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SECURITIES AND COMMODITIES MANIPULATION: IS THERE A PRINCIPLED REASON TO DISTINGUISH THE TWO?

Amanda N. Miller[1]

I. INTRODUCTION

Both the Securities Exchange Act of 1934 ("'34 Act") and the Commodity Exchange Act ("CEA") were passed in part to protect the integrity of the markets by prohibiting market manipulation. Congress did not define the term 'manipulation' under either Act, thus leaving it to the courts to define securities and commodities manipulation. The courts have defined manipulation differently in light of each Act's distinct anti-manipulation provisions. However, problems have emerged when plaintiffs allege market manipulation by means of legitimate transactions or trading strategies. A split has appeared in the Southern District of New York in the context of commodities manipulation on this very issue – whether legitimate transactions can form the basis of a claim for commodities manipulation. Judge Scheindlin, in attempting to grapple with this issue, has actually redefined commodities manipulation to reflect aspects of the definition of securities manipulation. This paper begins by briefly examining the different functions of the securities and commodities markets, which the anti-manipulation laws were designed to protect. Then, it compares the definitions of securities and commodities manipulation and examines Judge Scheindlin's opinion in *In re Amaranth Natural Gas Commodities Litigation,* which conflates the two definitions. The argument is then made that there is a principled reason to distinguish commodities manipulation from securities manipulation. Finally, a solution is offered for how to analyze commodities manipulation claims based on legitimate transactions.

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II. FUNCTIONS OF THE SECURITIES AND FUTURES MARKETS

The securities markets are really comprised of two interrelated markets – the distribution market and the secondary markets. The distribution market allows businesses to raise capital through the initial public offerings of their securities and the secondary markets provide a marketplace for the purchase and sale of these securities after they have been initially offered to the public.[2] The economic function of the secondary or trading markets is to create liquidity in order to execute customers' orders to buy or sell securities at a price related to the price of the preceding transaction. The distribution market depends on the efficient functioning of the secondary trading markets because prospective purchasers buy new issues of securities only if they have a reasonable assurance of liquidity.[3] The efficiency of these markets is important because market prices are often used as governors of conduct.[4] If a person has an interest in a security, he or she will base his or her investment decisions upon its value.[5] For example, a company trading its own stock in order to acquire another business may agree to deliver more stock if its market price drops.[6] Therefore, if security prices are manipulated, the reported prices will not reflect the true value. People who define their contractual obligations by reference to market prices and those subject to regulatory schemes, which contemplate market efficiency and integrity, find that their rights and obligations fluctuate in response to irrelevant factors.[7]

Futures markets perform price discovery for various market participants who buy or sell a commodity on the cash market.[8] When futures markets are

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2. Therese H. Maynard, *What is an "Exchange?"-Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange*, 49 WASH. & LEE L. REV. 833, 840 (1992).

3. *Id.*

4. Steve Thel, *Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934*, 1988 COLUM. & BUS. L. REV. 359, 369 (1988).

5. *Id.*

6. *Id.*

7. *Id.* at 370.

8. "The market for the cash commodity (as contrasted to a futures contract) taking the form of: (1) an organized, self-regulated central market (e.g., a commodity exchange); (2) a decentralized over-the-counter market; or (3) a local organization, such as a grain elevator or meat processor, which provides a market for a small region." CFTC Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter/glossary/glossary_c.html (last visited Apr. 26, 2009).

functioning properly at the close of trading in the futures contract,[9] the price of the future contract corresponds closely to the price of the cash commodity that will satisfy delivery.[10] "Price discovery allows investors to know, at any given time, the value of a commodity by simply looking at the prices on a board of trade."[11] Commodity futures trading also allows for hedging. Hedging is when an individual or business buys or sells a futures contract to protect itself against adverse price changes in the cash market.[12] Hedging necessitates the need for speculators because a hedge acts as insurance against adverse price changes and, because hedgers avoid risk, there must be someone to take the other side of their position.[13] Speculators are an integral part of the functioning of futures markets, providing active, liquid, and competitive markets.[14] Futures markets are operating efficiently when prices reflect as closely as possible the market factors of supply and demand. Therefore, manipulated prices - prices that do not reflect supply and demand - prevent futures markets from performing its basic functions, thus diminishing the utility of these markets to anyone who relies on or uses them.[15]

In order to protect the functioning of the securities and futures markets Congress passed the Securities Exchange Act of 1934 and the Commodity Exchange Act, which became law in 1974. The following section addresses each Act, focusing on their respective anti-manipulation provisions and compares how the courts have defined securities and commodities manipulation.

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9. *See* Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter/glossary/glossary_f.html#futurescontract (last visited Apr. 26, 2009) (defining "futures contract").

10. *Cargill, Inc. v. Hardin,* 452 F.2d 1154, 1157 (8th Cir. 1971).

11. Jerry W. Markham, *Manipulation of Commodity Futures Prices-The Unprosecutable Crime*, 8 YALE J. ON REG. 281, 287 (1991).

12. NATIONAL FUTURES ASSOCIATION, OPPORTUNITY AND RISK: AN EDUCATIONAL GUIDE TO TRADING FUTURES AND OPTIONS ON FUTURES 6, http://www.nfa.futures.org/investor/OppRisk/OppRisk.pdf.

13. *Cargill, Inc.*, 452 F.2d at 1158.

14. NATIONAL FUTURES ASSOCIATION, *supra* note 12, at 7.

15. *Cargill, Inc.*, 452 F.2d at 1158.

III. SECURITIES MANIPULATION

a. Definition is Deceit-Based

On October 29, 1929, also known as Black Tuesday, the stock market crashed, exposing numerous frauds in its aftermath.[16] The initial post-crash legislation, the Securities Act of 1933, was designed to provide investors with full disclosure of material information in connection with initial public offerings, to protect investors from fraud, and to promote honesty and fair dealing.[17] The Securities Exchange Act of 1934 ("'34 Act") was then enacted to protect investors against manipulation and control of stock prices, which Congress and the general public felt contributed to the stock market crash.[18] Section 10(b)[19] of the '34 Act gives the Securities and Exchange Commission ("SEC") the power to regulate manipulative *and* deceptive devices that disrupt the marketplace or harm investors.[20] Section 10(b) therefore prohibits both manipulation and fraud. In order to carry out the authority Congress granted the SEC under the '34 Act, the SEC promulgated Rule 10b-5 entitled "Employment of Manipulative and Deceptive Devices," which in pertinent part states "it shall be unlawful for any person . . . to employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security."[21] Neither Section 10(b) nor Rule 10b-5 defines manipulation, Rule 10b-5 does not even mention manipulation, but rather is couched in terms of fraud or deceit.[22] Thus, the Supreme Court, in defining securities manipulation, has limited it to those devices that act to

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16. Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 91 (2003).
17. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).
18. 15 U.S.C. § 78b(3), (4) (2009). *See also* Thel, *supra* note 4, at 362.
19. Section 10(b) entitled "Manipulative and deceptive devices" makes it "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 to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary." 15 U.S.C. § 78j (2009). Section 10(b) prohibits both manipulation and fraud.
20. Lawrence D. McCabe, *Puppet Masters or Marionettes: Is Program Trading Manipulative as Defined by the Securities Exchange Act of 1934?*, 61 FORDHAM L. REV. 207, 223 (1993).
21. 17 C.F.R. § 240.10b-5(a) (2009); s*ee also* 17 C.F.R. § 240.10b-5(c) (2009).
22. 17 C.F.R. § 240.10b-5 (2009).

deceive or defraud investors.[23] The Supreme Court, in each of the following cases, found that if the challenged conduct fell within the scope of Section 10(b), it was because the conduct was deceptive. The Supreme Court, in defining manipulation, injected the element of fraud into the definition of securities manipulation.[24]

In *Ernst & Ernst v. Hochfelder*,[25] the Supreme Court stated that manipulation is a "term of art" and "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[26] The Court relied on the 1934 edition of Webster's International Dictionary in defining manipulation.[27] In *Santa Fe Industries, Inc. v. Green*,[28] the Court, in examining a challenge by minority shareholders to a short-form merger,[29] held the alleged breach of fiduciary duty was not manipulative within the meaning of Section 10(b): "[t]he term ['manipulation'] refers generally to practices, such as wash sales,[30] matched orders,[31] or rigged prices, that are intended to mislead investors by artificially affecting market activity."[32] The Court further stated practices "artificially affecting market activity in order to mislead investors is fully consistent with the fundamental purpose of the 1934 Act 'to substitute a philosophy of full disclosure for the philosophy of caveat emptor.' Indeed, nondisclosure is usually essential to the success of a manipulative scheme."[33] The Court again found that manipulation requires a finding of deceit.[34] The Court further blurred the line between manipulation and fraud and secured deception as a necessary element of manipulation in *Chiarella v. United*

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23. McCabe, *supra* note 20, at 234.
24. Thel, *supra* note 4, at 383.
25. 425 U.S. 185.
26. *Id.* at 199.
27. *Id.* at 199 n. 21.
28. 430 U.S. 462, (1977).
29. A short-form merger is a merger that proceeds without shareholder approval. http://www.beechmontcrest.com/short-form_merger.htm (last visited Apr. 26, 2009).
30. "'Wash' sales are transactions involving no change in beneficial ownership." *Ernst & Ernst*, 425 U.S. at 205 n.25.
31. "'Matched' orders are orders for the purchase sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security." *Id.*
32. *Sante Fe Industries*, 430 U.S. at 476.
33. *Id.* at 477.
34. McCabe, *supra* note 20, at 225.

States,[35] noting that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."[36] In 1985, the Court extended its deceit-based definition of manipulation, to all cases arising under the '34 Act.[37] Today, in order to prove manipulation an injured investor must show deception for the '34 Act to provide relief.[38]

b. Elements of Securities Manipulation: What Constitutes a Manipulative Act?

In order for a plaintiff to make out a claim for securities manipulation under Section 10(b), she must allege "(1) manipulative acts; (2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange."[39] As previously stated, market manipulation "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[40] "Such conduct, closely resembling fraud, is patently manipulative, serving no purpose other than to transmit false information to the market and artificially affect prices.[41] The defendant's manipulative intent is therefore inferred from the conduct itself.[42]

Unlike wash sales,[43] for example, which are specifically prohibited under the '34 Act and are inherently manipulative,[44] legal trading activity poses greater difficulties. In cases involving otherwise legal trading activity (open-market cases), such as short sales and large or carefully timed purchases or

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35. 445 U.S. 222 (1980).
36. *Id.* at 234-35. *See also* Thel, *supra* note 4, at 386.
37. *See* Schreiber v. Burlington N., Inc., 472 U.S. 1, 5-8 (1985).
38. McCabe, *supra* note 20, at 225.
39. ATSI Communications, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 101 (2nd Cir. 2007).
40. *Sante Fe Industries*, 430 U.S. at 476.
41. SEC v. Masri, 523 F.Supp.2d 361, 367 (S.D.N.Y. 2007).
42. *Id.*
43. "'Wash' sales are transactions involving no change in beneficial ownership." *Ernst & Ernst*, 425 U.S. at 205 n.25.
44. "Section 9(a)(1) of the 1934 Act proscribes wash sales and matched orders when effectuated '(f)or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or . . . with respect to the market for any such security.'" *Id.*

sales of stock, "the transaction is real, to the extent the beneficial ownership is changing and the volume of trading is reflective of market activity."[45] The question is how do the courts distinguish legitimate trading strategies from those designed to manipulate and deceive?[46] The circuit courts are split on whether manipulative intent alone is sufficient to turn a legitimate act into a manipulative one, or whether there needs to be additional fraudulent conduct. The Third Circuit, in *GFL Advantage Fund, Ltd. v. Colkitt,*[47] held that legal conduct combined with only manipulative intent did *not* violate the '34 Act, but required additional deceptive or fraudulent conduct.[48] The court stated that such evidence could include unauthorized placements and parking of stock, secret sales without disclosing the real party in interest, guaranteeing profits to encourage short selling by others, fraudulently low appraisals, "painting the tape," and matched orders.[49] However, in *Markowski v. SEC,*[50] the Court of Appeals for the District of Columbia Circuit rejected the defendants' argument that they could not be convicted of market manipulation based on legal transactions because their bids and trades were "real."[51] The court upheld a SEC order sustaining a disciplinary action based on the defendants' conduct because it appeared that Congress determined that manipulation could be "illegal solely because of the actor's purpose."[52]

