowed to increase enough to compensate for increasing liquidity risk, credit risk and interest rate risk in 2007 and 2008.

The auction mechanism was used by a variety of issuers including municipalities, closed-end mutual funds, student loan trusts, asset-backed collateralized debt obligations (CDOs) and corporations. Table 1 reports the amount of ARS outstanding as of December 31, 2007 by type of issuer.[9]

Table 1
Auction Rate Securities Market Composition
(December 31, 2007)

Type		Amount Outstanding ($Billions)
Municipal Bonds		**$165**
Tax-Exempt	$146	
Taxable	$19	
Student Loans		**$85**
Tax-Exempt Student Loans	$29	
Taxable Student Loans	$56	
Investment Company Preferred Stock		**$63**
Tax-Exempt Preferred Stock (closed end fund)	$30	
Taxable Preferred Stock (closed end fund)	$33	
Corporate Preferred Stock		**$9**
Other [10]		**$8**
Total		**$330**

for fixed income securities as are Treasury yields. LIBOR swaps and futures markets are highly liquid, but the rate typically contains a small credit risk premium. T-Bills, on the other hand, are effectively riskless, but their markets are sometimes subject to technical dislocations. Thus, both have advantages and disadvantages as riskless benchmarks.

9. Cross Product Research, *Bank of America*, February 13, 2008.

10. This category includes, for example, non-student loan asset backed securities.

a) Municipal ARS

City and local governments (or their agencies) were the largest issuers of auction rate securities. Most of the ARS issued by these municipalities were exempt from federal income taxes and from income taxes levied by the state in which the bond was issued. Many municipal ARS were guaranteed by municipal bond insurance companies such as Ambac and MBIA, meaning that the insurers would advance interest and principal payments in the event of a default by the municipal issuer. Thus, in addition to the financial condition of the municipal issuer, the financial condition of the insurers could affect the credit risk of the ARS.

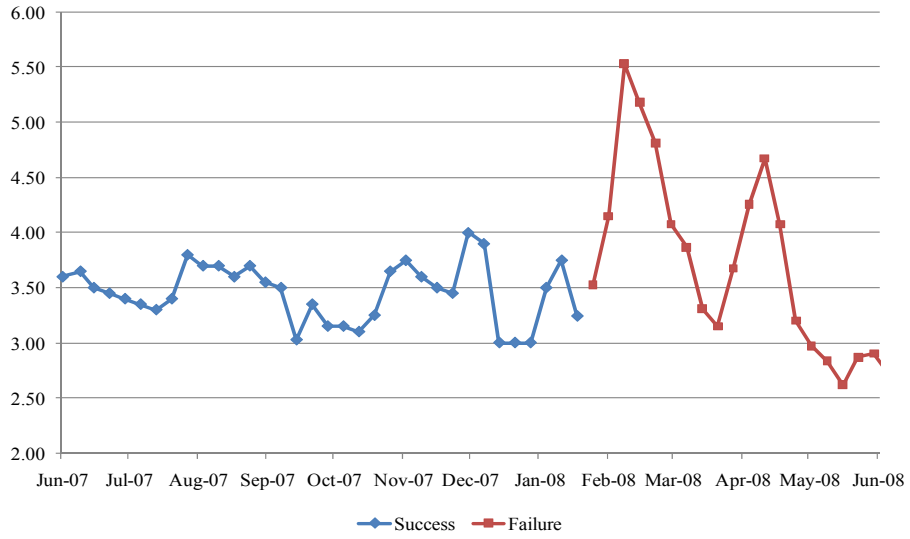
As an example of a municipal ARS, in 2002, ABAG Finance Authority for Nonprofit Corporations issued $71,500,000 of revenue bonds in the form of auction rate securities to fund the de Young Museum project in San Francisco. The auctions for these ARS were conducted at 7-day intervals. The prospectus defines the maximum rate as follows:

> *"ARS Maximum Rate" means, on any date of determination, the interest rate per annum equal to the lesser of (i) the Applicable Percentage of the higher of (A) the After-Tax Equivalent Rate on such date, and (B) the Index on such date, and (ii) 12% per annum; provided, that in no event shall the ARS Maximum Rate be more than the Maximum Lawful Rate.*
>
> *"After-Tax Equivalent Rate" means, on any date of determination, the interest rate per annum equal to the product of (i) the "AA" Composite Commercial Paper Rate on such date and (ii) 1.00 minus the Statutory Corporate Tax Rate on such date.*
>
> *"Index" means, with respect to each Series of ARS, on any date of determination, the BMA Index or, if such rate is not available, the Index so determined by the Market Agent for each Series of ARS, which shall equal the prevailing rate for bonds rated in the highest short-term rating category by Moody's and S&P that are subject to tender by the holders thereof for purchase on not more than seven (7) days notice and the interest on which is (i) variable on a weekly basis, (ii) excludable from gross income for federal income tax purposes under the Code, and (iii) not subject to an "alternative minimum tax" or similar tax under the Code, unless all tax-exempt bonds are subject to such tax.*

The ABAG Finance Authority ARS's maximum rate is determined by a complex combination of various fixed and floating rates. It would have been difficult for most investors, on any given date, to calculate the maximum rate. The broker dealers who were intervening to keep the auctions from failing knew how close the auctions were to failing and how much longer the

firms would wait before letting the auctions fail. Even the most sophisticated investors would not have this critical information. The weekly auctions for this ARS issue began to fail on February 20, 2008 and have been failing ever since. Figure 1 shows a partial history of the ARS coupons. The coupon rate continued to vary over time after the first auction failure indicating that the floating rate elements of the calculation were determining the coupon and not the fixed rate elements.

Figure 1 Failed Auction with a Maximum Rate (Minimum Price)



As municipal bond insurers' exposure to losses on subprime mortgage backed securities increased, the credit quality of the ARS declined. Many of these insurers were subsequently downgraded in 2008. Sophisticated investors concluded that the insurers would not have adequate capital to meet their subprime obligations given the risk of default in subprime mortgage backed securities, and as a result also might not be able to honor their ARS obligations. As a result of the increasing credit and liquidity risk in the ARS, investors demanded coupon rates higher than the maximum allowable rate, and there were not enough buyers for a successful auction without increasing broker-dealer intervention.

b) Closed-end funds Auction Rate Preferred Shares

Closed-end mutual funds sometimes issued a form of auction rate security called an Auction Rate Preferred Share (ARPS). Closed-end funds are a type of investment company that issues shares which trade on exchanges. Unlike open-end mutual fund units which are issued or redeemed each day by the mutual fund company, closed-end funds are closed to new capital after the initial offering. Closed-end fund share prices are determined by supply and demand and typically trade at a premium or discount to the fund's Net Asset Value (NAV). Also, in contrast to open-end funds, closed-end funds commonly borrow to invest more than the amount raised in their common shares offerings. Some closed-end funds borrowed by issuing preferred stock, some of which had been issued in auction rate form. The dividends paid on these Auction Rate Preferred Shares (ARPS) were set in auctions.

As an example, the BlackRock MuniYield Insured Fund issued $320,000,000 of Auction Rate Preferred Shares (which Blackrock called Auction Market Preferred Stock). The auctions for these ARPS were conducted at 7-day or 28-day intervals depending on the particular series. The maximum rate for these ARPSs depended on their credit rating at the time of the auction. As shown in Table 2, various credit ratings were each assigned a multiplier which was applied to the higher of the AA composite Commercial Paper Rate published by the Federal Reserve Bank of New York and a taxable equivalent rate based on the Kenny S&P 30-day High Grade Index:

Table 2
BlackRock MuniYield Insured Fund Maximum Rate Multipliers

Moody's Rating	S&P rating	Multiplier (No Notification)	Multiplier (With Notification)
Aa3 or higher	AA- or higher	1.10	1.50
A3 to A1	A- to A+	1.25	1.60
Baa3 to Baa1	BBB- to BBB+	1.50	2.50
Below Baa3	Below BBB-	2.00	2.75

If the Fund notified the Auction Agent that net capital gains or other taxable income were to be be included in the dividend, the "With Notification" multiplier was used; otherwise the "No Notification" multiplier was used.

c) Student Loan Trusts

Student Loan Asset Backed Securities (ABS) were issued by trusts that purchased and held student loans as collateral. The student loans were typically originated under the Family Federal Education Loan Program (FFELP).[11] The majority of the principal and interest of FFELP loans was insured by the U.S. Government and credit risk was minimal. The trusts often issued two types of asset backed securities: auction rate securities and floating rate securities indexed to LIBOR.

As an example, in 2004 the Missouri Higher Education Loan Authority issued $700,000,000 of Student Loan Revenue Bonds in the form of auction rate bonds. The issue consisted of tax exempt senior, taxable senior and taxable subordinate auction rate bonds. In particular, Series 2004F bonds were taxable senior auction rate bonds and had an auction period of 28 days. The auction mechanics for the 2004F bonds were opaque and would have been difficult for most investors to understand. A "maximum interest rate" was defined to be the lesser of 17% and a statutory rate. Buy orders above the maximum interest rate were disregarded by the auction agent. A "maximum auction rate" was calculated according to a complicated formula that used the 91-day Treasury bill rate and the credit rating of the bonds. The formula reads in part:

"Maximum Auction Rate" means, for any Auction, a per annum interest rate on the Auction Rate Bonds which, when taken together with the interest rate on the Auction Rate Bonds for the one-year period ending on the final day of the proposed Auction Period, would result in the average interest rate on the Auction Rate Bonds for such period either (i) not being in excess (on a per annum basis) of the average of the Ninety-One Day United States Treasury Bill Rate plus 1.20% for such one-year period (if all of the ratings assigned by the Rating Agencies to the Auction Rate Bonds are "Aa3" or "AA-" or better)…

For lower credit ratings, margins of up to 1.75% over the Treasury Bill Rate are specified. Finally, the "maximum rate" was defined as the lesser of the maximum interest rate and the maximum auction rate. If the market clearing rate was greater than the maximum rate then the coupon rate for the next period was set to the maximum rate. The difference between the market clearing rate and the maximum rate was "carried over" as an amount to be paid in the future. If there were insufficient bids to clear the market then the coupon rate for the next period was set to the maximum rate.

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11. "A Guide to Student Loan Auction Rate Securities," Citigroup, June 23, 2005.

d) Other

Some ARS are backed by Collateralized Debt Obligations (CDOs). These Credit Linked Notes (CLNs) are exposed to the same credit risk as a reference portfolio of securities. When these securities default, the principal of the CLNs is reduced. The ARS principal, in turn, is reduced by the same proportion and even if the auctions continue to clear investors can suffer capital losses. Many CDO ARS were exposed to subprime mortgage-backed securities.[12]

As an example, $175,000,000 of Camber Master Trust Series 8 Auction Rate Credit-Linked Note Certificates were issued on January 19, 2007 with an expected maturity date of March 20, 2017. The Auction Rate Certificates were collateralized by $350,000,000 notional amount of Eirles Two Limited Series 316 Floating Rate Portfolio Credit-Linked Secured Notes. The Notes, along with a basis swap agreement with Deustche Bank AG, funded interest payments due on the Auction Rate Certificates. The Notes were exposed to the risk of a credit default swap which named 125 unsecured corporate notes as reference entities. The composition of the portfolio of unsecured notes is shown in Table 3:

Table 3
Camber Master Trust Series 8
Composition of Reference Entities

Credit Default Swap Exposure by Industry	
Industrial	49%
Financial Services	16%
Banks	10%
Telecommunications	13%
Utilities	6%
Other	6%
Credit Default Swap Exposure by Credit Rating	
A and above	57%
BBB	40%
BB	3%

12. See "Recent Developments in Auction Rate Securities Litigation," *Carrington Coleman*, 18 April 2008.

When defaults occurred in the reference entities, the principal amount of the Credit Linked Notes was reduced and, in turn, the principal amount of the Auction Rate Certificates was reduced.

Several municipal bond insurance companies issued ARS through Contingent Preferred Stock (CPS) put facilities. These facilities sold ARS to investors and purchased high quality short-term assets whose maturities matched the frequency of the auctions (typically 28 days or less). The municipal bond insurance companies, however, had the right to sell (or "put") their preferred stock to the facilities. Thus, investors in the ARS issued by CPS facilities had exposure to the credit risk of the municipal bond insurance companies. The CPS ARS auctions were among the first auctions to fail in significant numbers in 2007, when investors became concerned about the financial condition of municipal bond insurer due to their large exposures to subprime mortgage-backed securities.[13]

III. Auction Description

Auctions were held at intervals of 7, 14, 21, 28 and 35 days. Based on submitted buy and sell orders, the brokerage firm responsible for administering the auction determined the coupon rate to be paid for the period from the current auction to the following auction. This broker dealer, referred to as the auction agent, followed procedures stated in the security's prospectus and also acted as a transfer agent, registrar, dividend disbursing agent and redemption agent. One or more "primary" broker-dealers entered into agreements with the auction agent for exclusive rights to participate directly in the auctions. These broker-dealers, referred to as remarketing agents, submitted buy and sell orders on behalf of themselves or their clients.