The Second Circuit in *ATSI Communications, Inc. v. Shaar Fund, Ltd.,*[53] held that short selling in high volumes is not, by itself, manipulative: "[t]o be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security. Similarly, purchasing a floorless convertible security is not, by itself or when coupled with short selling, inherently manipulative."[54] According to the court, a floorless convertible security, which is a legitimate investment vehicle, does not give rise to a strong inference of scienter by creating an opportunity for profit through manipulation.[55] "These circumstances are present for any investor in floorless convertibles. Accordingly, there is a 'plausible nonculpable explanation[ ]' for the

45. *Masri*, 523 F.Supp.2d at 367.
46. *Id.*
47. GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189 (3rd Cir. 2001).
48. *Id.* at 205.
49. *Id.* at 207-08.
50. 274 F.3d 525, (D.C. Cir. 2001).
51. *Id.* at 527-28.
52. *Id.* at 529.
53. 493 F.3d 87, (2nd Cir. 2007).
54. *Id.* at 101.
55. *Id.* at 104.

defendants' actions that is more likely than any inference that the defendants intended to manipulate the market."[56] Therefore, the court held that because ATSI did not adequately plead that the defendants engaged in any potentially manipulative activity, there was no circumstantial evidence of manipulative intent.[57] However, four months later in *SEC v. Masri*[58] the Southern District of New York recognized that the timing of high-volume, end-of-day open-market transactions is "more capable of artificially affecting the price of the security."[59] The court therefore rejected *GFL Advantage Fund, Ltd.* and held that "if an investor conducts an open-market transaction with the intent of artificially affecting the price of the security, and not for any legitimate economic reason, it can constitute market manipulation."[60] Furthermore, it held that allegations of other deceptive conduct are required only to the extent that they render plausible allegations of manipulative intent.[61]

IV. COMMODITIES MANIPULATION

a. Definition of Manipulation: Deceit Not Required

In 1974, Congress passed the Commodity Futures Trading Commission Act ("CFTCA"). The CFTCA created the Commodity Futures Trading Commission ("CFTC"), an independent regulatory agency with exclusive jurisdiction over commodity futures and options trading. The CFTC was created to ensure the integrity of the futures markets and to protect the public and market users from the evils of manipulation and fraud.[62] The Commodity Exchange Act ("CEA"), unlike the '34 Act, prohibits fraud and manipulation in separate sections.[63] Section 13(a)(2) of the CEA makes it unlawful for

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56. *Id.* (citation omitted).
57. *Id.*
58. 523 F.Supp.2d 361 (S.D.N.Y. 2007).
59. *Id.* at 369-70.
60. *Id.* at 372.
61. *Id.*
62. *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation? Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Energy and Commerce*, 110th Cong. 1 (Dec. 12, 2007), http://energycommerce.house.gov/cmte_mtgs/110-oi-hrg.121207.Lukken-Testimony.pdf (written testimony of Walter Lukken, Acting Chairman, Commodity Futures Trading Comm'n).
63. *See* 7 U.S.C. § 6b (2009) (general antifraud provision); 7 U.S.C. § 13(a)(2) (2009) (anti-manipulation provision).

"any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity."[64] However, like the '34 Act, the CEA does not define manipulation, but rather leaves it up to the courts.[65] The Seventh Circuit in *General Foods Corp. v. Brannan,*[66] stated that although there are many definitions of manipulation, "[p]erhaps as good as any is one of the definitions which appears in the government's brief, wherein it is defined as 'the creation of an artificial price by planned action, whether by one man or a group of men.'"[67] In *Frey v. Commodities Futures Trading Commission,*[68] the Seventh Circuit again defined manipulation as an "intentional exaction of a price determined by forces other than supply and demand."[69]

In contrast to securities manipulation, which requires that the manipulator intend to deceive investors, the intent required for commodities manipulation is very different.[70] Commodities cases focus on intent to create an artificial price.[71] In *In re Indian Farm Bureau Coop. Ass'n*,[72] the Commission stated that the intent required for a manipulation is "the performance of an act or conduct which was intended to effect an artificial price."[73] Absent intent to manipulate commodity prices there is no violation of the CEA:

> [M]arket participants have a right to trade in their own best interests without regard to the positions of others as long as their trading activity does not have as its purpose the creation of

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64. 7 U.S.C. § 13(a)(2) (2009).

65. Indiana Farm Bureau Coop. Ass'n, Inc., CFTC No. 75-14, 1982 WL 30249 at *3 (1982).

66. General Foods Corp. v. Brannan, 170 F.2d 220 (7th Cir. 1948).

67. *Id.* at 231.

68. 931 F.2d 1171 (7th Cir. 1991).

69. *Id.* at 1175. This definition appears to be a recitation of the one given by Arthur R. Marsh, the former president of the New York Cotton Exchange, in a hearing before a Senate subcommittee in 1928: "Manipulation, Mr. Chairman, is any and every operation or transaction or practice, the purpose of which is not primarily to facilitate the movement of the commodity at prices freely responsive to the forces to supply and demand; but, on the contrary, is calculated to produce a price distortion of any kind in any market either in itself or in its relation to other markets." Indiana Farm Bureau Coop. Ass'n, Inc., 1982 WL 30249 at *3.

70. This difference has been recently called into question by the Southern District of New York, and is the subject of a subsequent section of this paper.

71. *McCabe*, *supra* note 20, at 227.

72. Indiana Farm Bureau Coop. Ass'n, Inc., CFTC No. 75-14, 1982 WL 30249.

73. *Id.* at *4 (quoting *In re Hohenberg Brothers*, [1975-1977 Transfer Binder] COMM. FUT. L REP. (CCH) ¶ 20,271 (Feb. 18, 1977)).

> 'artificial' or 'distorted' prices. [I]t is this very motivation which gives lifeblood to the forces of supply and demand, the makes the price discovery function of the marketplace viable.[74]

The intent required for commodities manipulation highlights another area of departure from securities manipulation – the injury. Under securities manipulation, the manipulator intends to deceive the investor; therefore the injury is to the investor. Whereas under commodities manipulation, the manipulator intends to cause an artificial price, thus the injury is to the market.[75] This point is underscored by the fact that whether a manipulator profited is irrelevant "for the economic harm done by manipulation is just as great whether there has been a profit or a loss in the operation."[76]

b. Elements of Commodities Manipulation: No Manipulative Act Required

To state a claim for manipulation under the CEA the plaintiff must allege "(1) the defendant possessed an ability to influence market prices; (2) an artificial price existed; (3) the defendant caused the artificial price; and (4) the defendant specifically intended to cause the artificial price."[77] Unlike the elements of securities manipulation, a plaintiff pleading commodities manipulation does not need to prove that her damages were caused by a reliance on the assumption of an efficient market or manipulative acts such as wash sales. There are however certain well-known manipulative devices in the context of commodities manipulation, such as the "squeeze,"[78] and a "corner."[79] When plaintiffs allege manipulation based on these theories,

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74. *Id.* at *5.

75. *See id.* (rejecting general intent as the standard for manipulative intent because the Commission was "unable to discern any justification for a weakening of the manipulative intent standard which does not wreak havoc with the market place); McCabe, *supra* note 20, at 228 ("[I]n securities cases, the investor is injured. In commodities cases, the market is injured.").

76. *Cargill, Inc.*, 452 F.2d at 1163.

77. In re Amaranth Natural Gas Commodities Litig., 587 F.Supp.2d 513, 530 (S.D.N.Y. 2008).

78. A squeeze is "[a] market situation in which the lack of supplies tends to force shorts to cover their positions by offset at higher prices." CFTC Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter /glossary/glossary_s.html#squeeze (last visited Apr. 25, 2009).

79. A corner, on the other hand, is defined as "(1) [s]ecuring such relative control of a commodity that its price can be manipulated, that is, can be controlled by

courts look to the defendant's ability to control parts of the market to satisfy the first element of a manipulation claim. For example in *Peto v. Howell*,[80] in determining that the defendant cornered the corn market, the court looked at whether the defendant purchased long contracts[81] in excess of the known deliverable supply.[82] The court found that the defendant accumulated a long position of 8.5 million bushels of corn, of which 7 million bushels were to be delivered to the defendant. These 7 million bushels constituted 97% of the deliverable supply of corn in Chicago and 90% of the deliverable supply of corn in the entire country. There remained 1.5 million bushels of futures that could not be satisfied by delivery. Thus, the defendant had the ability to control and ultimately to corner the corn market by demanding an arbitrarily high price in settlement of the contracts that could not be satisfied by delivery.[83]

However, plaintiffs are neither confined to allegations of a squeeze or a corner, nor to allegations that the defendant possessed the ability to control parts of the market.[84] In *In re Soybean Futures Litigation,*[85] the plaintiffs did

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the creator of the corner; or (2) in the extreme situation, obtaining contracts requiring the delivery of more commodities than are available for delivery." CFTC Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter /glossary/glossary_co.html#corner (last visited Apr. 25, 2009). *See also Cargill, Inc.*, 452 F.2d at 1162 (stating that "[i]n its most extreme form, a corner amounts to nearly a monopoly of a cash commodity, coupled with the ownership of long futures contracts in excess of the amount of that commodity, so that shorts-who because of the monopoly cannot obtain the cash commodity to deliver on their contracts-are forced to offset their contract with the long at a price which he dictates, which of course is as high as he can prudently make it.").

80. 101 F. 2d 353 (7th Cir. 1938).

81. Long is defined as "(1) One who has bought a futures contract to establish a market position; (2) a market position that obligates the holder to take delivery; (3) one who owns an inventory of commodities." Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter/glossary/glossary_l.html (last visited Apr. 26, 2009).

82. Short is defined as "(1) The selling side of an open futures contract; (2) a trader whose net position in the futures market shows an excess of open sales over open purchases." Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter/glossary/glossary_s.html#short (last visited Apr. 26, 2009).

83. *Cargill, Inc.,* 452 F.2d at 1162 n.8.

84. "The methods and techniques of manipulation are limited only by the ingenuity of man." *Id.* at 1163.

85. 892 F.Supp 1025 (N.D. Ill. 1995).

not allege a squeeze or a corner, but "manipulation-by-false reports." The plaintiffs alleged that the defendants were able to inflate prices by misleading regulators about their processing and export requirements. This then exaggerated the market's demand for soybeans and artificially inflated prices.[86] Thus, the Northern District of Illinois distinguished cases involving squeezes and corners and declined to require that plaintiffs prove that the defendants controlled parts of the market. Similarly, in *CFTC v. Enron Corp.,*[87] the Southern District of Texas found that the CFTC sufficiently alleged that the defendants had the ability to influence prices without looking to the defendants' ability to control parts of the market. Specifically, the CFTC alleged that Enron's electronic trading platform was the dominant platform for trading in Henry Hub next-day gas spot market. Enron's platform accounted for 40% of the average daily volume of trading in that market, market participants routinely looked to Enron's platform for pricing information, and defendants bought a very large amount of gas in the Henry Hub spot market within about fifteen minutes, causing prices to rise artificially.[88]

Although the plaintiff is not required to allege a "manipulative act," a similar question to the one *ATSI* and *Masri* struggled to answer exists here - how do the courts distinguish legitimate transactions from those designed to create an artificial price? The answer should be simple – intent. "To establish intent, 'it must be proven that the accused acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand."[89] Similar to securities manipulation, "manipulative intent must normally be shown inferentially from the conduct of the accused."[90] This conduct can be based on misleading statements or omissions, or on a particular trading strategy.[91] Thus, the type of conduct alleged is extremely important because the plaintiff may or may not have to comply with the heightened pleading requirements of Rule 9(b).[92] This issue is irrelevant when alleging securities

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86. *Id.* at 1046.

87. 2004 WL 594752 (S.D. Tex. 2004).

88. *Id.* at *5.

89. CFTC v. Amaranth Advisors, LLC, 554 F.Supp.2d 523, 532 (S.D.N.Y. 2008).

90. *Enron Corp.*, 2004 WL 594752 at *7.

91. *Amaranth Advisors, LLC*, 554 F.Supp.2d at 531.

92. Rule 9(b) requires that in "alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud." Fed.R.Civ.P. 9(b). The complaint must set forth "to the extent possible, what manipulative acts were performed, which defendants performed them, when the manipulative acts were

manipulation because the element of intent involved requires a plaintiff to plead fraud. Therefore she will always be subject to Rule 9(b). However, a split has emerged in the Southern District of New York, in which Judge Scheindlin has redefined commodities manipulation, making it more akin to the definition of securities manipulation. This could have devastating consequences for the CFTC and future plaintiffs, and underscores the need to maintain the difference in how courts have consistently defined securities and commodities manipulation.

c. Split in the Southern District of New York

As previous sections of this paper have explained, there is a difference between how courts have defined manipulation under the '34 Act and the CEA. Manipulation in the context of Section 10(b) and Rule 10b-5 is a "term of art" and "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[93] Thus, in the securities world, manipulation has taken on a deceit-based definition and requires intent to defraud investors. Therefore, when pleading securities manipulation, it is clear that one needs to meet the heightened pleading standard of Rule 9(b), because a claim for securities manipulation *is* a claim for fraud.[94]

In contrast to securities manipulation, there is no mention of fraud in the courts' definition of commodities manipulation, nor is there any concern with deceiving investors. Manipulation is defined by the courts under Section 13(a)(2) of the CEA as "the creation of an artificial price by planned action,

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performed, and what effect the scheme had on the market for the securities at issue." *In re Amaranth Natural Gas Commodities Litig.,* 587 F.Supp.2d at 535 (footnote omitted). Rule 8(a), on the other hand, is the more liberal pleading standard and requires only "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed.R.Civ.P. 8(a)(2). *See also Bell Atl. Corp. v. Twombly*, 127 S.Ct. 1955 (2007) and *Iqbal v. Hasty*, 490 F.3d 143, 157-58 (2nd Cir. 2007) (requiring "plausibility," which "obligates a pleader to amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim *plausible*.").

93. *Ernst & Ernst*, 425 U.S. at 199.

94. *ATSI Communications, Inc.*, 493 F.3d at 101; s*ee also Internet Law Library v. Southridge Capital Mgmt*., 223 F.Supp.2d 474, 486 (S.D.N.Y. 2002) (stating "[t]he essence of a market manipulation claim is the allegation of conduct intended to deceive or defraud investors by conditioning or artificially affecting the market for securities.").

whether by one man or a group of men."[95] As a result, the focus in the context of commodities manipulation is whether the defendant intended to cause an artificial price. The Southern District of New York, in both *In re Crude Oil Commodity Litigation*[96] and *In re Natural Gas Commodity Litigation,*[97] has followed a "case-specific approach" by determining whether the alleged manipulative scheme sounds in fraud, thus necessitating the application of Rule 9(b). In *In re Crude Oil Commodity Litigation,* the court found that Rule 9(b) applied to the manipulation claim stating:

> Plaintiffs allege[d] that defendants unlawfully conspired with other market participants 'to *conceal* the availability, release and/or sale' of defendants' supplies of crude oil and Cushing, and also used proxies to sell their crude oil inventories 'so as to *not appear* to the market as a seller of crude oil' and 'to support their manipulative acts and conceal such from the marketplace.' Further, plaintiffs do assert that defendants made false or misleading statements in support of their claims of manipulation.[98]

The court concluded its analysis by pointing out "the crux of plaintiffs' allegations [were] that defendants misled the market with regard to supply and demand at Cushing by concealing its capacity and its actions, resulting in artificial prices."[99] In *In re Natural Gas Commodity Litigation,* the court also applied Rule 9(b) to the manipulation claim, even though the complaint did not allege fraud because "it allege[d] a scheme that is 'classically associated with fraud': the dissemination of *'inaccurate, misleading,* and *false trading information,'* and participation in 'a variety of *fraudulent* trade reporting strategies whose purpose was . . . to manipulate the spot prices of natural gas.'"[100]

Another more recent case from the Southern District, *CFTC v. Amaranth Advisors, LLC*,[101] continued to follow this "case-specific approach" in determining whether a claim for attempted manipulation under the CEA should be pled with particularity in accordance with Rule 9(b). Unlike the two cases previously mentioned, the court held that the liberal pleading standards of Rule 8(a) applied. "The CFTC allege[d] that defendants

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95. *General Food Corp*., 170 F.2d at 231.
96. 2007 WL 1946553 (S.D.N.Y. 2007).
97. 358 F.Supp.2d 336 (S.D.N.Y. 2005).
98. 2007 WL 1946553, at *5.
99. *Id.*
100. 358 F.Supp.2d at 343.
101. 554 F.Supp.2d 523 (S.D.N.Y. 2008).

intended to create artificial prices of natural gas futures contracts by deliberately waiting to sell a substantial number of futures contracts in the closing range on expiration date."[102] The court then distinguished this case from *In re Crude Oil* and *In re Natural Gas,* stating that "[h]ere, the CFTC's theory of attempted manipulation . . . is not based on false statements of fact intended to deceive a buyer or seller, but on the timing of trades intended to change the closing price."[103]

A few months later in *In re Amaranth Natural Gas Commodities Litigation,*[104] a split emerged within the Southern District. Instead of following the "case-specific approach" that the district had in the past, Judge Scheindlin redefined commodities manipulation. At issue were two types of transactions: (1) Amaranth's manipulation by buying and holding large positions; and (2) by selling large quantities of futures during the settlement period.[105] In addressing the question of whether simply buying and selling futures contracts in large quantities can constitute market manipulation, the court turned to *ATSI*. *ATSI* held that short selling securities even in large quantities is not by itself manipulative, but must be "willfully combined with something more to create a false impression of how market participants value a security."[106] Judge Scheindlin then found that *ATSI*'s logic applies to the commodities markets:

> Just as with securities, commodities manipulation *deceives* traders as to the market's true judgment of the worth of the commodities. . . . [E]ntering into futures contracts or swaps, without more, cannot constitute commodities manipulation. If a trading pattern is supported by a legitimate economic rationale, it cannot be the basis for liability under the CEA because it does not send a false signal. There must be 'something more,' some additional factor that causes the dissemination of false or misleading information.[107]

The court stated that this "something more" does not have to be a misrepresentation, but rather intent. "Because every transaction signals that the buyer and seller have legitimate economic motives for the transaction, if either party lacks that motivation, the signal is inaccurate. Thus, a legitimate

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102. *Id.* at 531.
103. *Id.*
104. 587 F.Supp.2d 513.
105. *Id.* at 535.
106. *ATSI Communications, Inc.*, 493 F.3d at 101.
107. *In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 534. (emphasis added).

transaction combined with an improper motive is commodities manipulation."[108]

The court held that Rule 9(b) applied to the pleadings, and in doing so again looked to *ATSI* for guidance, which stated that "a claim for market manipulation is a claim for fraud, it must be pled with particularity under Rule 9(b)."[109] Although *ATSI* is a securities case, the Court concluded, "there is *no principled reason* to distinguish between commodities manipulation and securities manipulation in selecting the applicable pleading standard. . . . [M]arket manipulation is inherently deceptive [t]hus, a complaint that alleges manipulation of commodities prices must satisfy Rule 9(b)."[110] Therefore, despite the fact that the plaintiffs did not allege fraud, nor did their complaint sound in fraud, the Court, through its reformulation of commodities manipulation concluded that a claim for commodities manipulation, is a claim for fraud making Rule 9(b) applicable in *all* cases. The following section examines the consequences of this conclusion and argues why there is indeed a principled reason to distinguish securities and commodities manipulation.

V. IS THERE A PRINCIPLED REASON TO DISTINGUISH BETWEEN SECURITIES AND COMMODITIES MANIPULATION?[111]

The court's rationale in deciding *In re Amaranth* highlights the severe consequences of conflating securities manipulation with commodities manipulation. First, the court incorrectly bifurcated the manipulative scheme into two transactions[112] in order to apply neatly securities case law, which addressed legitimate open-market transactions in entirely different contexts.[113] The court, in doing so, found that one transaction, the buying and holding of large positions, was not by itself manipulative without

108. *Id.*

109. *Id.* at 535.

110. *Id.* (emphasis added).

111. "While the 1934 Act prohibits both fraud and manipulation in section 10(b), the CEA has a separate anti-fraud section apart from the anti-manipulation provision. When the statute distinguishes fraud and manipulation by addressing them in different provisions, it would be redundant to construe manipulation to require a fraud element." *Amaranth Advisors, LLC*, 554 F.Supp.2d at 534.

112. *See In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 535.

113. See ATSI Communications, Inc., 493 F.3d 87, *and Masri*, 523 F.Supp.2d 361.

"something more," thus applying *ATSI*. For the second transaction, the selling of large quantities of futures during the settlement period, the court followed the logic of *Masri* and stated, "the timing of the sales are suspicious in themselves . . . [thus] allegations that a defendant repeatedly sold large numbers of futures just before the close of settlement periods are sufficient to allege commodities manipulation."[114] The court in effect concluded that selling large numbers of futures in this manner *is* inherently manipulative.

In applying securities case law to a commodities manipulation scheme, the court ignored the maxim that "[t]he methods and techniques of manipulation are limited only by the ingenuity of man."[115] Amaranth was trading over-the-counter ("OTC") [116] natural gas swaps[117] on an exempt commercial market ("ECM")[118] called the Intercontinental Exchange ("ICE"). ICE used the New York Mercantile Exchange ("NYMEX")[119] settlement price of natural gas futures to calculate the settlement price of its

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114. *In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 535.

115. *Cargill, Inc.*, 452 F.2d at 1163. In the case of Amaranth, they took advantage of the Enron Loophole. *See* 7 U.S.C. § 2(h)(3)-(5) (2000) (these sections are what is referred to as the "Enron Loophole").

116. "OTC derivatives are not traded on registered futures exchanges but are tailored transactions designed and brokered for sophisticated counterparties through regulated Wall Street institutions." Walter Lukken, Comm'r, Commodity Futures Trading Comm'n, Remarks at the Chicago Bar Association: The State of the CFMA (Feb. 3, 2004), http://www.cftc.gov/newsroom/speechestestimony/opalukken-06.html.

117. Swap contracts are agreements to exchange future cash flows based on various things, e.g., the price of electricity, and are generally traded over-the-counter or off-exchange. MICHAEL DURBIN, ALL ABOUT DERIVATIVES 31 (2006). *See also* CFTC Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter/glossary/glossary_s.html (last visited Apr. 26, 2009) (defining "swap").

118. The Commodity Futures Modernization Act of 2000 exempted certain electronic trading facilities from CFTC regulation, i.e. ECMs that trade OTC derivatives in exempt commodities only between eligible commercial entitites. These exemptions put OTC energy commodity transactions largely outside of the CFTC's oversight.