As a result of the bidding, a market clearing coupon rate was set so that 1) the total quantity that participants wanted to buy at the market clearing coupon would equal the total quantity participants wanted to sell at the market clearing coupon. The market clearing coupon was capped at a "maximum rate" by each security's prospectus and could be either a fixed rate, a floating rate or some combination of the two. For example, the maximum rate could be set at the minimum of a fixed rate like 14% p.a. or a multiple of a floating rate, say 200% of one-month LIBOR.

In some auctions, there were not enough buyers to purchase all the securities at interest rates below the maximum interest rate. In this event, the

13. "Fitch Comments on Financial Guarantors Soft Capital Facilities," *Business Wire*, August 15, 2007.

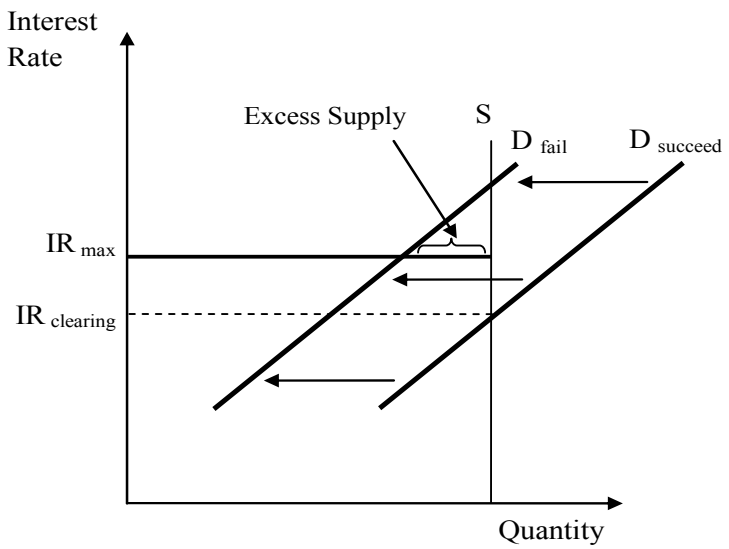
auctions "failed," no securities were exchanged, and the coupon rate for the following period was set to the maximum interest rate. Occasionally, no existing investors offered to sell their securities. In this event, the auction was declared to be an "all-hold" auction and the coupon for the next period was set to an "all-hold rate" which was defined in each security's prospectus and was often below typical market clearing coupon rates.

ARS always traded at par or face value in the auctions. If auctions didn't fail, the auction rate securities behaved like short-term securities. To see why, consider a hypothetical ARS issue for which the interval between auctions is 28 days and the coupon rate for the period until the next auction is 0.5%. Suppose an investor invests $100; after 28 days he receives a $.50 coupon, sells the security at the auction, and is returned $100 of principal. This is exactly how a short-term investment behaves - in the absence of defaults, there is no price risk at the end of the short investment period. When auctions failed, investors were not able to sell ARS at par and the securities lost their short-term character. Thereafter, until auctions resumed, the ARS behaved like long-term floating rate securities and became almost completely illiquid. These failures were likely to occur when credit risk and liquidity risk were especially high and so the market value of ARS dropped dramatically and discontinuously when auctions failed.

Despite the complex terminology sometimes used to explain auction mechanics, the basic intuition can be illustrated with simple supply and demand graphs. Approaching each auction, a current investor could decide to hold their securities unless the interest rate to be paid for the following period was too low, in which case the investor would sell. For example, an investor holding $100,000 of a $500 million XYZ ARS might instruct their agent to sell all $100,000 if the market clearing interest rate is less than 3%, and otherwise hold the $100,000 position. This instruction is equivalent to telling the agent to sell all $100,000 and buy $100,000 if the interest rate to be paid for the following period is greater than 3%. Of course, some potential buyers at an auction would not be current holders but their offers to buy various quantities depending on the market clearing interest rate could be specified the same way.

The Demand curves designated "D" in Figure 2 plot the cumulative quantity investors bid to purchase the XYZ ARS at increasing possible interest rates. The supply is fixed at $500 million in our example. If investors in total want to hold at least the entire issue at an interest rate less than the maximum rate, the auction succeeds and the interest rate for the coming interest rate period will be $IR_{clearing}$. If on the other hand, investors don't want to hold at least $500 million of the XYZ ARS at interest rates at or below the maximum interest rate, the auction fails.

Figure 2 When the demand for an issue falls (shifts to the left) so much that the market clearing interest rate exceeds the maximum allowed rate broker dealers quietly step in and buy up the excess supply or let the auction fail.



The demand and supply curves in Figure 2 are expressed in terms of quantities and interest rates. Auctions can also be described in terms of bond prices. Investors receive the principal amount plus the single coupon paid at the end of the auction period. The price of an auction rate security, like the price of a conventional zero coupon bond, is therefore the initial investment required to receive $100 at the end of the auction period. To illustrate, if the interest rate set for the coming auction period is 1% (not annualized), then an initial investment of $1,000 will result in a cash inflow of $1,010 at the end of the period. Thus the initial investment that would result in a payment of $100 at the end of the period is ($100 * $1,000/$1,010) = $99.01. Higher interest rates correspond to lower bond prices.

Auctions can succeed for a time and then fail because the market's assessment of the issuer's credit risk increases or the price that the market demands as compensation for any given level of credit risk increases. Perceived increased credit risk shifts the demand curve up and to the left. It is only the imposition of the maximum rate (or minimum price) that causes the auction to fail. As shown in Figure 2, with no constraints on the coupon

rate or, equivalently, the bond price, the same set of buy and sell orders results in a successful auction.

If the demand for an ARS is too low to clear the market, the broker dealers sponsoring the auction can place bids just below the maximum rate and the auction will clear. The lower the actual demand for an issue, the larger the quantity broker dealers must bid to avoid a failed auction. If the decline in actual demand is temporary the sponsoring broker dealers will find it profitable to support the auction since they receive underwriting and other fees and are being paid at or near the maximum rates on their ARS holdings. Participating broker dealers have much better information than public investors about the creditworthiness of the ARS issuers and how close auction-determined rates are to the maximum rates. The broker dealers are the only parties with information about their holdings and inclination to let the auctions fail. This severe asymmetry of information made public investors in ARS vulnerable to the brokerage firms' strategic behavior.

IV. Brief History of ARS

The first ARS were issued in 1984[14] and the early ARS issuers were predominantly corporations. In the early 2000s, municipalities became increasingly important issuers of ARS,[15] most of which paid coupons that were exempt from federal and state income taxes (in the state of issue). Closed-end mutual funds, CDOs and Student Loan ABS trusts also issued significant amounts of ARS.

ARS were often marketed by broker-dealers as "cash-equivalents" which became a focus of concern in the 2004 to 2007 timeframe, especially to the Financial Accounting Standards Board (FASB) and major accounting firms. Upon examining FAS 95 in 2005, Price Waterhouse Coopers concluded that "Most auction rate securities have maturities that span many years, and such securities will not qualify as cash equivalents."[16] In March 2007, FASB decided that "the notion of *cash equivalents* should not be retained in financial statement presentation."[17]

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14. Adrian D'Silva, Haley Gregg and David Marshall, "Explaining the Decline in the Auction Rate Securities Market," Chicago Fed Letter, November 2008.

15. "Auction Rate Securities," California Debt and Investment Advisory Commission, August 2004.

16. Price Waterhouse Coopers, Capital Markets Accounting Developments Advisory 2005-04, March 4, 2005.

17. FASB Board Meeting Minutes, March 27, 2007.

The trading practices of broker-dealers who sold ARS also came under close scrutiny in 2006, when 15 broker-dealers settled with the SEC over allegations that the broker-dealers did not adequately disclose to investors that they were intervening in ARS auctions during the 2003-2004 timeframe "by bidding for [the broker's] proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a 'market' rate, or to prevent all-hold auctions." The SEC found that due to the broker-dealers' actions "investors may not have been aware of the liquidity and credit risks associated with certain securities." As a result, the SEC concluded that the firms violated Section 17(a)(2) of the Securities Act of 1933 "which prohibits material misstatements and omissions in any offer or sale of securities."[18] In other words, the broker-dealers were supporting the ARS auctions without disclosing their activities, and by doing so may have been creating the false appearance that the securities were liquid (and therefore short-term investments). Moreover, although the SEC required each broker-dealer to disclose its "material and current auction practices and procedures," the broker-dealers were not required to disclose the large informational advantages and conflicts of interest inherent in their participation in the auctions.

From the inception of the ARS market in 1984 through the end of 2006, auctions occasionally failed although failures were not widespread. In mid-2007, however, ARS auctions failed in larger numbers. In August 2007, there were several failed auctions of CPS ARS, and Fitch said that it would not be surprised to see more auctions fail in the near term.[19] The CPS ARS had been issued by municipal bond insurance companies who also had large exposures to subprime mortgage-backed securities. By November 2007, auctions for approximately $6 billion of corporate ARS had failed (including the CPS put facility failures).[20]

Figure 3 illustrates graphically that signs of stress were emerging in ARS markets by as early as August 2007. The figure shows the spread between the SIFMA Auction Rate 1 Month Taxable Index[21] and two benchmarks: 1)

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18. "15 Broker-Dealer Firms Settle SEC Charges Involving Violative Practices in the Auction Rate Securities Market," SEC Press Release 2006-83.

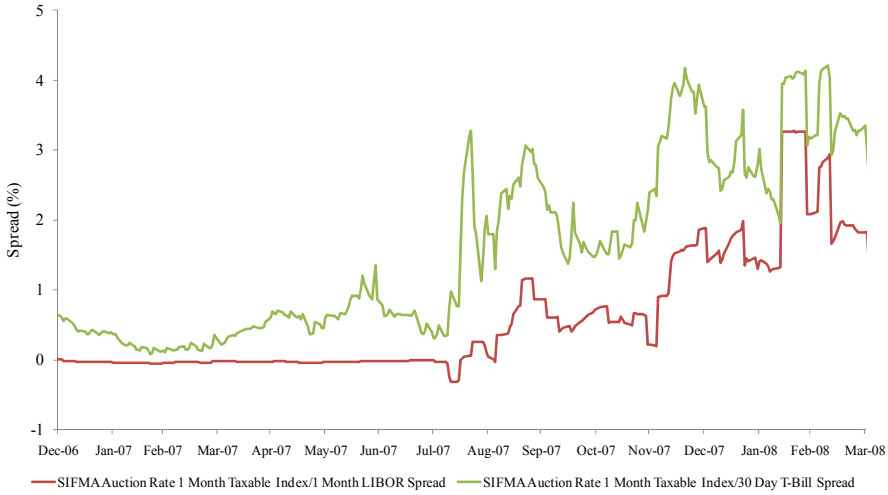
19. "Fitch Comments on Financial Guarantors Soft Capital Facilities," *Business Wire*, August 15, 2007.

20. "Rigged Bids, SEC Help Dealers as Auction Bonds Fail," *Bloomberg*, November 21, 2007.

21. The SIFMA Auction Rate 1-Month Taxable Index is an average of representative auction rates for taxable municipal ARS.

the 1 Month LIBOR Rate and the 2) 30-Day T-Bill Yield.[22] Figure 3 indicates that the risk premium for ARS increased in August 2007, at approximately the same time that the CPS ARS auctions failed. Prior to that time, the spread was stable and close to zero. The SIFMA/T-Bill spread also increased sharply in August. Both spreads increased sharply again in late November 2007.

Figure 3 History of ARS Coupon Spreads



At least as early as December 2007, broker-dealers stopped supporting some ARS auctions.[23] In mid-February 2008, broker-dealers stopped supporting many ARS auctions and auction failures increased dramatically – on many days well over half of the auctions failed. Figure 3 shows that both SIFMA/LIBOR and SIFMA/T-Bill spreads widened suddenly and dramatically in mid-February 2008, coincident with the widespread auction

22. LIBOR (London Interbank Offered Rate) is the interest rate at which banks borrow from each other in the London interbank market. T-Bills are short-term obligations of the US Government. LIBOR rates are commonly used benchmarks for fixed income securities as are Treasury yields. LIBOR swaps and futures markets are highly liquid, but the rate typically contains a small credit risk premium. T-Bills, on the other hand, are effectively riskless, but their markets are sometimes subject to technical dislocations. Thus, both have advantages and disadvantages as riskless benchmarks.