119. NYMEX is a designated contract market, which is "[a] board of trade or exchange designated by the Commodity Futures Trading Commission to trade futures or options under the Commodity Exchange Act." Glossary: A Guide to the Language of the Futures Industry, http://www.cftc.gov/educationcenter/glossary/glossary_co.html#contractmarket (last visited Apr. 26, 2009).

natural gas swaps.[120] Due to this relationship between the NYMEX settlement price of natural gas futures and the settlement price of ICE natural gas swaps, Amaranth was able to engage in market manipulation in order to turn a profit on its positions it held on ICE. Pursuant to NYMEX rules, the settlement price for natural gas futures is based on "the volume weighted average of trades executed from 2:00-2:30 p.m. ('closing range')"[121] on expiration day (the third to last business day of the month prior to which delivery must be made on open contracts). A few days before the expiration dates of the March and May 2006 NYMEX natural gas futures contracts, Amaranth began to accumulate long positions in these contracts. Amaranth then engaged in a massive selling off of those positions during the closing range on the expiration dates of the contracts in order to "smash" or decrease the settlement price on those contracts. The purpose of this trading strategy, known as "marking the close," was to decrease the settlement price of natural gas futures in order to benefit the respective short positions Amaranth held in natural gas swaps on ICE.[122]

Therefore, in this factual context, the buying and holding of large positions were inseparable from the selling of these positions during the settlement period – these "legitimate" transactions were an integral part to Amaranth's entire manipulative scheme and should *not* have been severed by the court. The court claims it was protecting legitimate economic decisions and preventing anti-manipulation laws from discouraging "the very activity that underlies the integrity of the markets they seek to protect."[123] However, by applying securities case law, the court is not keeping up with the "ingenuity of man" and risks closing itself off from hearing future innovative manipulative schemes that will take advantage of some future regulatory loophole. The definition of securities manipulation is much narrower than that of commodities manipulation.[124] Furthermore, the SEC, in light of the Supreme Court's definition of securities manipulation, has carved out about fifteen separate categories of manipulative activities, thus limiting the

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120. "Because ICE fixes the final settlement price for its main natural gas swap equal to the final settlement price of the corresponding NYMEX futures contract, NYMEX futures contracts and ICE swaps provide economically identical hedging and risk-management functions for natural gas users and traders." S. PERMANENT SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, 110TH CONG, STAFF REPORT: EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET 30 (2007).

121. NYMEX Exchange Rule 6.52A.

122. *Amaranth Advisors, LLC*, 554 F.Supp.2d at 526-28.

123. *In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 534-35.

124. McCabe, *supra* note 20, at 226-27.

universe of securities manipulation.[125] By applying securities case law in a piecemeal fashion to commodities manipulation cases, the court is unsuccessfully trying to fit a square peg into a round hole.

Additionally, redefining commodities manipulation using the definition of securities manipulation will have a chilling effect on both agency enforcement actions and private suits. As previously discussed, cases alleging fraud are subject to Rule 9(b), which requires the plaintiff to plead with particularity "the nature, purpose, and effect of the fraudulent conduct and the roles of the defendants."[126] Judge Scheindlin noted that because Rule 9(b) applies to market manipulation claims, "plaintiffs face a substantial hurdle in alleging that a legitimate transaction plus scienter constitutes commodities fraud."[127] Furthermore as discussed below, applying Rule 9(b) to all commodities manipulation cases, (as opposed to using a "case-specific approach"), demands the impossible – pleading fraud when fraud is not alleged.

As a result, under Judge Scheindlin's ruling, all manipulation claims will sound in fraud and be subject to heightened pleading standards. Securities manipulation is a claim for fraud so it must be pled with particularity: "[t]he essence of a market manipulation claim is the *allegation of conduct intended to deceive or defraud investors* by conditioning or artificially affecting the market for securities."[128] A plaintiff therefore cannot get around pleading fraud in the context of securities manipulation. In the context of commodities manipulation, according to Judge Scheindlin, Rule 9(b) applies because manipulation is inherently deceptive to traders. However, as Judge Chin pointed out in *CFTC v. Amaranth Advisors, LLC*, there are manipulative schemes, like the one Amaranth engaged in, that are not based on false statements intended to deceive other traders. Furthermore as previously argued, if Amaranth did not first accumulate a large position in natural gas futures, they would not have been able to manipulate the settlement price by selling them during the closing range on the expiration date. Although Judge Scheindlin did state that the 'something more' did not have to be a misstatement or an omission, her hybrid definition of commodities manipulation mandates that even if the complaint does *not* sound in fraud, the plaintiff is subject to Rule 9(b).

A trader can engage in legitimate transactions that affect prices without being manipulative. As one commentator noted:

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125. *Id.* at 225.

126. *ATSI Communications, Inc.*, 493 F.3d at 102.

127. *In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 535.

128. *Internet Law Library*, 223 F.Supp.2d at 486. (emphasis added).

> [C]onsider the case of a large speculator who purchases vast quantities of a commodity because he believes it to be undervalued. Prices increase in responses to this trading activity because other traders recognize that the speculator may possess private information on the true value of the commodity. Thus, the price rises to reflect this 'bullish' private information.[129]

This is exactly what Judge Scheindlin was attempting to protect.[130] Unfortunately, she turned pleading any type of commodities manipulation, whether by means of legitimate transactions or by a squeeze, into a Herculean task when no fraud is alleged. How can a plaintiff plead fraud with particularity when the complaint neither alleges it nor sounds in it? The only "fraud" subjecting a plaintiff to Rule 9(b) is the inherent deceit Judge Scheindlin held is present in every manipulation, which is not even an element of the cause of action. Unlike a claim for securities manipulation, where a plaintiff must allege intent to deceive and usually some deceptive conduct, a claim for commodities manipulation does not (and should not) require any allegations of fraud or deceit. Despite what Judge Scheindlin stated in her opinion,[131] her definition of commodities manipulation, if adopted by the Second Circuit, may require plaintiffs to allege fraudulent or deceptive conduct i.e. a misstatement or omission, thus adding another element to commodities manipulation.

Finally, redefining commodities manipulation with the element of fraud thwarts Congress' purpose of not defining the term in the first place. "[B]y simply prohibiting manipulation without defining the term, Congress sought to cover all types of conduct that could be formulated by someone seeking to affect market prices 'artificially.'"[132] "The aim must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand."[133] Thus, by effectively making it impossible to allege "legitimate" transactions were in fact manipulative under the CEA, the court is assuming a role that should be left to Congress[134] and stifling Congress' attempt to cover manipulative

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129. Craig Pirrong, *Commodity Market Manipulation Law: A (Very) Critical Analysis and a Proposed Alternative*, 51 WASH. & LEE L. REV. 945, 951 (1994).

130. *See In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 539 n.167.

131. *See id.* at 534.

132. Markham, *supra* note 11, at 360.

133. *Cargill, Inc.*, 452 F.2d at 1163.

134. "[A]ny effort to correct the manipulation definition would appear to lie now with the Congress, rather than the courts or the CFTC." Markham, *supra* note 11, at 360.

schemes or devices that man has yet to think of. There is also an argument to be made that if any definition should prevail, it should be that of commodities manipulation. "In comparison to the '34 Act cases, the Commodities cases have a broader definition of manipulation. This view of manipulation is closer to the definition held by financial experts at the time of the '34 Act's writing."[135]

VI. WHAT IS THE SOLUTION FOR LEGITIMATE TRANSACTIONS TURNED INTO VEHICLES FOR COMMODITIES MANIPULATION?

Whatever is to be done about traders manipulating the market through legitimate transactions, Judge Scheindlin's approach should not be followed. This is a policy decision that should be left up to Congress *not* the courts. Many commentators have suggested redefining manipulation in various ways in order to protect the kinds of legitimate conduct that Judge Scheindlin was rightfully concerned about.[136] As argued in Section V of this paper, the definition of commodities manipulation should not be redefined to reflect the definition of securities manipulation. The current definition of commodities manipulation, although broad and arguably vague, protects legitimate conduct as long as it is done *without* manipulative intent. There was no justifiable reason for Judge Scheindlin to go through the court's rationale in *ATSI* because her answer would have been the same regardless.

The four elements of commodities manipulation are as follows: "(1) the defendant possessed an ability to influence market prices; (2) an artificial price existed; (3) the defendant caused the artificial price; and (4) the defendant specifically intended to cause the artificial price."[137] These elements do not favor inherently manipulative devices like a squeeze, nor do they endanger legitimate conduct such as merely buying and selling large quantities of contracts. It has *always* been "the intent of the parties which separates otherwise lawful business conduct from unlawful manipulative activity."[138]

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135. McCabe, *supra* note 20, at 226-27.

136. *See* Markham, *supra* note 11, at 359 (discussing how one commentator "would establish a presumption that traders who do not offset their contracts before delivery are guilty of manipulation," another "has argued that manipulation should include some aspect of fraud or deceit," and another would "leave it to the markets to decide whether acts were economic and therefore manipulative").

137. *In re Amaranth Natural Gas Commodities Litig.*, 587 F.Supp.2d at 530.

138. *Indiana Farm Bureau Coop. Ass'n, Inc.*, 1982 WL 30249 at *5.

It was therefore completely unnecessary for Judge Scheindlin to analyze Amaranth's activities through the prism of securities case law when either way, she would have reached the same conclusion – legitimate transactions plus scienter equals commodities manipulation. The only reasonable explanation for her application of *ATSI*'s rationale and holding to commodities manipulation, is so she could redefine commodities manipulation as a claim for fraud, thus making it even harder for plaintiffs to get past the pleading stages.

In the context of manipulative schemes based on "legitimate" transactions, at some point there should be a rebuttable presumption that the defendant intended to cause an artificial price. For example in *In re Amaranth*, the accumulation of large positions (legitimate transactions) should maintain a presumption of legitimacy *until* they were later "suspiciously" sold during the settlement period (manipulative transactions). The idea behind this rebuttable presumption is that the legitimate transactions were a necessary component of the ultimate execution of the manipulative scheme therefore they should lose their "innocence."[139] The defendant should be given the opportunity to rebut this presumption and show that indeed the accumulation of large positions was innocent and legitimate. However, the court should not take it upon itself to sever the transactions and then analyze them in a vacuum.

VII. CONCLUSION

Securities markets and futures markets serve very different functions. Injecting an element of deceit or fraud into the definition of commodities manipulation will do more harm than good and will inhibit the prosecution of innovative manipulative schemes. Anti-manipulation laws, and the case law that flow from them, need to be tailored to protect the two markets' respective functions. A one-size fits all definition of manipulation will not work as long as there are different markets for securities and futures. Redefining commodities manipulation to reflect the definition of securities manipulation discards the "case-specific approach" and mandates a heightened pleading requirement for all commodities manipulation claims. In effect, it makes a claim for commodities manipulation indistinguishable from a claim for commodities fraud. Both the CFTC and private litigants will face an insurmountable obstacle when pleading manipulation if either no

139. *See id.* at *27.

fraud is actually alleged, or the complaint does not sound in fraud.[140] Conflating the two definitions also thwarts the purposes behind both the '34 Act and the CEA. The definition of commodities manipulation should remain unchanged and any change that does come should come from Congress, not the courts. So yes, there is a principled reason to distinguish securities manipulation from commodities manipulation.

140. *See* Markham, *supra* note 11 (arguing that commodities manipulation is an unprosecutable crime).

Notes & Observations

DEBUNKING THE NOP (NET OUT-OF-POCKET) DAMAGE ARGUMENT

Dale Ledbetter[1]

Claimants and their representatives have been victims of a campaign to legitimize net-out-of-pocket ("NOP") computations as a valid measure of damages in securities claims. There is no statutory support for this doctrine. It is a creation of the industry. Acceptance of this ill-conceived argument by uninformed decision makers is costing Claimants millions of dollars in decreased awards and reduced settlements.