23. "Muni Update: Auction Rate Securities," Janney Fixed Income Strategy, December 2007.

failures. In response to the auction failures, secondary markets developed in which the ARS could be traded but at significant discounts to par. ARS which had previously always traded at par now sometimes could only be sold at discounts of 25% or greater.[24] These discounts reflected significant illiquidity discounts from the lower prices that would have been required to clear the auctions but could not because of price floors imposed by broker-dealers.

Many firms that were involved in the sale of ARS to investors have reached settlements with federal and state regulators. As part of the settlements, the firms agreed to redeem large amounts of ARS that they sold and some have paid substantial fines. For example, the SEC reached an agreement with Citigroup in August 2008 to redeem at par $7.5 billion of ARS that Citigroup sold to smaller investors and to make some investors whole who sold their securities at a loss in secondary markets.[25] The Financial Industry Regulatory Authority (FINRA) reached an agreement with several firms,[26] requiring the firms to repurchase $1.8 billion of ARS from individual investors (at par) and to pay $3.25 million in fines.[27]

State regulators have also been active in negotiating settlements with broker-dealers. Since the ARS market collapsed in 2008, state securities regulators have reached settlements with over a dozen firms to redeem more than $61 billion in ARS. These firms include Merrill Lynch, UBS, TD Ameritrade, Bank of America, Goldman Sachs, Deutsche Bank, JP Morgan Chase, Citigroup and Credit Suisse.[28] In October 2009, the State of Colorado filed charges against Stifel, Nicolaus and Co., alleging that the firm 1) had not provided training to its retail sales force regarding the risks associated with purchasing ARS or the nature of ARS investments, the mechanics of Dutch auctions and the possibility of auction failures, 2) failed to disclose the true nature of ARS investments to its clients, 3) did not disclose to its sales representatives the fact that broker-dealers had been propping up the ARS market and 4) systematically sold ARS securities to its retail customers as conservative, safe, liquid investments that were just like money market funds. In December 2009, Stifel reached a settlement with state regulators

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24. "The Nascent Secondary Market in Auction-Rate Securities," *Market Movers*, April 25, 2008.

25. SEC Press Release 2008-168.

26. The firms were SunTrust Investment Services, SunTrust Robinson Humphrey, Comerica Securities, First Southwest Company and Washington Mutual

27. FINRA News Release, September 18, 2008.

28. See "Wells Fargo to Repay Clients Who Held Auction Rate Securities*, Dow Jones Newswires*, 18 November 2009.

led by regulators from Colorado, Indiana, Maryland and Missouri to redeem more than $100 million in auction rate securities from its customers.[29]

Many of the firms that reached settlement agreements were primary (or "upstream") broker-dealers that issued, underwrote and remarketed the securities. Others, however, were "downstream" brokers who purchased ARS from primary broker-dealers and then marketed and sold the ARS to their clients. For example, TDS Ameritrade, a downstream broker, reached a settlement with the SEC in July of 2009.[30] Comerica, Fidelity, First Southwest, SunTrust and Washington Mutual are other examples of downstream brokers that have reached settlement agreements over their sales of ARS.[31] Finally, in July 2009, the State of New York filed fraud charges against Charles Schwab, a downstream broker, in connection with the marketing and sale of auction rate securities.

V. ARS Auctions Failed Because of Built-In Bad Incentives

The way in which auctions were structured and implemented was subject to serious flaws which, when exposed to increasing credit spreads in 2007 and 2008, resulted in widespread auction failures and extreme illiquidity of investors' ARS holdings.

a) Participation of Broker-Dealers in Auctions

The SEC alleged that broker-dealers supported auctions without proper disclosure and, as a result, may have masked the liquidity and credit risk associated with auction rate securities. Recent research has shown, however, that the implicit support of dealers for auctions also contributed directly to the collapse of auction markets in February 2008. Han and Li (2008) used data on auction results and intraday transactions to study the role of investors and broker-dealers in the municipal auction rate security market in February

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29. See "State Securities Regulators Announce Settlement with Stifel, Nicolaus & Co., Inc. in Auction Rate Securities Investigations," *NASAA News Release*, December 29, 2009.

30. See "TDS Ameritrade's Settlement Excludes RIAs," *InvestmentNews*, July 26, 2009.

31. See "The Collapse of the Auction-Rate Securities Market and Its Impact on the Securities Litigation Docket," *Securities Litigation and Regulation: Andrews Litigation Reporter*, October 21, 2008.

2008. They found that "the decision of an unexpected first-mover to withdraw auction support, led to simultaneous withdrawal of liquidity support by other dealers" and that the withdrawal of support by broker-dealers and investor panic "amplified each other and resulted in the collapse of the ARS market." They authors concluded that "As auctions dealers cracked under the pressure and let auctions fail, investors' panic was further intensified. This reveals the flawed design of the ARS product, in which dealers' support is implicit, rather than explicit."

b) Maximum Rates

ARS prospectuses specified a "maximum rate" which effectively put a floor on the price at which ARS could be traded. The maximum rate was binding when ARS investors assessed increased credit and liquidity risk in the ARS.

The impact of maximum rates on auction failures is well documented in academic literature. McConnell and Saretto (2009) performed an empirical study and found that "the likelihood of auction failure was directly related to the level of the bonds 'maximum auction rates' that cap the bond yields." The authors concluded that auctions failed because investors declined to bid for bonds when their required yield was greater than the maximum rate. McConnell and Saretto also used an empirical model to predict the hypothetical market clearing coupon rate in the absence of any rate caps. For failed auctions, these "implied" clearing coupon rates were significantly above the maximum rates. Han and Li (2008) also found that the likelihood of auction failure depended significantly on the level of the maximum rate. Thus, maximum rates caused auctions to fail that, had rates been allowed to adjust and the auctions clear, would have resulted in prices that reflected the preferences and information of all market participants.

VI. Conclusion

Auction rate securities were long-term floating rate securities that had the superficial appearance of liquid, short-term securities when investors were able to sell their ARS at par in the frequent auctions. The success of ARS auctions was illusory and investors were exposed to strategic behavior by broker dealers who had tremendous informational advantages. The nonpublic participation in the auctions by broker-dealers and then their precipitous withdrawal of that support led to catastrophic spirals. In addition, the

maximum allowed coupon rates meant that auctions would fail when investors would not be compensated for the credit and liquidity risk in the securities they were left holding.

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A SQUARE PEG IN A ROUND HOLE: WHY THE INVESTMENT COMPANY ACT IS A POOR REGULATORY FIT FOR HEDGE FUNDS

Douglas Hoffer[1]

We are in the middle of a global financial crisis. This crisis has made new financial regulation a priority for many politicians, pundits, and academics who feel greater regulation will prevent future economic meltdowns. Hedge funds are frequently mentioned as a target of new regulation. There are many reasons why hedge funds are targeted: First, hedge Funds have become a trillion dollar business, and many people think that such a big industry should not go unregulated;[2] Second, many people fear the secrecy with which they believe hedge funds operate, and these people thus believe that greater hedge fund transparency would be beneficial;[3] Third, many people distrust the wealthy investors that invest in hedge funds.[4] Regardless of why so many people would like to see greater hedge fund regulation, it seems likely that hedge funds will be more regulated in the future. The question then becomes: what kinds of additional regulation would be appropriate for hedge funds?

One commentator has recently suggested expanding the Investment Company Act to cover hedge funds.[5] This alternative should not be pursued. This article will explore the primary reasons the Investment Company Act is a poor regulatory fit for hedge funds, which are: 1) The Investment Company Act limits or prohibits many activities that make hedge funds useful; 2) The Investment Company Act is designed to protect unsophisticated investors, but hedge fund investors are sophisticated and thus

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2. Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission,* 2006 U.Ill. L.Rev. 975, 976 (2006).

3. Dale A. Oesterle, *Regulating Hedge Funds,* 1 Entrepreneurial Bus. L.J. 1, 12 (2006); see also Ben S. Bernanke, Chairman, Fed. Reserve Bd., Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006) (Calling hedge funds "opaque.").

4. Oesterle, *supra,* at 12.

5. See Mercer Bullard, *Regulating Hedge Funds Managers: The Investment Company Act as a Regulatory Screen,* 13 Stan. J.L. Bus. & Fin. 286 (2008).

do not need protection; and 3) Expanding the Investment Company Act to cover Hedge Funds will have negative consequences. To understand why the Investment Company Act is a poor regulatory fit it is important to first understand the characteristics of hedge funds.

1. The term "hedge fund" is generally used to refer to privately managed investment funds that are exempt from many securities laws.

Hedge funds do not have a universal definition. The term "hedge fund" is generally used to refer to privately managed investment funds that are exempt from many securities laws.[6] Hedge funds are generally exempt from the public offering requirements of the 1933 Securities Act, the periodic reporting requirements of the 1934 Exchange Act, and the registration requirements of the 1940 Investment Company Act.[7] Hedge funds are also not financial market players such as underwriters, market makers, or broker-dealers that are specifically regulated by other federal legislation.[8] These exemptions, which are consistent with the purposes of securities regulation, allow hedge funds to employ complex trading strategies that would otherwise be prohibited or less effective.[9] When hedge funds avoid SEC regulation it is not the result of illicit behavior, but instead is the result of being "structured in an open and above board fashion to take advantage of the exclusions that Congress has seen fit to build into the securities laws regime."[10]

The principal exemptions hedge funds use to avoid coverage under the Investment Company Act are the Section 3(c)(1) exclusion and the Section 3(c)(7) exclusion. Section 3(c)(1) of the Investment Company Act exempts from the definition of investment company any investment vehicle with 100 beneficial owners or less provided it does not make, or propose to make, any public offering of its securities.[11] Section 3(c)(7) of the Investment Company Act exempts from the definition of an investment company any investment vehicle that only sells its securities to "qualified purchasers" and does not make, or propose to make, any public offerings.[12] A qualified purchaser is

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6. Erik J. Greupner, *Hedge Funds are Down-Market: A Call for Increased Regulation?,* 40 San Diego L.Rev. 1555 (2003).
7. Oesterle, *supra* at 7.
8. *Id.* at 4.
9. *Id.* at 3.
10. Paredes, *supra,* at 976.
11. *Id.* at 694; 15 U.S.C. § 80a-3(c)(1).
12. Gibson, *supra,* at 695; 15 U.S.C. § 80a-3(c)(7).

any of the following: 1) a natural person who owns at least $5 million in investments; 2) a family owned company that owns at least $5 million in investments; 3) certain trusts; and 4) any other person that owns and invests on a discretionary basis at least $25 million in investments.[13] In addition to utilizing the exemptions in federal securities laws, hedge funds have other characteristics in common.

2. Hedge funds vary in trading strategies, but common among most hedge funds is an absolute return approach. An absolute return approach, because it seeks success in all market conditions, requires flexibility.

Hedge funds vary in trading strategies, but most hedge funds employ an absolute return approach to investing in which they seek to make money in a variety of market environments, including declining markets.[14] An absolute return approach, because it seeks success in all market conditions, requires flexibility.[15] Conversely, registered investment companies tend to favor a relative return approach which seeks to duplicate or exceed the performance of a selected asset class, securities index, or some other benchmark.[16] Accordingly, a registered investment company that loses money in a declining market may be considered successful if it beats its benchmark.[17]

A reporter for the hedge fund industry identified seven main categories of hedge funds: 1) event driven; 2) global; 3) global/macro; 4) market neutral; 5) sectors; 6) short sellers; and 7) long only.[18] Event driven strategies follow specific types of events like corporate takeovers, and invest to exploit arbitrage profit in anticipation of the event.[19] Global hedge funds emphasize investing in non-U.S. securities.[20] Global/macro hedge funds

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13. *Id.*

14. For an overview of the hedge fund industry by the SEC staff, see U.S. Securities and Exchange Comm'n, Implications of the Growth of Hedge Funds (2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter Hedge Fund Staff Report].

15. *Id.*

16. *Id.*

17. *Id.*

18. Henry Ordower, *Demystifying Hedge Funds: A Design Primer,* 7 U.C. Davis Bus. L.J. 323, 366 (2007); see also Hedge Fund Staff Report at 33-36. This is not an exhaustive list, and other commentators have described different categories.

19. *Id.*

20. *Id.*

emphasize specific risk factors such as currencies and commodities.[21] Market Neutral hedge funds use long-short and arbitrage strategies.[22] Sectors hedge funds focus on specific business sectors.[23] Short-sellers trade on predictions that securities will decrease in value.[24] Long hedge funds are similar to most mutual funds in that they invest for appreciation in value.[25] Although different categories of hedge funds pursue different investment strategies, most hedge funds utilize leverage.

Hedge funds frequently utilize leverage to take advantage of short term trading strategies.[26] Investors historically obtained leverage primarily by buying securities with borrowed money.[27] Today hedge funds obtain leverage through a variety of ways including direct financing, purchasing securities on margin, taking short positions in securities, employing collateralized borrowing through repurchase agreements, and executing derivatives transactions.[28] Hedge funds are limited in the leverage they may use by margin and collateral requirements imposed on lenders or broker-dealers, as well as the willingness of lenders or other counterparties to provide them with credit.[29]

In addition to leverage many hedge funds are also characterized by short selling, lock-ups, buying and selling illiquid securities, performance fees, and secrecy. All of these concepts will be examined later in this paper. First, it is worthwhile to discuss the usefulness of hedge funds.

3. Hedge funds play a useful role in capital markets by 1) Reducing and eliminating mispricing; 2) Providing liquidity; and 3) Providing a source of risk transfer and diversification.

Hedge funds play a useful role in capital markets. Timothy Geithner, the current United States Secretary of the Treasury, highlighted a number of positive roles hedge funds play in capital markets: 1) hedge funds play a useful arbitrage role in reducing or eliminating mispricing in financial markets; 2) hedge funds are an important source of liquidity, both in periods

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21. *Id.* at 366-67.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. Gibson, *supra,* at 686.
27. Hedge Fund Staff Report, *supra,* at 37.
28. *Id.* at 686-87.
29. Hedge Fund Staff Report, *supra,* at 38.

of calm and stress; and 3) hedge funds provide an important source of risk transfer and diversification by taking risks that would otherwise have remained on the balance sheets of other financial institutions.[30] All three of these roles are worth examining.

First, hedge funds play a useful arbitrage role in reducing or eliminating mispricing in the financial markets. Arbitrage trades are conducted in a variety of markets, and hedge funds make up a significant proportion of arbitrageurs in global financial markets.[31] Arbitrage trades eliminate price discrepancies between similar securities issues, thus providing liquidity to other investors who benefit from the ability to buy and sell securities at reasonably uniform prices. [32] Accordingly, the absence of arbitrageurs negatively impacts financial markets. In fact, some experts attribute part of the economic turmoil during late September and early October of 1998 to the withdrawal of arbitrageurs from the markets.[33]

Second, hedge funds are an important source of liquidity in both in periods of calm and stress. Many hedge funds buy and sell assets against prevailing market sentiment, which diminishes temporary supply and demand imbalances.[34] Former Federal Reserve Chairman Alan Greenspan, while trying to persuade Congress against further hedge fund regulation, underscored hedge funds' important role in maintaining market liquidity:

> If you start to inhibit the number of types of unregulated participants in the financial market from taking the types of risks and supplying the liquidity, I'm fearful that we will remove some of the flexibility that we have in our overall [financial] system. And while I'm certainly of the opinion that should hedge funds accept capital from retail investors they should be under the same regulations as mutual funds, but so long as their source of funds, equity funds, are professional or large investors with net worths, say, exceeding a million dollars or more, I see no purpose in

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30. Oesterle, *supra,* at 6; see also Timothy F. Geithner, President and CEO, Fed. Reserve Bank of New York, Keynote Address at the National Conference on the Securities Industry: Hedge Funds and Their Implications for the Financial System (November 17, 2004), available at http:// www.ny.frb.org/newsevents /speeches/2004/gei041117.html.

31. Report of the President's Working Group on Financial Markets, Hedge Funds, Leverage and the Lesson of Long-Term Capital Management 11 (1999), available at *http://www.mfainfo.org/images/pdf/PWG1999.pdf.*

32. *Id.*

33. *Id.* at A-6.

34. *Id.* at A-5.

> regulation and I see very significant potential loss in doing so. *This reintroduces an important point noted earlier. Before one worries too much about systemic risk, one must recognize that hedge funds are important to ensuring the smooth operation of financial markets and the accuracy of securities prices, upon which investor confidence and the integrity of securities markets depend*.[35]

Third, hedge funds provide an important source of risk transfer and diversification by taking risks that would otherwise have remained on the balance sheets of other financial institutions. For example, a taskforce of industry experts concluded that hedge funds play an important role in maintaining the stability of swaps markets.[36] The taskforce cited interest rate swap markets as an example to illustrate this point.[37] Interest rate swaps allow borrowers and lenders with different risk attitudes to improve financing terms.[38] The ability to transfer this risk depends on the stability of the link between the prices of interest rate derivatives and the prices of benchmark interest rates.[39] This stability, the taskforce concluded, depends on the willingness of arbitrageurs such as hedge funds to undertake convergence trades when swap spreads diverge from normal patterns.[40]

4. Expanding the Investment Company Act to cover hedge funds will have negative consequences including: 1) Reducing hedge fund market participation; 2) hindering the ability of hedge funds to engage in risk taking; and 3) forcing hedge funds to relocate offshore.

Expanding the Investment Company Act to cover hedge funds will have numerous negative consequences including reducing hedge fund market participation.[41] Hedge funds rely on current Investment Company Act exemptions to engage in complex trading strategies. Expanding the

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35. Renomination of Alan Greenspan: Hearing Before the S. Comm. On Banking, Housing and Urban Affairs, 108th Cong. (2004) (statement of Alan Greenspan, Chairman, Fed. Reserve Bd. Of Governors) (emphasis added); see also Paredes, *supra,* 1002.
36. Hedge Fund Staff Report at A-7.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. Paredes, *supra,* at 1006.

Investment Company Act to cover hedge funds will make some trading strategies sufficiently less profitable that hedge funds will have to abandon them altogether. In fact, some commentators have expressed concern that expanding the restrictive nature of the Investment Company Act to cover hedge funds will result in significant pools of money leaving the market.[42]

Other legal commentators have suggested that applying the Investment Company Act to hedge funds would end the ability of hedge funds to exist in their current form and maintain their unique investment attributes.[43] Among the unique hedge fund investment attributes that the Investment Company Act prohibits or limits is 1) the use of leverage; 2) short selling; 3) lock-up periods; 4) performance fees; and 5) secrecy.

5. The Investment Company Act prohibits or limits 1) the use of leverage; 2) short selling; 3) lock-up periods; 4) performance fees; and 5) secrecy.

The Investment Company Act prohibits and limits many activities that make hedge funds useful. For example, The Investment Company Act limits the use of leverage used by registered investment companies.[44] Investment companies may invest in derivatives that are inherently leveraged only if the company sets aside liquid assets in an amount equal to the potential liability or exposure created by the transaction.[45] Although the Investment Company Act does not expressly prohibit funds from trading in derivatives, some derivative trading strategies require the kind of leverage the statute was designed to prevent.[46] Leverage allows hedge funds to magnify their exposure to investments and thus amplify their profits. Prohibiting leverage would undoubtedly reduce hedge fund exposure to capital markets thus increasing market mispricing, decreasing liquidity in the market, and reducing risk transfer and diversification in the market. Limiting leverage is not the only restriction the Investment Company Act places on registered

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42. Karmel, *supra,* at 934.

43. Steven M. Davidoff, *Black Market Captial,* 2008 Colum. Bus. L.Rev. 172 .

44. Mercer Bullard, *Regulating Hedge Funds Managers: The Investment Company Act as a Regulatory Screen,* 13 Stan. J.L. Bus. & Fin. 286 (2008).

45. Report of the President's Working Group on Financial Markets, *supra,* at A-1.

46. Roberta Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility – What Regulation by the Securities and Exchange Commission is Appropriate?,* 80 Notre Dame L.Rev. 909, 916 (2005).

investment companies which would lead to decreased hedge fund exposure to capital markets.

The Investment Company Act also restricts the use of short selling by registered investment companies. Like the restriction on leverage, registered investment companies are only permitted to sell short if it sets aside liquid assets in an amount equal to the potential liability or exposure created by the transaction.[47] Short selling has been maligned in the media, yet most financial experts recognize the important role short sellers play in maintaining market liquidity. Hedge funds add liquidity to markets by short selling and thus become effective counterparties to long traders.[48] Because mutual funds and other institutions are prohibited from short-selling, the short selling of hedge funds has become vital to market liquidity. Market liquidity reduces costs for all participants by making markets more efficient. Additionally, all market participants suffer when there is an absence of short sellers because greater mispricing occurs and there are fewer parties available for risk transfer. Accordingly, all market participants would suffer if hedge funds were prohibited from short selling.

Market participants would also suffer if the Investment Company Act were expanded to cover hedge funds because the Investment Company Act limits the use of lock-up periods and illiquid securities. A "lock-up period" is a period of time, usually one year, during which hedge fund investors are prohibited from redeeming their shares. Section 22 of the Investment Company Act requires investment companies, with limited exceptions, to redeem fund shares within 7 days regardless of how much time an investor has spent in the fund. Compliance with Section 22 would force hedge funds to either borrow funds to pay the redemption or close out of a position in the market. Both alternatives would limit hedge fund exposure to capital markets which leads to a decrease in market liquidity; an increase in market mispricing; and a decrease in the ability to transfer risks for all market participants.

The Investment Company Act also requires that funds value their assets at their market value, and for assets for which there is no readily available market price (i.e. illiquid securities), at the fair value that could be realized on their present sale.[49] This hinders mutual funds from holding significant

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47. Oesterle, *supra,* at 28-30.

48. J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Regulation, Part II, A Self-Regulation Proposal,* 32 Del. J.Corp. L. 799 (2007).

49. Bullard, *supra,* at 310.

amounts of illiquid securities, which are often difficult to value.[50] Conversely, hedge funds may hold substantial amounts of hard-to-value illiquid securities.[51] This characteristic is useful in normal markets because it creates a market for securities that might otherwise be difficult to sell, and it is especially useful now that the government is trying to find buyers for hard-to-price illiquid mortgage backed securities. Moreover, the Term Asset-Backed Securities Loan Facility (TALF) program might not have been possible without hedge funds' ability to purchase large amounts of illiquid securities.[52]

Lastly, the Investment Company Act does not allow investment advisers to charge performance fees.[53] Hedge funds typically charge asset based fees and performance fees.[54] Asset based fees typically range from one to two percent annually of the assets under management regardless of investment success.[55] Performance fees are usually a percentage of the increase in the value of the assets under management.[56] The performance fee restriction would be especially troublesome to hedge funds because performance fees offer a big incentive for hedge funds to take the risks necessary to produce absolute returns. Taking away this incentive would undoubtedly lead to reduced hedge fund exposure to financial markets which would lead to the associated negative consequences of increased market mispricing, decreased market liquidity, and decreased risk transfer.

In addition to limiting and prohibiting many activities that make hedge funds useful, the Investment Company Act also is a poor regulatory fit because it is designed to protect unsophisticated investors. Hedge fund investors are sophisticated and thus hedge fund investors do not need protection.

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50. *Id.* (noting that the SEC has informally required mutual funds to limit illiquid securities to no more than 15 percent of their assets).

51. *Id.*

52 . The TALF program supported the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration.

53. Report of the President's Working Group on Financial Markets, *supra*, at A-1.

54. Henry Ordower, *Demystifying Hedge Funds: A Design Primer,* 7 U.C. Davis Bus. L.J. 323, 345 (2007).

55. *Id.* at 346.

56. *Id.*

6. The primary purpose of the Investment Company Act was to protect unsophisticated investors.

The Investment Company Act, like most existing federal securities laws, was passed as a reaction to the financial turmoil of the Great Depression.[57] Many retail investors lost a lot of money during the Great Depression, and the resulting financial panic created a systemic financial crisis. Among the major federal securities laws passed in the wake of the Great Depression were the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The focus of these depression-era securities laws was on the retail consumers who most needed protection. Consequently, all of these depression era securities laws included exceptions for financial actors who provided services to smaller, more discrete segments of the public, as opposed to financial actors that provided services to large segments of the public.[58] These laws also focused on disclosure as a way to prevent future consumer losses and systemic risk.

The Investment Company Act was primarily designed to protect unsophisticated investors, which not only comprised a large percentage of the general public, but also tended to be the most susceptible to the abuses of the investment company industry.[59] The Investment Company Act of 1940 was Congress's response to the widespread fraud and mismanagement of the investment company industry that was responsible for over $1 billion in investor losses in the 1930s.[60] The investment company industry of the 1930s was fraught with self dealing, fraud, and misappropriation of fund assets by fund managers.[61] The Investment Company Act successfully regulated the mutual fund industry, but the Investment Company Act is not a good regulatory fit for the hedge fund industry.

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57. See generally Tamar Frankel, *Private Investment Funds: Hedge Funds' Regulation by Size,* 39 Rutgers L.J. 657 (2008).

58. Tamar Frankel, *Private Investment Funds: Hedge Funds' Regulation by Size,* 39 Rutgers L.J. 657, 660 (2008).

59. H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions,* 23 ANNRBFL 777, 781 (2004).

60. *Id.*

61. *Id.*

7. The Investment Company Act is a poor regulatory fit for hedge funds because it was designed to protect unsophisticated investors. Hedge fund investors are sophisticated so they do not require protection.