This article is designed to inform Claimants and arm their representatives on how to fight the fallacious concept of NOP. Claimants can only get fair awards and be fully compensated by educating arbitrators and courts and by rejecting the false arguments of defense counsel.[2]

We will use recent Morgan Keegan cases as an analytical example of the misuse of NOP. Morgan Keegan has made aggressive presentations in support of NOP as a measure of damages in the hundreds of cases brought by victims of the RMK Funds. These cases represent an extreme example of NOP abuse. The dollar impact would be lessened in a situation involving dividend paying stocks or more traditional fixed income securities. However, the deception would be no less real.

The RMK Funds were managed by James C. Kelsoe ("Kelsoe"), who, prior to starting the first of the RMK Funds, had no experience in the management of a mutual fund. There were two open-ended funds started in 1999. There were four closed-end funds which came out from 2003 until early in 2006.

Morgan Keegan strongly encouraged the reinvestment of dividends in the open-ended funds. Reinvestments were automatic in the closed-end funds unless the investor took steps to opt out. The vast majority of investors were persuaded to reinvest, rather than withdraw RMK dividends.[3] Due to

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2. Thanks go to the many who have contributed to this article through prior writings and/or informal conversations, including Joe Long, Barbara Black, Jeff Gross, Dan Woska, Steve Buchwalter, Fred Rosenberg, Naill Falls, Adam Gana, Andrew Stoltmann and Richard Frankowski. Apologies go to the many others who have, no doubt, contributed.

3. Emails were sent to the entire Morgan Keegan sales force in mid-July 2007

inflated "fair value" pricing, these reinvested dividends were generally used to purchase additional shares at false prices which led to substantially increased losses. The SEC[4] has identified improper practices on the part of Morgan Keegan which resulted in false net asset values ("NAV") in its recent action against Morgan Keegan.

Morgan Keegan had numerous incentives to keep investors from reducing holdings in the funds. Now, with an avalanche of pending claims Morgan Keegan takes the position that there is no difference, for damage calculations, between reinvested dividends and those that are withdrawn. The Morgan Keegan calculation is illustrated by the following example:

> Consideration paid;
> Less amount received on disposition; and
> Less dividends (whether reinvested or withdrawn).

The impact of this calculation is devastating to investors who were persuaded to reinvest dividends. Not only were they sold shares at inflated prices which allowed Morgan Keegan to reap higher fees based on various "services" provided to the funds BUT the inflated values were then used against investors in the computation of "NOP."

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after the funds had began their precipitous decline which extolled the virtues of dividend reinvestment and were clearly designed to encourage investors to reinvest all dividends in the funds.

4. On April 7, 2010, actions were initiated by the SEC, FINRA and a group of four states against Morgan Keegan alleging wrongdoing with regard to the RMK Funds. See Dan Jamieson, *FINRA, SEC and State Regulators Swarm Morgan Keegan with Fraud Charges*, INVESTMENT NEWS, April 7, 2010, http://www.investmentnews.com/article/ 20100407/FREE/100409883. A central theme in the SEC filing related to the false NAV pricing:

> During various periods between at least January 2007 and July 2007, the daily net asset value ("NAV") of each of the funds was materially inflated as a result of the fraudulent conduct of Respondents.

In re Morgan Asset Management, Inc., et al, S.E.C. Administrative Proceeding File No. 3-13847, Order Instituting Administrative and Cease and Desist Proceedings, p.4 ¶11 , http://www.sec.gov/litigation/ admin/2010/33-9116.pdf (April 7, 2010).

> The funds' valuation policies and procedures required that dealer quotes be obtained for certain securities ... Kelsoe actively screened and manipulated the dealer quotes...

Id. at ¶13.

After an investor was sold shares at an inflated price, the full "value" of those dividend reinvestments were, and are still, deducted by Morgan Keegan from the investor's losses to arrive at "NOP." Thus, Morgan Keegan benefited in several ways from the reinvested dividend "sales" and adds insult to injury by computing those dollars so as to argue that the reinvestments "reduced" losses. The argument is beyond misleading. It is preposterous. And yet, the argument has been sold to many Claimants and their representatives as the "correct way" to calculate damages.

Claimants should reject that calculation and instead rely on other damage theories. Many states provide for recission damages, benefit of the bargain or accurate damage calculations that capture the lost time-value of money. The following example is based on the Tennessee Securities Act required damages formula:[5]

> Consideration paid; plus
> interest at legal rate from the date of payment[6]; less
> amount received on disposition; less
> income received; plus
> interest at the legal rate from the date of disposition.

There is ample support for the validity of this calculation. The most persuasive evidence is offered by the Morgan Keegan statements sent to clients. The statement will show the quantity and description of the holding, the symbol, unit cost, date acquired, sell price, sell proceeds and then, most importantly, the short term or long term gain or loss. The loss numbers should be blown up at a hearing and should be highlighted in appropriate documents for any settlement discussions.

Morgan Keegan's own documents treat reinvested dividends as new purchases, and the losses on those purchases are added to the losses on original purchases. For them to convince a panel that reinvested dividends should be deducted from losses requires a contradiction of their own statements. In other words, Morgan Keegan adds reinvested dividends to the cost basis of mutual funds, as required by the IRS. Morgan Keegan does one

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5. TENN. CODE ANN. §48-2-122. This calculation can also be presented in conjunction with language similar to the Arkansas statute on damages for securities fraud, which states that "damages may be for out-of-pocket losses or for the benefit of the bargain."ARK. CODE ANN §23-42-106(b)(2). (2010).

6. TENN. CODE ANN. § 48-2-122(k). The legal rate of interest is 10% Tenn. Code Ann. §47-14-121.

thing on its statements and then argues just the opposite to its victims in arbitration.

A typical "expert's" report prepared on behalf of Morgan Keegan looks like this example (based on numerical assumptions, not on an actual case):

Date Held	**Trading Result from Investment and Reinvested Dividends**	**Income[7]**	**Net ROI**
08/01 – 09/07	(150,000)	75,000	(75,000)

In this example, all dividends were reinvested. Morgan Keegan makes the assumption that there is no difference between reinvested and withdrawn dividends. Using the example above, if the investment became worthless the true loss would be $150,000 not $75,000.

Brokers routinely strip many victims of a large portion of the damages in their accounts by calling dividends "withdrawals" while ignoring that these dividends were instantly "reinvested" in the same account. Shockingly, many claimants' attorneys willingly accept this atrocious accounting.

Let's look at how the Internal Revenue Service addresses reinvested dividends. IRS Publication 564, Mutual Fund Distributions, makes clear that brokers not only deceive their victims but disagree with the federal government:

> Shares Acquired By Reinvestment
>
> The original cost basis of mutual fund shares you acquire by reinvesting your distributions is the amount of the distributions used to purchase each full or fractional share. This risk applies even if the distribution is an exempt interest dividend that you do not report as income.[8]

The IRS then makes a specific recommendation as to recordkeeping:

> When you acquire shares through reinvestment keep the statements that show each date, amount and number of full

7. Which are all, in fact, reinvested dividends.

8. (I.R.S.) Publication 564, Mutual Fund Distributions, p.5 (2009) http://www.irs.gov/pub/irs-pdf/p564.pdf.

> or fractional shares purchased. Keep track of any adjustments to basis of the shares as they occur.[9]

The IRS continues in their helpful mode by offering what is specifically labeled as a "TIP":

> Generally, you must know the basis per share to compute gain or loss when you dispose of the shares. This is explained under *Identifying the Shares Sold* later.[10]

All this language is conveniently ignored by Morgan Keegan lawyers who tout "NOP" calculations to ill-informed panels. Claimants' counsel have an obligation to correct this misinformation.

IRS Publication 564, continues with a lengthy explanation for identifying the shares and provides an example of "How to Figure Basis of Shares Sold." There is a specific paragraph devoted to reinvested distributions:

> Reinvested Distributions: If your dividends and capital gain distributions are reinvested in new shares, the holding period of each new share begins the day after that share was purchased. Therefore, if you sell both the new shares and the original shares, you might have both short-term and long-term gains and losses.[11]

Interestingly, there is no mention of NOP in IRS Publication 564.

Morgan Keegan presents pre-hearing briefs to each panel containing a damage discussion similar to this:

> Claimants' recovery should be limited to their actual out-of-pocket losses from their investment. Not only did Claimants fail to properly account for their own failure to mitigate, they also overstate their losses by failing to take into account the years of dividends and income they enjoyed from the Funds. The accepted method of measuring damages in securities cases in general – and suitability claims in particular – is the actual net out-of-pocket losses proximately caused by the alleged misconduct.
>
> Claimants are limited to what they actually lost as a proximate result of the alleged fraudulent conduct, not what they might have gained through a different investment strategy. As another court has held, 'the question is not what the Plaintiff might have gained, but what he has lost…'.

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9. *Id.*
10. *Id.*
11. *Id.* at p. 8.

> In order to further insure that plaintiffs do not receive more than what they actually lost, state law also mandates that damages must be offset by the income received by the security. *See* Tennessee Securities Act, T.C.A. § 48-2-122(c)(1) (damages are calculated 'less the amount of any income received on the security').

It is true that you pay tax on the dividends you reinvest. This is comparable to the so-called "phantom income" received by many employees of dot-com companies during the 1990s but differs in several key respects. In a typical example, an employee would be given stock rather than options and would owe tax on the value of the stock at the time it was given to him. For example, assume that an employee was given 100,000 shares valued at $10.00 each. He would owe tax on the million dollars in share value. Assume that he would owe, approximately 35% in tax. However, a year later he would not have paid the tax because he held on to all the shares and the shares were now worthless. Yet he still owed the government $350,000. This process led to many a personal bankruptcy on top of all the corporate disasters as the dot-com era waned.

The employee in the example did *receive* the shares. He took them into his possession and made the decision to hold them. They were *not* dividends paid from securities previously sold to an investor. Paying tax on the reinvested dividends differs in that the taxpayer has been taxed on something that he did *not*, in fact, receive. However, the taxpayer would, if Morgan Keegan's computations are used, pay tax twice on the same money.

For example, assume you bought a thousand shares of a fund at $10.00, meaning you had a $10,000 investment, and you reinvested dividends in that year of $1,000 and the next year you reinvested $2,000 in dividends for a total of $3,000 in reinvested dividends. For the sake of the example, let's assume you then sold all the shares for $15,000. You would take the $10,000 original purchase price and add $3,000 to that amount based on the reinvested dividends and you would have an adjusted cost basis of $13,000. You would have to pay tax on the reinvested dividends at the time they were given to you and if you did not add that amount to your adjusted cost basis, you would be paying tax on the same dollars a second time.

Given the same situation, if instead of going up in value, the purchase went down and you later sold for $8,000, you would take the sales price of $8,000 and deduct from that the new cost basis of $13,000 meaning you would have a capital loss of $5,000. That is exactly the way your accountant will tell you the reinvested dividends should be accounted for and it is the way, you as a taxpayer, are put in the most advantageous position. To do

otherwise leaves you with a greater tax liability than you should actually have.

Matt Krantz, a financial markets reporter and the author of INVESTING ONLINE FOR DUMMIES clearly describes the IRS position:

> [I]f you received dividends of $500.00 during the time you owned the stock and reinvested that money in more stock … your cost basis is the $1,500 you paid for the stock plus the $500.00 in dividends you reinvested, or $2,000.[12]

Brokers' counsel realizes the difference between dividends that are reinvested and those that are withdrawn and has made the distinction in communications with Claimants' counsel. Brokers and their counsel attempt to have it "both ways" depending on what they view to be their best interests.

As noted above, it was Morgan Keegan's sales strategy and philosophy to its clients to "reinvest" dividends paid by the RMK Funds. Reinvested dividends were never "received." Black's Law Dictionary defines "receive" as follows: "to take into possession and control, accept custody of." [13] Clearly, Morgan Keegan clients did not "receive" the dividends that were reinvested and used to purchase over-priced "fair valued" shares of RMK Funds.

IRS Rev. Proc. 2009-20 adds further support for the proper calculation of investors' losses.