The Investment Company Act is designed to protect unsophisticated investors, but hedge fund investors are sophisticated so they do not require protection. The primary investors of hedge funds are wealthy individuals and institutional investors.[62] Although hedge fund's lack of disclosure limits the information available to investors it is not true that hedge fund investors are completely left in the dark. A significant portion of hedge fund investors, particularly institutional investors, engage in active due diligence prior to investing in hedge funds.[63] A 2004 study by Deutsche Bank bolsters this point. The study found that 40% of hedge fund investors spent between three and six months engaging in due diligence prior to investing, and over 20% of hedge fund investors spent six months or more engaging in due diligence prior to investing. [64]

Moreover, Congress has consistently recognized that sophisticated investors do not need the protection of the nation's securities laws. The vast majority of hedge fund investors qualify as "accredited investors" under Regulation D of the 1933 Act, and thus are considered able to "fend for themselves" when investing.[65] Since hedge funds can fend for themselves they do not need the protection of the Investment Company Act. Additionally, it is possible that expanding the Investment Company Act to cover hedge funds will lead to less hedge fund regulation and transparency.

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62. Report of the President's Working Group on Financial Markets, *supra*, at 1.

63. Paredes, *supra,* at 992.

64. *Id.* at 992-93.

65. Paredes, *supra,* at 990-91; see also Rule 501(a) of the 1933 Act, 17 C.F.R. § 230.501(a) (defining "accredited investor"); see also S.E.C. v. Ralston Purina Co. 346 U.S. 119 (1953) (touchstone of private offering exemption is that offerees are able to "fend for themselves" and thus do not need protection of federal securities laws).

8. Expanding the Investment Company Act to cover hedge funds will force many hedge funds to relocate offshore and thus actually decrease hedge fund regulation.

Excessive hedge fund regulation would force some hedge funds to relocate offshore.[66] Although many of these hedge funds would still invest in U.S. markets, they would escape any government oversight.[67] Since many hedge funds already run mirror offshore entities it would not be difficult for them to relocate completely offshore, although moving completely offshore may dissuade investors from staying in the fund[68] Former Federal Reserve Chairman Alan Greenspan noted that any direct U.S. regulations restricting the trading flexibility of hedge funds would doubtless induce the more aggressive funds to emigrate from under U.S. jurisdiction.[69]

CONCLUSION

In conclusion, it is clear that the Investment Company Act is not a good regulatory fit for hedge funds. The purpose of the Investment Company Act, to protect unsophisticated investors, is inconsistent with hedge fund regulation. The Investment Company Act would prohibit or limit many activities that allow hedge funds to play a useful role in financial markets. Additionally, expanding the Investment Company Act to cover hedge funds would have other negative consequences such as forcing hedge funds to relocate offshore. For these reasons Congress should consider other, more appropriate, regulation for hedge funds than the Investment Company Act.

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66. J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Regulation, Part II, A Self-Regulation Proposal,* 32 Del. J.Corp. L. 799, 827 (2007).

67. *Id.*

68. *Id.* (Noting that the bonding hypothesis for exchange listing holds that "foreign companies list in the United States to signal to investors that they are well-governed companies with nothing to fear from regulation.").

69. See Hedge Fund Operations: Hearing Before the House Comm. on Banking & Fin. Servs., 105th Cong. 37 (1998) [hereinafter Hearing] (statement of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System) (discussing the issue of hedge fund regulation).

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Horace Grant v. Morgan Keegan & Company Inc.
FINRA Case No. 08-00775

Claimant, a famous former professional basketball player, invested money in various Morgan Keegan proprietary bond funds, including the Multi-Sector Income Fund, High Income Fund, Strategic Income Fund, and Advantage Income Fund. Those funds crashed spectacularly in 2007 and 2008 based on their large concentration in low priority tranches of asset backed securities, rather than investments in typical corporate bonds.

Claimant alleged the following causes of action: (1) misrepresentations and omissions; (2) violations of California Corporate Securities Code sections 2500, 25400(d), 25401, and 25216; (3) violation of the California Consumer Legal Remedies Act; (4) breach of fiduciary duty; (5) violation of NASD Conduct Rule 2110, Rule 2120, NASD Conduct Rule IM-2310-2, and NASD Conduct Rule 3010(a); (6) negligence; (7) failure to supervise; (8) breach of contract; (9) fraudulent misrepresentation; and (10) vicarious liability.

In the Statement of Claim, Claimant requested compensatory damages of approximately $1.5 million, plus punitive damages, interest, attorneys' fees, and other costs.

Award: The Panel ordered Respondent to pay Claimant $1.45 million in compensatory damages, plus $10,000 in costs.

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

Respondent's Counsel: Terry R. Weiss, Esq., Greenberg Traurig LLP, Atlanta, Georgia.

Claimant's Experts: Richard Evans.

Respondents' Experts: Kjell Ekdahl, Scott Moore, and Michael Weiner.

Arbitrators: William J. Adams (Public Chairperson); William Lee Krantz (Public); and Jonathan Schwartz (Non-Public)

Significance: The Panel's award represented approximately 100% of the principal losses Claimant sustained. The net out of pocket losses were approximately $330,000. This was also the largest award against Morgan Keegan for the RMK Funds at the time.

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James Searcy, Trustee of the James Searcy Revocable Trust v. Citigroup Global Markets, Inc., et al.
FINRA Case No. 09-00813

Claimant was a 79-year old business owner with a net worth of between $5 and $10 million. He previously sold a natural foods company and invested the proceeds in a Smith Barney account. The stated account objectives were Conservative Income.

The account was invested in a diversified portfolio of high quality equities with a heavy concentration in preferred stocks issued by banks and other financial services companies. In 2008, Claimant sent a series of e-mails to the broker suggesting that he sell the stocks and invest the proceeds in CDs. Claimant's son, who is a hedge fund manager and had "informal" decision making authority over the account (Claimant never executed a Power of Attorney giving his son formal decision making authority), contacted the broker and told him to go to cash because the market was on the verge of collapsing and that it would be "apocalyptic." The broker ignored the client's e-mails and the son's warnings.

On October 1, 2008, Claimant met with the broker and expressed concern about his account. After the meeting, the broker sold some, but not all, of Claimant's positions. On or about October 8, 2008, Claimant submitted orders to sell the remaining equities in the account. These orders were executed in a timely manner.

At the hearing, Respondents' defense was that Claimant was responsible for his losses because he issued the sell orders. Respondents' expert also testified that Claimant erred by mitigating his damages. However, this ignored the fact that the market continued to decline well after the equities were sold.

Claimant requested $1,095,000 in compensatory damages, based upon a well-managed portfolio, plus $155,000 in interest, and $416,000 in attorneys' fees. From October 1, 2008 through October 8, 2008 (the date the sell orders were received), Claimant sustained approximately $525,000 in losses.

Claimant asserted the following causes of action: (1) breach of fiduciary duty; (2) constructive fraud; (3) negligence; (4) violation of Nevada Revised Statutes §§ 90.570 and 90.660; (5) breach of contract; (6) control person liability, respondeat superior, and agency. Claimants requested damages of $10 million, plus costs and attorneys' fees.

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

Award: The Panel awarded Claimant a total of $525,000, which was specifically allocated as $477,000 in compensatory damages, plus $48,000 in attorneys' fees pursuant to Nevada law.

Claimant's Counsel: David Liebrader, Esq., Law Offices of David Liebrader, Inc., Las Vegas, Nevada

Respondent's Counsel: Alejandro Schwed, Esq., Morgan Stanley Smith Barney, LLC, New York, New York

Claimant's Expert: None

Respondent's Expert: Dean Johnson, Investment Analytics, Bend, Oregon

Arbitrators: Howard W. Shannon (Public Chairperson), James H. McAvoy, Sr. (Public), and Alan Duncan (Non-Public)

This award is significant because the Panel essentially ordered Respondent to pay 100% of the damages sustained in a one-week period after Claimant, who was a wealthy former business owner, met with the broker on October 1, 2008. The Panel also awarded statutory attorneys' fees; however, the amount of attorneys' fees was somewhat arbitrary. This was a case in which Respondents significantly undervalued the case and where Respondent's "how dare you mitigate" defense was, at least in part, ignored.

Andrew M. Stein, et al. v. Morgan Keegan & Company Inc.

FINRA Case No. 08-03109

Claimant was a wealthy, but relatively unsophisticated investor. At age 35, he had taken his family's furniture business from being on the brink of bankruptcy to a book value of approximately $55 million. He sold the business and invested the proceeds (approximately $32 million) with Morgan Keegan. Prior to making the investment, Claimant met with Jim Kelsoe, manager of the RMK Funds. More than $12 million was invested in the RMK Select Intermediate Bond I Fund, the RMK Select High Income I Fund, the RMK Advantage Fund, Inc., RMK Strategic Income Fund, and the RMK Multi-Sector High Income Fund. Over the years, Claimant had taken more than $ 6 million in income. As a result, Claimants' net out of pocket losses were slightly less than $6 million.

During the hearing, Claimants' broker testified in favor of Claimant. The broker took responsibility for all the investment decisions, confirmed that Claimant always followed his advice and that Claimant was risk-adverse, and that he would not have recommended the RMK Funds if he had known or understood the risks himself.

Claimants asserted the following causes of action: (1) violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b)/SEC Rule 10b-5; (2) violation of § 11 of the Securities Act of 1933, 15 U.S.C. § 77k; (3) violation of § 12(a) of the Securities Act of 1933, 15 U.S.C. § 771; (4) liability under § 15 of the Securities Act of 1933, 15 U.S.C. §170; (5)

violation of §34(b) of the Investment Company Act; (6) violation of the Tennessee Securities Act of 1980, T.C.A. § 46-2-101 at *seq*.; (7) violation of NASD Conduct Rules 2110, 2120, IM-2310-2 and 3010; (8) unsuitability (9) breach of fiduciary duty; (10) negligence; (11) failure to supervise; (12) breach of contract; (13) fraud; (14) vicarious liability; and, (15) civil conspiracy. Claimants requested damages of $10 million, plus costs and attorneys' fees.

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

Award: The Panel awarded Claimants $2.5 million in damages

Claimants' Counsel: Andrew P. Campbell, Esq., Leitman, Siegal, Payne & Campbell, P.C., Birmingham, Alabama

Respondent's Counsel: Shephard D. Tate, Esq., Bass, Berry & Sims PLC, Memphis, Tennessee

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

Respondent's Expert: Christopher Laursen, NERA Economic Consulting, Washington, D.C.; Steven Scales, Secure Financial Services/Scales Consulting Group, Cordova, Tennessee

Arbitrators: Paul W. Sterman (Public Chairperson), Myron S. Dunay (Public), and Bernice Leah Stander (Non-Public)

This case is significant because the Panel ordered Respondent to pay $2.5 million in damages to a wealthy investor and former business owner. In addition, Claimants' counsel has a pending claim on behalf of Claimant in Alabama state court against MAM and Regions (the sister corporation and actual manager of the RMK Funds as well as the parent of Morgan Keegan). Although Morgan Keegan stressed the pendency of that claim throughout the hearing, the Panel entered an award on behalf of Claimants. Claimants' counsel specifically acknowledged Charles Thompson, Dale Ledbetter, Andrew Stoltmann, and Adam Gana for their "incredible" amount of support.

Raymond Kelly, et al. v. Charles Schwab & Co., Inc.

FINRA Case No. 08-02307

Defendant's representative sold Claimants shares in the Charles Schwab YieldPlus Fund. The representative told Claimants that the YieldPlus Fund was as liquid and safe as a money market fund, but paid interest at a rate that was slightly higher than the rates paid by money market funds. In May 2007, based upon these representations, Claimants liquidated $200,000 in equities and used the proceeds to purchase an equivalent amount of shares in the

YieldPlus Fund. From January 1, 2007 through May 29, 2008, the YieldPlus Fund declined in value by approximately 34%.

Claimants sought general and compensatory damages of $91,022, lost opportunity damages, costs, punitive damages, interest, attorneys' fees, and/or rescission.

Claimants alleged the following claims: (1) violation of FINRA rules; (2) breach of fiduciary duty; (3) breach of contract; (4) constructive fraud; (5) fraud by misrepresentation and omission; (6) negligence; (7) respondeat superior; (8) negligent supervision; and, (9) violations of the Nevada Securities Act.

Respondents denied the claims and raised various affirmative defenses.

Award: The Panel ordered Respondent to pay Claimants $74,430.77 in compensatory damages, pre-judgment interest at the rate of 3.25% per annum, and $25,650.00 in attorneys' fees pursuant to Nev. Rev. Stat. § 90.660.

Claimants' Counsel: Thomas A. Hargett, Esq., Maddox Hargett & Caruso, P.C., Fishers, Indiana

Respondent's Counsel: Michael M. Gless, Esq., Keesal, Young, & Logan, Long Beach, California

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

Respondent's Expert: Michael Weiner, Legal Economic Consulting Group

Arbitrators: Darryl J. Horowitt (Public Chairperson), Paul H. Lamboley (Public), and Barry A. Mainardi (Non-Public)

This case is significant because the Panel awarded more than 80% of Claimants' net out of pocket losses in Schwab YieldPlus. Including attorneys' fees and pre-judgment interest, the total award exceeded 110% of NOPs.

Richard E. Moffitt v. Investors Capital Corporation, et al.

FINRA Case No. 09-00905

Claimant was an 80-year old single man who was retired as the result of his age and various disabilities that prevented the continuation of his employment as a construction contractor. Claimant opened an account with Respondents in July 2007 and proceeded to invest more than $369,000. During the next six months, Respondents engaged in an active trading "strategy" that resulted in more than $100,000 in commissions, markups, and markdowns. In total, more than $3,000,000 of transactions were executed,

including more than $579,000 in sales that were necessary *after* Claimant transferred his account to another firm.

Through the use of margin and manipulation of the account balances, Respondents accumulated multiple six figure positions in speculative securities and, at times, positions as large as $600,000 in a single stock. At the end of the six month period, Claimant's account carried a margin balance approaching $500,000. Respondents accumulated large positions in unsuitable equities such as Garmin, Goldman Sachs, and Intercontinental Exchange, Inc. As the market turned, Respondents sold the holdings to pay for the margin balances accrued because Claimant had no additional funds to put in the account. Claimant followed Respondents' directions because, through his inexperience, he did not fully comprehend the trading and or strategies employed and because of his lack of relevant information upon which to evaluate Respondents recommendation and actions.

Claimant asserted the following causes of action: (1) breach of contract; (2) common law fraud; (3) conspiracy; (4) promissory estoppel; (5) negligence; (6) malpractice; (7) breach of fiduciary duty; and, (8) breach of state securities laws. Claimants requested $279,000 in compensatory damages, as well as other unspecified relief.

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

Award: The Panel awarded Claimant $224,095 in compensatory damages, as well as $26,891 in pre-judgment interest (at 6% per annum), and $49,654 in attorneys' fees.

Claimants' Counsel: Anthony V. Trogan, Law Offices of Anthony V. Trogan, PLLC, West Bloomfield, Michigan

Respondent's Counsel: James A. McGovern, Esq., Marshall, Dennehey, Warner, Coleman & Goggin, Pittsburgh, Pennsylvania

Claimant's Expert: None

Respondent's Expert: None; however, an in-house compliance officer testified at the hearing on behalf of Respondents.

Arbitrators: John P. Gouttlere (Public Chairperson) Harvey Frank (Public), and William C. Alsover, Jr., (Non-Public)

This case is significant because the Panel awarded approximately 80% of the net out of pocket losses. Including interest and attorneys' fees, the award was equal to approximately 110% of Claimant's NOPs.

Kathleen Pomery as Trustee on Behalf of The Pomeroy Family Trust, The Pomeroy Bypass Trust and the Marital Deduction Trust v. Charles Schwab & Co., Inc.

FINRA Case No. 08-03904

Claimant was an elderly widow who had been left significant assets, including a number of trusts, by her late husband in the 1990s. Claimant tended to keep half or more of her investable assets in cash or cash equivalents, such as treasuries, CDs or money market funds. In the Spring of 2006, while calling Schwab back to reinvest a $95,000 CD which had matured, Claimant was convinced to invest roughly $5,000,000, which had been previously invested in a tax-free money market fund, into the Schwab California Tax-Free YieldPlus Fund ("SWYCX"). This fund, while in the same family as the now infamous Schwab YieldPlus fund - SWYSX, was touted as an ultra-short California Municipal Bond fund which was supposed to be a good alternative for cash.

During the hearing, the taped conversation between the region bond expert for Schwab and the Claimant was played for the Panel. Interestingly, the notes from Schwab's broker did not match the actual taped conversation. During that taped conversation, it was clear Schwab's representative was comparing the SWYCX fund to treasuries and CDs, with little qualification of the additional risks.

Ultimately, the SWYCX fund lost roughly 10% when comparable funds were largely profitable during this same time period. As a result, Claimant lost a little under $600,000 in capital, but less than $300,000 on a net-out-of-pocket bases given the dividends of almost two years.

Claimant alleged the following causes of action: (1) breach of contract and warranties; (2) promissory estoppels; (3) violations of California Corporate Securities Code sections 2500, 25400(d), 25401, and 25216; (4) violation of the California Consumer Legal Remedies Act; (4) violation of elder abuse statutes; (5) violation of NASD Conduct Rule 2110, Rule 2120, NASD Conduct Rule IM-2310-2, and NASD Conduct Rule 3010(a) and (6) negligence.

In the Statement of Claim, Claimant requested compensatory damages of approximately $600,000 in compensatory damages plus interest, attorneys' fees, and other costs.

Award: The Panel ordered Respondent to pay Claimant: $604,094 in compensatory damages, 7% interest for two years, $150,000 in attorney's fees pursuant to the California Welfare and Institutions Code § 15657.5 and $14,850 in costs.

Claimants' Counsel: Samuel B. Edwards, Esq. and Kirk G. Smith, Esq., Shepherd, Smith, Edwards & Kantas, LLP, Houston, Texas.

Respondent's Counsel: Philip A. McLeod, Esq., Keesal, Young & Logan, San Francisco, California.

Claimant's Expert: Joseph R. Prendergast, PhD, Securities Litigation and Consulting Group, Inc.

Respondents' Experts: John Maine and Greg Kyle of LEGC.

Arbitrators: Jane Bradley (Public Chairperson); Mary Margaret Bush (Public); and William A. Husa (Non-Public).

Significance: This case is significant as the Panel essentially awarded the full amount of damages sought, including all trading losses (no offset for the interest earned), interest on top of the losses, costs and attorney's fees. The award of attorney's fees is particularly significant as it very difficult to obtain attorney's fees in California. The client was 89 years old, so attorney's fees were sought under California's Elder abuse statue. This case represents one of the few times a California arbitration panel has used the Elder abuse statute to award attorney's fees. In addition, this is the first case in which an award has been entered for the SWYCX fund. At least two prior cases resulted in no award. Schwab took the position that this fund was managed entirely different than the more notable YieldPlus taxable fund. The Panel saw that internally Schwab marketed them exactly the same and therefore allowed Claimant to raise many of the same arguments.

CASES & MATERIALS

Jason A. Richardson[1]

RECENT CASES

PRIOR TO ARBITRATION

Selecting Causes of Action: Liability for Recommendations to Hold Securities

Holmes, et al. v. Grubman, et al.,
No. S09Q1585 (Ga. Feb. 28, 2010)

Georgia law recognizes claims for damages resulting from improper recommendations to hold securities, and imposes fiduciary duties to brokers in dealings with their customers.

This Georgia Supreme Court case involves investors' claims against Smith Barney and its financial analyst, Jack Grubman, for improper recommendations to hold. In June 1999, William K. Holmes (and four entities under his control) owned 2.1 million shares in WorldCom, Inc., a defunct telecommunications company. Holmes alleged that in June 1999, he verbally ordered his broker to sell all of his WorldCom stock, which was then trading at about $92/share. According to Holmes, his broker convinced Holmes not to sell, and to purchase additional shares as the price declined. Further, Holmes alleged that the broker recommended that he hold the investment either because of the brokerage firm's self-serving desire to keep its investment banking relationship with WorldCom or its reliance on Grubman's research, which Holmes alleged was improper. In October 2000, Holmes was forced to sell all of his WorldCom shares in order to meet margin calls, resulting in a loss of nearly $200 million.

This case originated in a bankruptcy court in Georgia, but was transferred to the Southern District of New York and consolidated with

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1. Jason Richardson is an attorney with the law firm of Shepherd, Smith, Edwards & Kantas, L.L.P. located in Houston, Texas. He received his J.D. and M.B.A. degrees from the University of Houston in 2006, and is a member of the Texas and Illinois Bars. Mr. Richardson and the other members of his firm have a nationwide practice devoted to helping investors recover wrongful losses from brokerage firms and have represented thousands of customers from many states in their desire to aid the public investor. He can be reached at jrichardson@sselaw.com.

related litigation. After appeal to the Second Circuit, the court certified three questions for the Georgia Supreme Court:

1. Does Georgia common law recognize fraud claims based on forbearance in the sale of publicly traded securities?
2. With respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, is proximate cause adequately pleaded under Georgia law when a plaintiff alleges that his injury was a reasonably foreseeable result of defendant's false or misleading statements, but does not allege that the truth concealed by the defendant entered the market place, thereby precipitating a drop in the price of the security?
3. Under Georgia law, does a brokerage firm owe a fiduciary duty to the holder of a non-discretionary account?

The Georgia Supreme Court held, first, that Georgia law permits "holder claims" subject to two limitations: (1) the defendant's alleged misrepresentations occurred in direct communications to the plaintiff, and (2) the plaintiffs must demonstrate specific reliance on the defendant's representations. Further, the court held that negligent misrepresentation claims, like fraud claims, can be based on forbearance in the sale of publicly traded securities. The direct communication and specific reliance limitations on fraud claims by "holders" also apply to negligent misrepresentation claims.

In addressing the second certified question, the court concluded that, with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, a plaintiff has the burden of proving that the truth concealed by the defendant entered the marketplace, thereby precipitating a drop in the price of the security.

Finally, on the third certified question, the court concluded that the fiduciary duties owed by a broker to a customer with a non-discretionary account are not restricted to the actual execution of transactions. The court noted that a broker generally has a heightened duty when recommending an investment which the customer has previously rejected or as to which the broker has a conflict of interest. The court approved of lower court rulings that found a broker's fiduciary duties are founded in the laws of agency: "A stock broker's duty to account to its customer is fiduciary in nature, so that the broker is obligated to exercise the utmost good faith. Requirements of good faith demand that in the principal's interest it is the agent's duty to make known to the principal all material facts which concern the transactions and subject matter of his agency." *See* OCGA § 23-2-58.

Standards for Late Exclusion from Class Actions

In re Charles Schwab Corporation Securities Litigation
(N.D. Cal. May 27, 2010), No. C 08-01510 WHA.

Filing a FINRA arbitration claim prior to the opt-out deadline for a class action is not a substitute for properly opting out of the class.

In the instant case a group of seven Charles Schwab customers sought permission to opt out of a class after the applicable deadline (December 28, 2009). Two of the class members claimed to have never received notice of the class action, while others argued that they should be considered to have properly opted out by virtue of the fact that they had filed FINRA arbitration claims.

The Court noted that the standard for determining whether a class member should be allowed to opt out of a class action after the applicable exclusion deadline has passed is whether the class member's failure to meet the deadline is the result of "excusable neglect." *See Silber v. Mabon,* 18 F.3d 1449, 1454-55 (9th Cir. 1994). Under this standard, courts can accept late filings caused by "inadvertence, mistake, or carelessness, as well as by intervening circumstances beyond the party's control." *Pioneer Inv. Serv. Co. v. Brunswick Assoc. Ltd. P'ship*, 507 U.S. 380, 388 (1993). In the Ninth Circuit, courts evaluate "excusable neglect" by considering the "degree of compliance with best practical notice procedures; when notice was actually received and if not timely received, why not; what caused the delay, and whose responsibility was it; how quickly the belated opt out request was made once notice was received; how many class members want to opt out; and whether allowing a belated opt out would affect either the settlement or finality of the judgment." *Silber*, 18 F. 3d at 1455.

The Court found that according to claims administrator records, notices were mailed to the class members who claimed not to have received them, and none were returned "undeliverable." As a result, the Court concluded that constitutionally sufficient notice was provided to these class members.

The Court then rejected the argument that filing a FINRA claim prior to the opt-out date should be treated as a sufficient substitute for properly opting out of the class. The Court stated that if class members could file FINRA claims instead of expressly opting out of the class, they could improperly game the system. For example, they could simply wait and see how a class action played out, and then – if a settlement or judgment was reached that was not to their liking – argue that their FINRA claims should allow them to proceed on their own. Alternatively, they could abandon their

FINRA claims in the middle of the proceedings to reap the benefits of a class action award or settlement.

The Court finally held that the class members' failure to opt out was not as a result of any "excusable neglect" and denied their motion for late exclusion from the class.