> The revenue procedure provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent. This revenue procedure also describes how the Internal Revenue Service will treat a return that claims a deduction for such a loss and does not use the safe harbor treatment described in this revenue procedure.[14]

The IRS provides safe harbor tax treatment for investors who were victims of Ponzi schemes. The IRS defines a "qualified investment" for purposes of the tax "safe harbor" as:

> (a) The sum of:
>
> (1) The total amount of cash, or the basis of property that the qualified investor invested in the arrangement in all years; plus
>
> (11) The total amount of net income with respect to the specified fraudulent arrangement

12. MATT KRANTZ, INVESTING ONLINE FOR DUMMIES, (6th ed. 2007).
13. BLACK'S LAW DICTIONARY 1268 (6th ed. 1990).
14. Rev. Proc. 2009-20, 2009-14 I.R.B. 749.

> that is consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations;
>
> (b) The total amount of cash or property that the qualified investor WITHDREW (emphasis added) in all years from the specified fraudulent arrangement (whether designated as income or principal).[15]

The language could not be more clear. There is a difference between reinvested dividends and those that are withdrawn.

The best witness to counter the NOP argument at a hearing is the client's own CPA or other person who prepared the client's tax return. A simple line of questions, or some variation of those set out below, provide a strong counter to the NOP argument.

DIRECT EXAMINATION OF CLIENT'S CPA

1. Background Information
   - Name
   - Residence
   - Educational background
   - Occupational background
2. Did you do work for the Claimant(s)?
3. In what capacity?
4. Did you prepare the tax returns for the Claimant(s) during the time they owned the RMK Funds?
5. Did you arrive at any conclusions as to how the Claimant(s) ownership of RMK Funds were reported on their tax returns? Please share your conclusions with the Panel.
6. What makes up that total loss?

"It is the original principal invested, plus all the additional purchases made through reinvested dividends less the amount received when the shares were transferred out or sold."

7. And what IRS guidance or authority do you rely on in making that calculation?
8. In preparing the tax returns for the Claimant(s), what information received from Morgan Keegan did you rely on?

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15. *Id.*

- Annual statements?
- 1099's

9. Were any of those dividends withdrawn or distributed?
10. How much was distributed?
11. And were the rest of all of the dividends used to purchase additional shares?
12. So, in summary, what were the Claimant(s) total losses for the accounts as a result of owning the RMK Fund?
    $_____
    (Amount)

CASE LAW

In addition to IRS directives, accounting principles, equity, common sense and state statutes, there is strong case law support for rejection of the NOP concept.

In *Forsythe v. Hales*,[16] the court noted that damages in a non-jury case are "within" the discretion of the trial court. The court held that the proper measure of damages is either the price at the time of conversion or the highest intermediate value reached within a reasonable time after notice of the conversion by the plaintiff whichever is greater (quoting *Myzel v. Fields*[17]). The court rejected defendant's request to apply an out-of-pocket measure of damages.

Randall v. Loftsgaarden[18] provides a lengthy discussion of the out-of-pocket damage measurement. The Court rejects tax benefits as an offset. The Court commented that "any implicit offset for a return of consideration must be confined to the clear case in which such money or property is returned to the investor."

In *Hershock v. Fiascki*[19] the court also rejected the NOP argument. The court noted that "the important element in allowing a recovery for other than out-of-pocket damages is whether the asserted damage is actual and non-speculative." That is true of the vast majority of cases filed by Claimants.

16. 255 F.3d 487, 491 (8th Cir. 2001).
17. 386 F.2d 718, 746 (8th Cir. 1967).
18. 478 U.S. 647, 659 (1986).
19. Civ. No. 90-0497, 1992 U.S. Dist. Lexis 9305 (E.D. Pa. July 2, 1992).

In *Kane v. Shearson Lehman Hutton, Inc.*[20], the 11th Circuit Court of Appeals rejected "netting:"

> [T]here is no support to be found under federal or Florida law for the "netting" theory Shearson argues for here. What is found, under both federal and Florida law, is the intent to have securities antifraud provisions enforced stringently to deter fraud. As the district judge noted, "If the ... methodology espoused by [Shearson] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equaled prior gains."[21]

The court's lesson is clear that using the aggregation method to calculate NOP undermined the stated goal of deterring fraud. Respondents often use the same arguments in NOP presentations as they do when arguing for "netting."

In *Levine v. Futransky*[22], the court held that gains in the account could not be used to offset losses. The court added a concise summary of damages:

> Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold.[23]

Mitsubishi Motors Corporation v. Soler Chrysler-Plymouth, Inc.[24], made clear that arbitrators must follow the law[25] and noting that by agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded the statute; it only submits to their resolution in an arbitral, rather than a judicial forum.[26]

In *Henson v. Morgan Stanley DW, Inc.*[27] Morgan Stanley was found liable, but the arbitrators awarded a small recovery. Even though the panel did not specifically cite the Tennessee Act in its award the court awarded the full measure of the statutory damages:

> The panel cannot simply ignore the undisputed evidence in the record as to the amount of Plaintiffs' damages or reject it

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20. 916 F. 2d 643 (11th Cir. 1990).
21. *Id.* at 646 (citations omitted).
22. 636 F. Supp. 899 (N.D. Ill. 1986).
23. *Id.* at 900.
24. 473 U.S. 614, 105 S.Ct. 3346 (1985).
25. *See* Tennessee State Statute for calculating damages.
26. *See* Supra at 27 JOSEPH C. LONG, BLUE SKY LAW §9:14 (2009).
27. 2005 WL 1806426 (*M.D. Tenn. June 7, e.s. 2005*).

> when there is none to the contrary and also ignore the mandates of the statute relied upon the expert in determining the damages. ... The panel's finding of damages in the amount of $59,504.44 is inexplicable and is not supported by the evidence in the arbitration record and the controlling law. **The Court concludes the panel's award is arbitrary and capricious, it is in manifest disregard of the law because it "flies in the face" of a clearly established state statute, and the award must be modified**.[28]

Alliance Mortgage Co. v. Rothwell[29] draws a clear distinction between "out-of-pocket" and "benefit of the bargain" calculations:

> The "out-of-pocket" measure of damages is directed to restoring the plaintiff to the financial position enjoyed by him prior to the fraudulent transaction, and thus awards the difference in actual value at the time of the transaction between what the plaintiff gave and what he received. The "benefit of the bargain" measure, on the other hand, is concerned with satisfying the expectancy interest of the defrauded plaintiff by putting him in the position he would have enjoyed if the false representation relied upon had been true: it awards the difference in value between what the plaintiff actually received and what he was fraudulently led to believe he would receive.[30]

This case is important for two reasons. It differentiates between NOP and "benefit-of-the bargain." However, the case also provides a meaningful definition of NOP: "directed to restoring the plaintiff to the financial position enjoyed by him prior to the fraudulent transaction and thus awards the difference in actual value at the time of the transaction between what the plaintiff gave and what he received." [31]

As noted above, the Black's Law dictionary definition makes it obvious that reinvested dividends do not constitute funds "received."

In *Salahutdin v. Valley of California, Inc.*[32] the court notes that the "benefit of the bargain" rule is clearly the better and more just rule in situations involving fraud.

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28. *Id.* at *6 (emphasis added).
29. 10 Cal. 4th 1226, 44 Cal.Rptr.2d 352 (1995).
30. *Id.* at 1240, 44 Cal.Rptr.2d at 360.
31. *Id.*
32. 24 Cal. App. 4th 555, 29 Cal. Rptr. 2d 463 (Cal. Ct. App. 1994).

In *Garnatz v. Stifel, Nicolaus & Co., Inc.*[33] the court specifically rejected the NOP argument:

> In the present case, defendants urge strict application for of the out-of-pocket rule. They would deny plaintiff any recovery at all, since the value of the bonds equaled their purchase price. But the fact that plaintiff got what he paid for does not mean he did not suffer any legally cognizable injury from defendant's fraud.[34]

NOP ignores the time-value of money. If a customer opened a brokerage account in 1930 and invested $1000 and today that account 80 years later is worth $1000, the client has zero NOP. BUT the time-value of money tells us that the $1000 invested in 1930 is worth $13,054.43 just to have the same buying power as it did in 1930. The Department of Labor website[35] calculates CPI adjusted time value of money. Courts and statutory damages are meant to capture this reality. NOP, especially over long or during turbulent periods of time, ignores this reality.

CONCLUSION

Enough! Claimants should never willingly agree to NOP as a valid measurement of damages. Reject the contention that Claimants should accept the concept of NOP "because Panels accept it." Some panels may well accept NOP solely because they have not been properly educated. Let's be sure that whatever decision panelists reach is based on a complete understanding of *ALL* relevant factors. If Claimants and their representatives make a united and concerted effort to fight this "respondent friendly" method of calculation, progress can be made in educating and persuading the decision makers.

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33. 559 F.2d 1357 (8th Cir. 1977).

34. *Id.* at 1360.

35. U.S. Bureau of Labor Statistics, "Inflation Calculator", http://data.bls.gov/cgi-bin/cpicalc.pl.

LESSONS LEARNED
FROM MANAGED MONEY ACCOUNTS BEHAVIOR
BY A PROFESSOR EMERITUS OF FINANCIAL ECONOMICS

Frederick Rosenberg[1]

OVERVIEW

Common beliefs in the investment industry are that market averages are unbeatable over time, that active management generally fails to beat the averages and that index investing is preferable to the risk of individual stock ownership. The industry has sold the public the concept that reducing risk exposure to equities during periods of high volatility amounts to a harebrained if not vain commitment to "time the markets." Thus, as recent events demonstrate, once allocated, most portfolios are commonly left to suffer through horrendous short-term losses rationalized by historical long-term performance in which the markets have always recovered. Most investors, however, cannot wait 10 to15 years to see real market returns, especially those who are dependent on dividend income. In truth, most investor's wealth is achieved principally through working and savings and is *not* due to the market performance of their portfolios.

In the following interview, Professor Arnold Langsen discusses the volatile stock market behavior over the past three years. He takes a point of view on portfolio management, portfolio insurance and controlling losses, and illustrates the theoretical concepts for practical strategies that ought to be considered by professional managers, investment advisors and investors (and their attorneys). Hopefully, you will come away from this interview understanding that there actually are active methodologies that both control

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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.

downside risk and still offer growth comparable to higher risk portfolios with static portfolio allocations.

Arnold Langsen, *Professor Emeritus,* was named Outstanding Professor of the Year by the Trustees of the California State Universities in 1984. He was the Invited Professor of Finance at the University of California at Berkeley from 1985 through 1990. His undergraduate courses in Financial Intermediation became a classic and were given high marks by his students. During the era of Portfolio Insurance in the early 1980s, he became involved with the work of Fischer Black (of the Black/Scholes model) for a dynamic asset allocation model that he has applied as a consultant to a money management firm and as a Trustee on the Board of a mutual fund management firm. Professor Langsen is Frederick Rosenberg's uncle.

FR[2]: The stock market plunged nearly 50% from October 2007 through early 2009. Many attorneys were consulted by potential clients whose nest-egg portfolios crashed in value. What should they understand about these events?

Professor Langsen:

There are a number of strategies and theories that need to be scrutinized. I believe we should start by looking at what we call *active* versus *passive* portfolio management. The portfolio selection process attributed to Harry Markowitz is now over 60 years old and still holds up as a foundation for diversified investing.There are two parts: selecting a set of investment candidates and from that choose a portfolio subject to certain constraints that may include portfolio managers' decisions but ultimately respond to investors' wants and needs. The outcome is a set of weights (percentage of investable funds) assigned to each selected investment.

Passive portfolio management suggests a buy-and-hold strategy in which the weights remain constant over a long stretch of time no matter what the results may be.That is, there is no correlation between the weights and the resulting rates of return. *Active* portfolio management, on the other hand, is one where the weights change in response to changes in the assets' market conditions. That is, portfolio managers *manage*. Diversification in active portfolio management should include cash held in reserve, not so-called cash-equivalents, but cash, money, dollars kept in an account where it may not be earning very much (if any at all), but it isn't losing any money either. That, too, is part of active management.