Enjoining Arbitration Proceedings: The Continued Viability of the "Serious Questions" Standard

Citigroup Global Markets, Inc. v. VCG Special Opportunities Master Fund Limited
No. 08-6090-cv (2nd Cir. Mar. 10, 2010)

The "serious questions" standard for the consideration of a motion for preliminary injunction remains valid after several Supreme Court decisions clarifying the requirements and burdens placed on a party seeking injunctive relief.

VCG is a hedge fund based on the Isle of Jersey, which entered into a brokerage agreement with Citigroup Global Markets ("CGMI") under which CGMI was obligated to provide a variety of brokerage and clearing services for VCG. VCG also entered into a credit default swap ("CDS") agreement with Citibank, N.A. – a sister-affiliate of CGMI. After entering into the swap, Citibank declared a writedown of the assets covered in its CDS agreement with VCG, which triggered VCG's obligation to pay Citibank $10,000,000.

VCG unsuccessfully sued Citibank, alleging that Citibank had violated the terms of the parties' CDS agreement by declaring the writedown. In addition, VCG initiated FINRA arbitration proceedings against CGMI. In response, CGMI moved a district court to enjoin the arbitration hearing, arguing that CGMI had no obligation to arbitrate VCG's claims because it was not a party to, and did not broker, the VCG-Citibank CDS. More specifically, CGMI argued that VCG was not a "customer" of CGMI for purposes of the transactions at issue.

The district court granted CGMI's motion for a preliminary injunction, relying on the Second Circuit's standard for the entry of a preliminary injunction, which requires the movant to show (a) irreparable harm absent injunctive relief and (b) either (1) likelihood of success on the merits or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly in the movant's favor. Specifically, the district court found that CGMI had provided

evidence that raised "serious questions" as to whether VCG was, in fact, a customer of CGMI with respect to the swap transaction and granted the injunction on that basis.

On appeal to the Second Circuit, VCG argued that the trial court abused its discretion because the "serious questions" standard for the entry of a preliminary injunction had been eliminated by three recent Supreme Court decisions.[2] The court soundly rejected VCG's argument, and after analyzing the recent Supreme Court cases, stated, "[w]e have found no command from the Supreme Court that would foreclose the application of our established 'serious questions' standard as a means of assessing a movant's likelihood of success." The court then held that the "serious questions" standard for consideration of a motion for a preliminary injunction remains valid, and that the trial court did not abuse its discretion when relying on that standard. As a result, CGMI will not be required to participate in FINRA arbitration proceedings against VCG.

Compelling Non-Signatories to Arbitration: Doctrine of Direct-Benefit Estoppel

Wealth Rescue Strategies, Inc. v. Thompson
No. H-08-3107 (S.D. Tex. Nov. 17, 2009)

A court may compel a non-signatory to arbitrate disputes if the non-signatory derives a direct benefit from the contract containing the arbitration clause.

This case involves a dispute between two investment advisors regarding the handling and division of fees. Chris L. Jones and Robert W. Thompson worked as investment advisors, and were associated persons of Walnut Street Securities, a FINRA member firm. Jones and Thompson formed a relationship in which the two would solicit clients to pool small dollar amounts required to participate in GE Private Asset Management. These individual investment accounts were maintained through Walnut, and as a requirement of participating, each client entered into a written fee agreement that split fees between Walnut, Jones, and Thompson. An additional party to the suit was Wealth Rescue Strategies, Inc., a company that collected and distributed Jones' earnings. The essence of the complaint raised by Jones

2. *Munaf v. Geren*, 553 U.S. 674 (2008); *Winter v. Natural Resources Defense Council, Inc.*, 129 S. Ct. 365 (2008); *Nken v. Holder*, 129 S. Ct. 1749 (2009).

and Wealth Rescue Strategies was that Thompson modified client fee agreements to divert fees to himself.

Thompson sought to compel Jones and Wealth Rescue to FINRA arbitration. The only written agreements containing an arbitration clause were the U-4s signed by Jones and Thompson in their employment relationship with Walnut. Wealth Rescue was not a signatory to any agreement containing an arbitration clause.

The court found that the arbitration clause in the Form U-4 requires all disagreements subject to FINRA that exist between the signatory and any other person to be arbitrated in accordance with FINRA regulations, noting that FINRA Rule 13200(a) states that any "dispute aris[ing] out of the business activities of a [M]ember or an [A]ssociated [P]erson and is between or among: Members; Members and Associated Persons; or Associated Persons" is necessarily a dispute governed by FINRA. The Court found that both Jones and Thompson met the definition of an associated person.

The court held that this FINRA-imposed duty to arbitrate was broad enough to encompass the business activities of Jones and Thompson based on the plain language of the contract and applicable rules. Furthermore, the court found that not only did an agreement to arbitrate exist in the U-4s, but the broad nature of the duty to arbitrate—all business activities between associated persons—encompassed the claims at issue in the case. Therefore, because the requirements under the Federal Arbitration Act had been met, the court ordered that the parties submit to FINRA arbitration.

Although the agreements to arbitrate were signed only by Jones and Thompson, the court ordered Wealth Rescue to submit to FINRA arbitration along with Jones and Thompson. The court invoked the doctrine of "direct benefit estoppel," under which a non-signatory who derives a direct benefit from the contract containing an arbitration clause is precluded from repudiating the agreement in the course of litigation. Here, Wealth Rescue was assigned the revenues earned by Jones in his role as an investment advisor. Included in these revenues were those Jones earned pursuant to his business relationship with Thompson. The court found that Wealth Rescue's collection of such fees established a direct benefit from the U-4 contracts, which contained the agreement to arbitrate. Thus, the court found that Wealth Rescue could be subject to the arbitration agreement therein.

DURING THE ARBITRATION

Statute of Limitations for Federal Securities Claims
Merck v. Reynolds
559 U.S. _____ (2010).

A federal securities fraud claim accrues (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, "the facts constituting the violation"—whichever comes first. The "facts constituting the violation" specifically include the fact of scienter. Thus the statute of limitations for federal securities fraud claims does not expire until two years after a plaintiff discovers facts showing not only an alleged misrepresentation or omission, but also the defendant's alleged scienter, subject to an absolute five-year period of repose.

This case involves securities fraud claims filed by investors who alleged that Merck had made misrepresentations regarding the risk of heart attacks associated with its drug, Vioxx. The plaintiffs alleged that Merck had violated the anti-fraud provisions of the Securities Exchange Act of 1934, for which claims are subject to a statute of limitations that provides that such claims are considered timely if filed either "2 years after the discovery of the facts constituting the violation; or 5 years after the violation." 28 U.S.C. § 1658(b). In its defense, Merck argued that the plaintiff's claims were time-barred because the plaintiffs had notice of misrepresentations or omissions over two years prior to filing their claims. The Supreme Court granted certiorari to resolve a split among the circuits regarding the interpretation of § 1658(b).

The Court determined that in light of the fact that plaintiffs are required to plead facts demonstrating scienter to meet the pleading standard of 15 U.S.C. § 78u-4(b)(2), the very purpose of the discovery rule would be frustrated if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter. The Court rejected Merck's argument that discovery of misrepresentations or omissions was equivalent to discovery of scienter. The Court held that a defendant must establish that a plaintiff had discovered "facts showing scienter" to show that the plaintiff had discovered the "facts constituting the violation."

The Court also overturned precedent in many circuits by holding that "inquiry notice" does not trigger the limitations period of § 1658(b), stating, "[w]e cannot reconcile it with the statute, which simply provides that "discovery" is the event that triggers the 2-year limitations period—for all plaintiffs." The Court noted that notions of "inquiry notice" and "storm warning" may be useful in determining the time at which discovery of

relevant facts occurred to the extent that they generally identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating, however, the Court was clear that the limitations period does not begin to run until the plaintiff "discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,' including scienter—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation."

As a result of this decision, defendants must satisfy a heavier factual burden to sustain a motion to dismiss based on limitations, since they must establish the plaintiff's discovery of scienter.

AFTER THE ARBITRATION

Vacatur: Manifest Disregard for the Law: Sale of Securities Made in Violation of Federal Law

See More Light Investments v. Morgan Stanley DW Inc.
No. CV 08-0580-PHX-MHM (D. Ariz. July 29, 2009)

An arbitration panel manifestly disregards the law, rendering its award subject to vacatur, when it ignores federal law making the sale of the disputed securities voidable.

In April 1995, Plaintiff See More Light Investments, a general partnership, purchased fifty-five Republic of Cuba 4.5% Bearer Bonds from Defendant Morgan Stanley DW Inc. for the price of approximately $23,250. These bonds were distressed—the Republic of Cuba had defaulted on them after the Communist Revolution of 1959—and they were taken off the market following Plaintiff's purchase.

In 2006, Plaintiff commenced arbitration before FINRA against Morgan Stanley and alleged the following: failure to deliver the bonds; breach of fiduciary duty; intentional misrepresentation; and negligence. Plaintiff requested the following relief: rescission of the sale of the bonds, compensatory damages, punitive damages, and interest at an annual rate of 10%. After a two-day evidentiary hearing in February 2008, the arbitration panel denied all of Plaintiff's claims. Plaintiff filed a timely appeal to vacate the award. Morgan Stanley countered with a motion to confirm the award.

Among other grounds for vacating the award, Plaintiff alleged that the arbitration panel exceeded their powers by manifestly disregarding the law by ignoring the fact that Morgan Stanley violated the law in purchasing and retaining the Cuban bonds.

Plaintiff alleged that the arbitrators, by their award, ratified a transaction that federal law declares is null and void and that, by doing so, the arbitrators acted in manifest disregard of that law. The federal law Plaintiff alleged the arbitrators ignored was the Cuban Assets Control Regulations ("Regulations"). That law prohibits transactions involving property in which Cuba has at any time had any interest of any nature whatsoever, direct or indirect. The following transactions are specifically prohibited under the terms of the Regulations: "all dealings in, including, without limitation, transfers, withdrawals, or exportations of, any property or evidences of indebtedness or evidences of ownership of property by any person subject to the jurisdiction of the United States." The Regulations further declare that "any transfer which is in violation of any provision of this part or of any regulation, ruling, instruction, license, or other direction or authorization thereunder and involves any property in which a designated national has or has had an interest is null and void and shall not be the basis for the assertion or recognition of any interest in or right, remedy, power or privilege with respect to such property."

As the sale of Cuban bonds constituted a transaction as defined by the Regulations, there was no doubt that the transaction between Plaintiff and Morgan Stanley was prohibited and null and void. Moreover, the FINRA Award indicated that the arbitrators recognized the relevant law, namely the Cuban Assets Control Regulations. In light of the arbitration panel's summary decision, the court concluded that the arbitrators, after recognizing the relevant law, ignored it. The court then held that the arbitrators exhibited a manifest disregard of the law and exceeded their powers under the Federal Arbitration Act.

As for damages, because the sale of the bonds was a voided contract and had no legal effect, and because Plaintiff paid Morgan Stanley consideration for the bonds, Plaintiff was entitled to recover the money it paid to the firm. That amount was $23,250. Furthermore, because Morgan Stanley enjoyed the benefit of those funds since the time of purchase in 1995, Plaintiff was also entitled to recover interest on the principal.

Vacatur: Challenging Fitness of Arbitrators

Penson Financial Services, Inc. v. Holland
No. CCB-09-3014 (D. Md. Feb. 18, 2010)

An arbitrator's inability to operate a tape recorder and prolonged silence during an evidentiary hearing do not demonstrate misconduct, partiality,

fraud or any sufficient lack of qualifications to justify setting aside an arbitration award under the Federal Arbitration Act.

Penson filed a claim in FINRA arbitration against its customer, Aaron Holland, in which it alleged Mr. Holland's failure to pay a debit balance in his account. Penson sought $214,661 in compensatory damages as well as interest, attorneys' fees, and costs. After a final hearing before three arbitrators in Baltimore, Maryland, the panel awarded Penson the full amount of compensatory damages, but did not award them interest, fees, or costs. When Penson filed an application to confirm the award, Mr. Holland opposed it *pro se*, alleging that (1) one of the arbitrators was mentally unfit to serve on the panel; (2) one of the arbitrators was replaced a day before the hearing, and Mr. Holland was not given an option in deciding who the next arbitrator would be; and (3) he wished he could have had a jury trial.

First, the court found that even if Mr. Holland's allegations regarding the arbitrator's silence and inability to operate a tape recorder were true, such facts do not satisfy the Federal Arbitration Act's requirements for setting aside an arbitration award. Next, the court found that Mr. Holland could not show he was prejudiced by the presence of a last-minute replacement arbitrator, and same was proper because FINRA Code of Arbitration Procedure Rule 12411 permits replacement of arbitrators under such scenarios. Finally, the court found that Mr. Holland waived his right to a jury trial by entering into the customer agreement that contained an enforceable arbitration agreement.

RECENT FINRA PUBLICATIONS

Regulatory Notice 10-05: Deferred Variable Annuities
FINRA Reminds Firms of Their Responsibilities under FINRA Rule 2330 for Recommended Purchases or Exchanges of Deferred Variable Annuities

FINRA Rule 2330, which is the new consolidated rule on deferred variable annuities, was implemented on February 8, 2010. Rule 2330 establishes sales practice standards regarding recommended purchases and exchanges of deferred variable annuities. More specifically, Rule 2330 contains recommendation requirements, including suitability and disclosure obligations, and provides for required supervisory and training for associated persons that deal in variable annuities.

Regulatory Notice 10-05 addresses a specific concern expressed by brokerage firms that may hold (or delay delivery of) an application for a deferred variable annuity and a customer's non-negotiated check payable to

an insurance company while it engages in mandated supervisory review, and prior to submission to the insurance company. FINRA clarifies that member firms will not violate Rule 2330 if submission delays are shorter than seven business days (during which time supervisory/principal review of the transaction is taking place), the associated person who recommended the transaction has taken reasonable steps to safeguard the customers check, and that OSJs have proper procedures in place to protect the check and application.

Regulatory Notice 10-09: Reverse Convertibles
FINRA Reminds Firms of Their Sales Practice Obligations with Reverse Exchangeable Securities (Reverse Convertibles)

FINRA issued Regulatory Notice 10-09 to remind brokerage firms of their suitability responsibilities when recommending investments in "reverse convertibles." Reverse convertibles are structured products, often sold as fixed income investments, which typically offer high yields (up to 25% is not unusual) to investors over a short maturity period (often a year or less). Reverse convertibles function similarly to a put option, as there is a risk that a full return of principal at the maturity date may be substituted by a predetermined number of shares of a reference asset. The value of such shares may be far below the purchaser's original investment. In most cases, the investor is entitled to receive his principal at maturity unless the price of the underlying reference asset falls to a certain level, known as the "knock-in" or "barrier" level, in which case the issuer may elect to put the shares on the investor in lieu of returning the investor's principal. Generally higher coupon rates indicate increased potential for volatility of the reference asset, which in turn means greater likelihood that the investor will end up owning shares of the reference asset upon maturity of the reverse convertible.

FINRA offers the following guidance to brokerage firms to help them comply with their suitability obligations when recommending reverse convertibles: Firms should consider whether purchases of reverse convertibles should be restricted to investors whose accounts have been approved for options trading, and whether it would be appropriate to apply the suitability requirements for option trading to those products, including the requirement for firms recommending opening transactions in options contracts to have reasonable grounds for believing that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating these risks. Firms that do not limit reverse convertibles to accounts approved for options trading should develop

other comparable procedures designed to ensure that these investments are sold only to persons for whom the risk is appropriate. These firms should be prepared to demonstrate the basis for allowing customers with accounts not approved for options trading to purchase reverse convertibles. Firms are also reminded that approving an account to trade reverse convertibles is not a substitute for a thorough suitability analysis.

FINRA also states that because reverse convertibles are complex investments that may be difficult for customers to understand, registered representatives should discuss the following with customers prior to the purchase:

- How the product works, including its payout structure, relevant information about the reference asset and, if applicable, that the investor will not participate in any appreciation in the value of the reference asset;
- The fact that the principal value of the investment is not guaranteed and the customer might suffer a loss on the investment;
- The ability of an investor to sell the product prior to maturity, and the potential sales price, may depend on the willingness of the issuer or another party to maintain a secondary market; and
- If applicable, the fact that the firm has published its own research reports regarding the reference asset, the content of that research, and how the research is or is not relevant to a recommendation to purchase or sell the reverse convertible.

Firms are additionally reminded that providing risk disclosure in a prospectus or supplement does not cure otherwise deficient disclosure in sales material, even if that sales material is accompanied or preceded by the prospectus or supplement. Further, firms and registered representatives should not suggest that reverse convertibles are ordinary debt securities, and may not suggest that a product's credit rating has any bearing on the expected performance of the reference asset.

Regulatory Notice 10-11: Deficient Claims
Amendments to the Arbitration Rules Regarding Deficient Claims
Effective Date: March 22, 2010

Effective March 22, 2010, the Codes of Arbitration Procedure for Customer and Industry Disputes are amended to clarify that if a claim deficiency is corrected within 30 days from the time a party receives notice of a deficiency, the claim will be considered filed on the date the initial statement of claim was filed.

Rules 12307 and 13307 of the Codes of Arbitration Procedure for Customer and Industry Disputes, respectively, had addressed deficient claims and provided that the Director of FINRA Dispute Resolution will not serve a claim that is deficient. The Rules were silent as to which date – the original date of filing or the date the deficiency was cured – would be used by FINRA as the record date of filing. As amended, Rules 12307(b) and 13307(b) provide that if a deficiency in the claim is properly cured within 30 days of notice of the deficiency, the claim will be considered filed on the original date of filing. This rule change will serve to help resolve issues concerning eligibility of claims for arbitration.

WHERE WE STAND

Historically, PIABA has commented on a number of issues[1], on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority ("FINRA").

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

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

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

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Scott Shewan, scottshewan@att.net, Peter J. Mougey, pjm@levinlaw.com or Robin S. Ringo, rsringo@piaba.org for assistance.

The following PIABA Comment Letter regarding *Release No. 34-6157/SR-FINRA-2009-075 – Proposed Rule Change to Amend THE Postponement Fee and Hearing Session Fee Rules of the Code of Arbitration Procedure for Customer and Industry Disputes* was submitted to the Securities and Exchange Commission by Scott R. Shewan on December 21, 2009.

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

RE: File Number SR-FINRA-2009-075

Dear Ms. Murphy:

I write on behalf of PIABA (Public Investors Arbitration Bar Association) to comment on SR-FINRA-2009-075. The proposal involves two rule changes. Both relate to fees to be paid by parties in arbitration. The first would provide that the late postponement fee not be waived if the parties request a postponement within three business days before the scheduled hearing session. The second would codify FINRA's current internal practice of charging $450 per hearing session for a single-arbitrator case with an unspecified damage claim.

We oppose both rule changes. We understand that these rules are purportedly intended to clarify existing practice. However, we oppose any rule which would result in higher fees to the customer in a FINRA arbitration proceeding.

Moreover, we believe that the proposed rule changes are based upon a faulty premise. That premise (and the premise under which FINRA operates in general) is that there should be a connection between whether (and in what amount) a party pays a fee/penalty and whether (and in what amount) an arbitrator receives a payment for the arbitrator's service to the forum. This premise is faulty, irrational, and cannot be justified by any of the purposes for which FINRA was ostensibly created and authorized to resolve customer disputes.

We believe that it is reasonable for arbitrators to receive a fair payment for their service and for their setting aside time in their schedules for the arbitration hearings. It is not reasonable, or justifiable, to create a direct

connection between the amounts the arbitrators are paid and whether the litigants comply with FINRA timelines, such as whether notice of postponement is provided within a certain period of time.

It is in the best interest of investors, and the public, that FINRA not impose an impediment to resolution by penalizing the parties for settling the case at the last minute. It is not uncommon for the parties to reach a resolution of their case just as they are ready to go to hearing. Settlements should be encouraged, even if they happen at the eleventh hour. This is the purpose of waiving postponement fees when the reason for the postponement is the parties' desire to engage in FINRA mediation. If late postponement fees are to be assessed, they should be assessed against the industry respondent; after all, it was the respondent which could have paid a settlement earlier and avoided the inconvenience to the panel.

With respect to the second proposed rule change, it does not seem to be fair or reasonable to charge a hearing session fee of $450 for one arbitrator while a charge of $1,000 is made for three arbitrators. However, a greater issue subsumes this one. In a system where mandatory pre-dispute arbitration is the rule and where the customer/investor has no choice of forum, the cost to access the forum should be nominal. The costs of the operation of the forum (including the payment to arbitrators) should be borne by the entity that benefits the most from the SRO arbitration system, i.e., FINRA and its member firms.

Even more to the point, postponement fees are an unfair burden on the parties to an arbitration proceeding, especially the customer claimants who generally have far less financial wherewithal to pay exorbitant fees for a postponement. Postponements can be necessitated for a number of reasons, including unexpected illnesses and family emergencies. It is unfair and inappropriate to penalize the parties for matters which are completely outside their control. Postponement fees should be abolished altogether.

Thank you for your consideration of our concerns.

Very truly yours,
Scott R. Shewan
President

The following PIABA Comment Letter regarding *Release No. 34-61060/File No. SR-FINRA-2009-072 (Proposed Rule Change to Amend the Deficient Claims Rules)* was submitted to the Securities and Exchange Commission by Scott R. Shewan on December 17, 2009.

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

Re: Release No. 34-61060; File No. SR-FINRA-2009-072 (Proposed Rule Change to Amend the Deficient Claims Rules)

Dear Ms. Murphy:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") in support of the above-referenced proposed amendment to FINRA Rule 12307(b) of the Customer Code of Arbitration Procedure. The proposed rule change would clarify that claims of public investors will be deemed filed upon the initial filing date, if the customer cures certain filing deficiencies within thirty (30) days of notice from FINRA of that deficiency. PIABA believes the proposed rule change will advance the goal of investor protection, and accordingly urges adoption of this proposed change as written.[1]

PIABA is a group of approximately 450 attorneys, including several law school clinic professors, who primarily represent defrauded and aggrieved individual investors against broker-dealers and their registered representatives. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Collectively, PIABA members have represented tens of thousands of investors in securities arbitrations through the country. Our members and their clients have a strong interest in all FINRA rules which govern the arbitration process.

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[1] A corresponding rule change is proposed within SR 2009-072 for filings under the Industry Code of Arbitration Procedure. PIABA has no objection to that portion of the proposal. However the comments herein are directed solely at the proposal as relates to the Customer Code of Arbitration Procedure.

The proposed amendment of FINRA-DR Rule 12307(b) of the Customer Code seeks to codify that any deficient claims will be deemed to have been filed on the original filing date if they are cured within thirty days of notification of a deficiency from the director of the tribunal. Adoption of this rule change will provide much needed clarity to recurring questions concerning when a claim is deemed filed.

Deficiency letters are routinely issued to even the most seasoned claimant attorneys. Some of the deficiency letters pertain to relatively trivial matters as compared to the importance of an investor victim attempting to submit his request for relief. We are pleased that FINRA is addressing these processing issues in this rule proposal with a view to equitably serving the interests of public investors.

In addition to filing a statement of claim with FINRA-DR to commence an arbitration proceeding, claimants are required to submit a Uniform Submission Agreement and tender of the applicable filing fee. Additionally, some states, such as California, require that an out of state attorney also file a certificate from a state bar association approving the appearance. In the event that the local FINRA-DR office deems the forms or information and fees submitted with the filing to be insufficient, the statement of claim is not served upon the respondent and a deficiency notice is served upon the claimant requesting that any deficiency be cured within thirty days.

FINRA-DR often identifies deficiencies with the Uniform Submission Agreement. In some cases, it may be that the Uniform Submission Agreement does not identify the most current title of a corporate respondent (a common problem with the recent spate of mergers and consolidations in the industry), or that a CRD number is needed for an individual respondent with a common name. Other times, it is claimed that the inappropriate individual signed the Uniform Submission Agreement in the case of a trust or corporation, or that additional claimant signatures are needed on the form. Additionally, Uniform Submission Agreements are sometimes rejected for being illegible or for being facsimile copies. We believe it likely that *pro se* claimants understandably encounter additional problems in finalizing their forms and papers in accordance with FINRA requirements.

Likewise, questions often arise with respect to the filing fees paid in connection with the filing of the claim. Generally, filing fees are assessed depending upon the amount in controversy. However, FINRA-DR staff sometimes questions the amount in controversy and requests a higher filing fee. The request for an additional fee can also result in the issuance of a deficiency letter.

The filing date of a statement of claim can have a crucial bearing on the claims asserted with respect to eligibility requirements and the statute of

limitations.[2] Under the current rule, there has been no uniform standard applied at FINRA-DR as to the filing date to be utilized, i.e., the initial filing date or the date on which the deficiency was cured. The rule amendment properly seeks to clarify that the filing date to be utilized is the original filing date.

The proposed rule amendment is consistent with the overarching investor protection goals of Section 15A(b)(6) of the Securities Exchange Act. 15 U.S.C. 78o-3(b)(6).

We applaud FINRA's thoughtful attention to the issues herein. We submit that the Commission should adopt the proposed rule changes as written. Thank you for the opportunity to provide comments in this matter.

Respectfully,
Scott R. Shewan
President

2. PIABA has long maintained that statutes of limitations do not apply in arbitration proceedings. Nonetheless, the issue is commonly raised and argued in the context of securities arbitration.