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2. The interviewer is me, Frederick Rosenberg.

FR: I want to look at what you're saying from the investor's point of view. Analysis of the mutual fund industry demonstrates that about 75% of all funds underperform their bogie in any year and that over time the index wins out consistently. Shouldn't investors simply invest in the index and forget about active management?

Professor Langsen:

Index investing is an alternative to managed accounts in general. What you're suggesting is that individual investors consider "do-it-yourself" investing, e.g. that they buy the S&P 500 Index. This can be done because the S&P500 is traded as an ETF (Exchange Traded Fund) under the symbol, SPY.

But, consider this.: If we add a second ingredient- *cash* - then we have what James Tobin, one of our earliest Nobel Laureates, a collegue of mine at Berkeley, suggested a long time ago. In a framework of risk and return, Tobin says[3] that investors can control their risk exposure by what became known as the *separation theorem*, putting part of their investable funds in an Index (for diversification) and the rest in cash equivalents, such as U.S. Treasury bills. Then, the investor becomes an *active manager* as he moves his allocations between cash and equities as the market conditions dictate. Most investors don't want to get that personally involved in a dynamic strategy, but managing is what professional managers get paid for and Tobin's Separation Theorem should be used as a standard when analyzing professional portfolio management results relative to the market.

FR: But there are some critics of active management who say that since timing the markets has proven to be a folly, active management amounts to market timing and is a foolish endeavor.

Professor Langsen:

I don't agree Active portfolio management is not the same as timing the market; it is more a reaction to current market behavior, so that as common stocks lose value you sell some and put the proceeds in cash equivalents. And if the market is increasing in value you use some of the cash to invest in common stocks again, probably at a lower price than when you last owned them. And, by the way, don't be concerned with how much or how little return you may get on the cash; think of it as *investments-in-waiting*. Surely

3. A paper, "*Liquidity Preference As Behavior Toward Risk",* 1958.

even zero return is better than losing parts of your nest-egg. This is a principle that Fischer Black calls a s*implified* approach to portfolio insurance- a portfolio theory[4] that does not involve options or other derivatives yet achieves the same result.

FR: Isn't there a problem with Fisher Black's strategy of dynamically reallocating between Cash and Equities based upon current market conditions? How does an advisor know when and how to reallocate, considering the lagging nature of market information? Could you elaborate on the Simplified Approach to Portfolio Insurance?

Professor Langsen:

Correction, there really is no lag in market information. If the markets are efficient in anything, it's in processing information and quickly acting on it. Of course you must understand that information entering the marketplace comes in many forms: the good, the bad and the ugly rumors that have no foundation, the planted stories, whispers and whimpers. But no matter what, the market will react and quickly.

The major goal of dynamic asset allocation in an active management setting is to provide *downside protection* while maintaining opportunities for *upside capture.* There are a number of protected investment products offered to investors, most tied to some time horizon and state-contingent conditions. This isn't the forum for discussing all the pros and cons of all such investment products. There are two, however, that are associated with Fischer Black that I want to discuss.

Fischer Black had a background in physics and mathematics with a PhD from Harvard. He eventually entered the world of finance through his connection with the Arthur D. Little consulting firm. Black taught at the University of Chicago and MIT before becoming a partner at Goldman Sachs. He is best known as the co-author with Myron Scholes of *The Pricing of Options and Corporate Liabilities* in 1973. This paper was the basis for awarding the Nobel Prize 1997 to Scholes but, unfortunately, Fischer Black had died before that at a much too early age and the Nobel Prize is not awarded posthumously.

An option is a contract that gives the holder the *right* but not the *obligation* to buy or sell a security by a certain date at a price determined in advance. A *put* option gives the holder the right to *sell* a security for a price determined today; therefore, it offers downside protection. There is a price

4. A working paper at Goldman Sachs, *Simplifying Portfolio Insurance,* 1986.

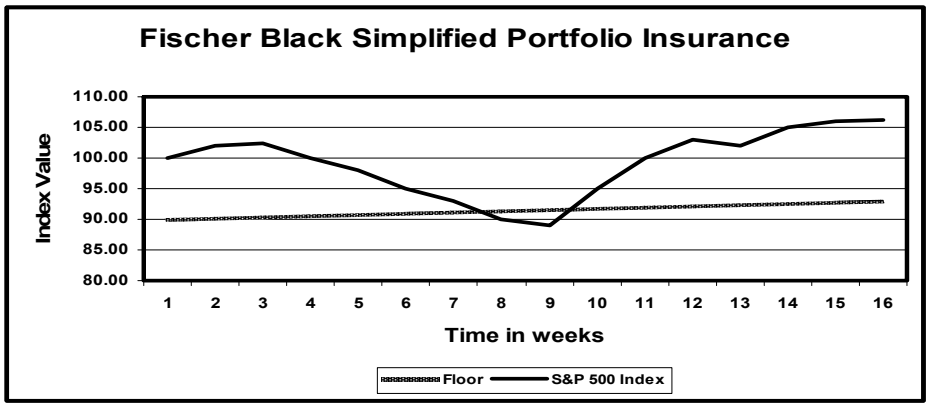
for buying the option as Black and Scholes showed that is determined by measures of volatility, interest rates and the time-to-exercise date. Therefore, the net protection is less due to the cost of the option which is, under normal conditions, about 5% of the portfolio being protected.

In the early 1980s a group of academics at UC Berkeley used the theories of options pricing to offer portfolio insurance to large pension funds and other corporate entities. It was a complex algorithm and had a limited time horizon. So, enter Fischer Black. Almost every Friday evening at UC Berkeley, there was an academic paper presented by a visiting scholar to get feedback before offering it for publication in a financial journal. Black was there on one such occasion in 1985 and I talked with him after the meeting. He showed me how he would simplify portfolio insurance.

Black was a partner at Goldman Sachs at the time. He sent me a copy of a Goldman Sachs research working paper that outlined his idea and that gave some test results. I've used his model ever since with some modifications in my dealing with portfolio management and as a trustee on the board of an investment firm. Here is what Fischer Black had to say in reference to simplifying portfolio insurance: "This report offers an approach to portfolio insurance that is easy to understand and straightforward to implement. Our approach is especially well-suited to meet the needs of pension funds that do not want the value of their pension fund assets to fall below a *floor* defined by the present value of their pension liabilities."

In the first instance, the *floor* could be invested entirely in treasury bills or other cash equivalents and the *floor* would grow at the Treasury bill interest rate. Furthermore, once the *floor* is established, its growth is independent of other elements in a financial portfolio. Black called the difference between the value of a portfolio and the *floor* the c*ushion*.It's invested in stocks that Black calls *exposure*.

But Black continued: "To increase your exposure to common stocks, you can trade in a way that imitates the effect of a put option. Imitating a put option, though, means using complex option formulas. We have a way to set a floor and increase your exposure to common stocks that is simple and flexible and can be used without any knowledge of option pricing theory." This, from the man who invented option pricing theory! It's illustrated by the following graph where the lower line is the floor, the upper line is the index value and the difference between the two lines is the cushion.



From a high in week three to week seven the cushion decreased and using Black's algorithm, so did the exposure. During that period, downside targets in 4% increments were triggered and exposure was systematically and incrementally reduced until week seven when exposure fell to zero (i.e., the cushion reached zero), leaving the portfolio entirely in cash or equivalents. Then, starting in week 10 the cushion increased as the SPY appreciated; upside targets were triggered and exposure increased by buying stocks using funds that had been on the sidelines as cash.

FR: Interesting, but how does it work in practice?

Professor Langsen:

Over the past three years, my portfolios have fluctuated between 100% exposure and zero exposure when they are all cash in reserve. There are many days when I make no trades and most times when called for I increase or decrease exposure in 4% increments. I go for long periods at 100% exposure and likewise some consecutive days in all cash. My portfolio was down about 4% when the market was down 40%. Four percent is a reasonable price to pay for simplified portfolio insurance.

This simplified portfolio insurance algorithm is the foundation for active portfolio management with dynamic asset allocation. It's possible to use this methodology in different ways in different applications. The active exposure could include stocks, bonds, real estate and various other securities and the reserve could be treasury bills or just plain cash in the bank or at some brokerage firm, the essential characteristics being riskless and liquid.

I start with the mean/variance approach of Harry Markowitz, selecting investment candidates through a screening process and eventually I come up

with about 50 to 100 potentials. These I enter into an optimizing program with an objective of minimizing risk within several constraints. To achieve diversification, I believe that 25 securities are sufficient in most applications. So one of the constraints places 25 securities as the upper bound and since I don't sell short, no weight can be less than zero, the lower bound.

Once the portfolio is formed, I apply the simplified portfolio insurance algorithm as follows: I use the SPY contract traded during Exchange hours as the benchmark. I plot the floor and each and every day, I track the index, calculate the cushion and calculate the percentage exposure. Since my portfolios are related to the SPY benchmark, by setting a constraint that the portfolio Beta equals one, my portfolio tracks the index with an Alpha (excess return) greater than one. Since I have at most 25 securities which will be about 4% each of the investable funds, I can use the Exposure percentage to determine how many securities I have at any given time. I do this to adjust the portfolio instead of adjusting all 25 securities. For example, when the exposure percentage is 80% I should have 20 securities and when the exposure is 40% I should have 10 securities. If you're holding only an index, that can be reduced proportionately as well. I run my screening program every Saturday morning to find any new candidates that meet my requirements. And I rebalance my optimized portfolio at least once a month.

CONCLUSIONS

FR: Professor Langsen, your active management approach resulted in an orderly reduction of exposure in small increments during the 2008 – 2009 meltdown, which assured that the floor held up under adverse market conditions. By your calculation, the 4% loss between mid 2007 and early 2009 is a minimal cost for insuring the portfolio simply, without significant losses and without options costs and exposure. As market conditions improved, the cushion expanded and using Black's algorithm, exposure increased. Is that correct?

Professor Langsen:

Basically that's correct. Presently my portfolio is at 60% exposure and depending on the market conditions could still vary substantially. But I need to reiterate that the principal objective of the Black Algorithm is to limit portfolio losses, hopefully at the floor, with minimum cost and without the time and cost limitations of the options market while still providing the opportunity for market returns comparable to portfolios with fixed allocations.

Let me conclude with the words of the best investor of our generation, Warren Buffet, who said: "Rule #1 OF MAKING MONEY IS NOT TO LOSE MONEY. Rule #2 IS NEVER TO FORGET RULE #1."

That's it for now. If you have reasonable questions, here's my e-mail address: arnoldlangsen@gmail.com.

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WHAT TIVO AND JP MORGAN TEACH US ABOUT REVERSE CONVERTIBLES[1]

Craig McCann and Eddie O'Neal[2]

Prior research on structured products has demonstrated that equity-linked notes sold to retail investors in initial public offerings are extraordinarily poor investments. In this paper, we review recent literature and market events and extend our previous work to document the systematic over-pricing of a particular type of enhanced-yield structured product – *Reverse Convertible Notes*. We show that these complex notes are typically significantly overpriced when sold in initial public offerings. As a result of their complex payoffs and the lack of a secondary market to correct the mispricing, reverse convertible notes continue to be sold at inflated prices because investors do not fully understand these products.

Despite this substantial overpricing, and the significant losses on the reverse convertible notes issued in 2008 that matured later in 2008 and 2009, there have been a substantial number of new issues of these dubious investments by JP Morgan, Barclays and many others brokerage firms in 2010. We offer JP Morgan's May 14, 2010 TiVo-linked reverse convertible as an extended illustration of the per se unsuitability for individual investors of many retail reverse convertible structured products.

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I. Introduction

In a previous paper[3], we illustrated the two basic types of equity-linked structured products sold to retail investors in the United States – Principal-Protected Notes and Enhanced-Yield Notes[4]. In this paper we report the recent developments in our research into one type of enhanced-yield structured products – Reverse Convertible Notes or simply "reverse convertibles".

Reverse convertibles are short-term notes whose principal repayment is linked to the performance of a stock or a group of stocks. If the underlying stock's price falls below a pre-specified level during the term of the note, investors may receive substantially less than the face value of the notes. Reverse convertibles tend to pay higher coupon rates than traditional notes because they expose investors to much more risk. Whereas the buy and hold investor in a traditional short term note is only exposed to the issuer's credit risk, investors in reverse convertibles are also exposed to the risk of a decline in the price of the reference security. Reverse convertibles are fundamentally notes with embedded short put options. Investors in reverse convertibles are partially compensated for the risk of the embedded short put options with higher periodic coupons. The risk of these embedded short put options was realized by many investors in late 2008 and early 2009 as the notes matured after substantial stock market declines.

We study reverse convertibles because they are common, simple to replicate and value, and because they provide insight into the pricing and sales practices of other equity-linked structured products. We conclude that reverse convertibles sold to retail investors in initial public offerings were dominated by other readily available investments and so are *per se* unsuitable.[5]

Our research is consistent with Henderson and Pearson (2010) who estimate that investors who purchased an aggregate of $2 billion of short-term SPARQS® reverse convertibles from Morgan Stanley in 69 offerings from 2001 to 2005 paid on average 8% more than the securities' true value. Henderson and Pearson (2010) also document that the overpricing in the

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3. *See* McCann and Luo (2006).

4. By way of examples of our general thesis that retail structured products were over-priced at their initial offering, we reported on the valuation of Merrill Lynch's 7-Year S&P 500 MITTS® issued on August 30, 2002, JP Morgan's 5-Year Capped Quarterly Observation Notes linked to the S&P 500 issued on June 22, 2004 and Citigroup's 3-Year, Intel-linked TARGETS® issued on February 15, 2005.

5. See also Laise (Wall Street Journal 2006) and Fisher (Forbes 2006).

SPARQS® offerings resulted in significant investor losses compared to a direct investment in the reference stock or basket of stocks. They conclude *"it seems unlikely that investor purchases of structured equity products can be explained by any plausible normative model of the behavior of rational investors."*[6] More plainly, no rational and informed investor would buy these products.

Reverse convertibles have received a lot of attention lately both in the academic literature and in the popular press.[7] For example, a 2009 Wall-Street Journal article[8] raises the concern of whether investors fully comprehend the complexity of these investments and whether the brokers selling them fully explain the complexity and structure of these products to the investors.

Regulators have been paying attention to these products as well. The Financial Industry Regulatory Authority (FINRA) fined H&R Block in 2010 for failing to create adequate procedures for supervising sales of reverse convertibles to retail customers and fined and suspended H&R Block broker Andrew MacGill for selling unsuitable reverse convertibles to a retired couple. FINRA Chairman Richard Ketchum commented, *"Reverse convertibles are complex investments which, like many structured products, often entail significant risk of loss. For the typical retail investor, for instance, it would be unwise to put a significant portion of life savings into riskier structured products such as reverse convertibles."*[9] FINRA followed by issuing an "Investor Alert"[10] and a "Regulatory Notice"[11] to highlight these concerns.

In the next section, we illustrate the basic problems with reverse convertibles using a recently issued JP Morgan note linked to the price of TiVo stock. We follow this example with a more general discussion of the types of reverse convertibles sold to retail investors in the United States.

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6. *See* Henderson and Pearson (2010), page 4.
7. *See* Bethel and Ferrell (2007) for a review of the literature.
8. *See* Light (Wall Street Journal 2009).
9. www.finra.org/Newsroom/NewsReleases/2010/P120914.
10. www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883.
11. FINRA Regulatory Notice 10-09, "Reverse Convertibles", February 2010.

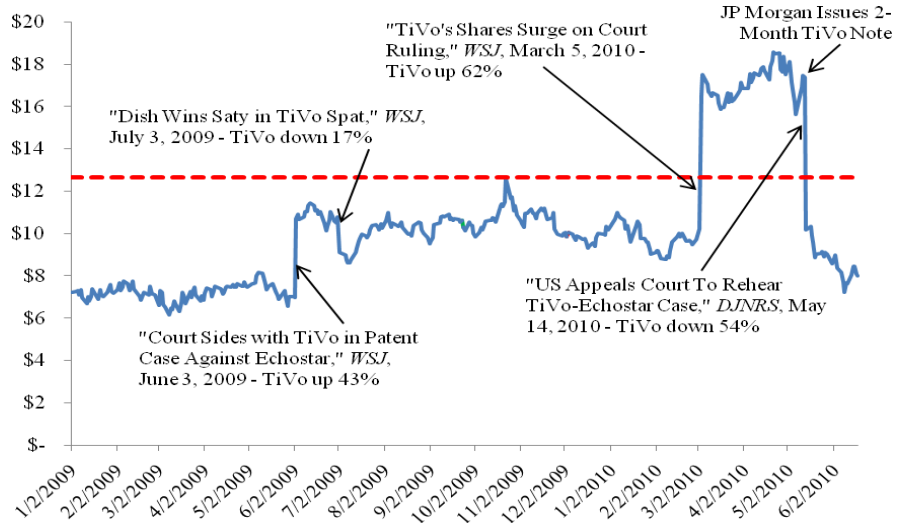
II. Case Study – JPMorgan's TiVo Reverse Convertible

A. TiVo's stock price reflected patent litigation success and failure

TiVo, Inc. ("TiVo") manufactures and sells digital video recorders, or DVRs, that allow users to record and playback cable television shows at a later time.

In recent years TiVo's stock price has been largely determined by the evolution of TiVo's protracted patent infringement litigation with Dish Network Corp. and its parent EchoStar Communications Corp. On June 3, 2009 TiVo's stock price increased by 43% in response to news that a federal court found that EchoStar was continuing to infringe on TiVo's patents despite an earlier injunction and awarded TiVo an additional $103 million in damages. A month later on July 3, 2009 EchoStar was granted a temporary injunction allowing its customers to continue to use EchoStar's infringing DVRs. This decision weakened TiVo's bargaining position with EchoStar and TiVo's stock price fell 17%. On March 4, 2010 an appeals court affirmed an earlier $200 million judgment in favor of TiVo and TiVo's stock price closed at $16.53 - up 62% from its $10.21 closing stock price the day before. See Figure 1.

Figure 1: TiVo Closing Stock Price, January 1, 2009 to June 18, 2010. The three largest one-day changes in TiVo's stock price were all in response to developments in TiVo's patent infringement litigation with two competitors, Dish Network and EchoStar Communications.



B. JP Morgan sells investors a bet on TiVo's litigation fortunes.

On May 14, 2010, JPMorgan Chase & Co. issued $800,000 in notes linked to the price of TiVo's common stock.[12] The notes mature on July 15, 2010 and pay an annualized coupon of 64.25%. On July 15, 2010, in addition to coupon payments, investors in the TiVo-linked note will receive either $1,000 or the market value of 59.24 TiVo shares if it is less than $1,000 and TiVo's stock price ever declines below $12.66 during the note's two-month term.[13] Thus, unlike a traditional note, reverse convertibles like this TiVo-linked note sometimes pay less than the face value of the note at maturity and investors must be fully compensated for this risk with higher coupon rates if the structured product is fairly priced. The high coupon rate on the TiVo-linked note only partially compensates investors for the risk they will receive less than $1,000 at maturity.

Prior to March 4, 2010, TiVo's stock price had not closed above the note's $12.66 trigger price since July 14, 2003 and had closed below $12.66 on 99.8% of the days in the almost 10 years since November 20, 2000. The March 4, 2010 opinion which was being appealed accounted for a large fraction of TiVo's $18 stock price and all of its excess over $12.66. Moreover, excluding the daily returns on June 3, 2009, July 3, 2009 and March 4, 2010, the annualized standard deviation of TiVo's daily returns over the prior year was only 42.6%. Thus, it was extremely unlikely that TiVo's stock price would fall below $12.66 within two months absent a major reversal in TiVo's patent litigation with EchoStar. Therefore, JP Morgan's TiVo-linked note was simply a bet on whether TiVo would suffer a major litigation setback between May, 14, 2010 and July 15, 2010. The stylized payoffs to this bet are listed in Table 1.

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12. The note was priced on May 11, 2010 to settle on May 14, 2010. *See* SEC filing www.sec.gov/Archives/edgar/data/19617/000119312510119097/d424b2.htm.

13. $12.66 is 75% of TiVo's $16.88 closing stock price on May 11, 2010 when JPMorgan set the terms of the TiVo-linked note. The $1,000 offering price was equal to the value if 59.24 shares of TiVo stock.

Table 1
Summary payoffs to the stylized bet with JP Morgan

	Adverse Litigation Development?	
	No	Yes
Coupons	$100	$100
Maturity Payment	$1,000	$600
Total Payments	$1,100	$700
Less Issue Price	-$1,000	-$1,000
Net Payoff	$100	-$300

TiVo's stock price prior to the March 4, 2010 court decision had been around $10 for many years and $10 likely represents an upper bound on what the stock price would be if the March 4, 2010 decision was substantially undermined. We assume for simplicity that the note converts into 60 shares of TiVo stock and that JP Morgan's credit risk and the time value of money over the two-month term of the note is negligible. With these simplifying assumptions, investing in the JP Morgan note is equivalent to agreeing to pay JP Morgan at least $400 if the March 4, 2010 decision was substantially undermined in exchange for a $100 payment from JP Morgan.

Unfortunately for investors who took this bet with JP Morgan, on the same day the TiVo-linked note offering settled, an Appeals Court reversed the March 4, 2010 decision and TiVo's stock price dropped 42%. On the very first day the $1,000 notes became almost certain to convert into 59.2417 shares of TiVo stock that were then worth only $601.90 and have declined in value steadily since. Investors currently appear likely to effectively pay JP Morgan $500 to settle a wager for which they received only $107.08.[14]

This JP Morgan note highlights many of the worst features of reverse convertibles. 1) Brokerage firms link reverse convertibles to extremely volatile stocks, making the embedded short put options extremely costly to investors and valuable to the brokerage firms. 2) Brokerage firms have much better information than retail investors about the events which will trigger the destructive conversion of the notes into shares of depreciated stock. 3) Brokerage firms significantly overcharge retail investors for reverse convertibles because they fail to compensate investors for the risks of the

14. After this report was first distributed, TiVo closed at $8.01 per share on the reverse convertible's Observation Date, July 12, 2010. The Maturity Payment therefore was only $474.53 per $1,000 face value. Ultimately, investors paid $525.47 to settle the wager with JP Morgan for which they were paid $107.08.

embedded put options and the issuers' credit risk. 4) As a direct result of their high hidden costs and short maturities, reverse convertibles typically have *negative* expected returns.

While TiVo had not been an unusually volatile stock for the past five years, the March 4, 2010 court opinion created significant short term uncertainty about the value of TiVo stock. Over the 12 months prior to May 14, 2010, excluding the three critical litigation-related dates identified in Figure 1, TiVo's stock price had a historical volatility of only 42.6%. Sophisticated market professionals recognized a decision was imminent and could have a dramatic impact on TiVo's stock price. TiVo's short term implied volatility nearly doubled in the two weeks prior to JP Morgan's note offering and declined quickly after the May 14, 2010 court decision.

Even knowing that TiVo's short term implied volatility was unusually high wouldn't fully convey the significant risk of JP Morgan's reverse convertible since the embedded put option was nearly binary. Either TiVo would continue to be worth about $18 per share over the next couple of months or it would drop back to $10 per share or less. There was a substantial likelihood that EchoStar's petition would be successful and a successful petition would almost certainly cause TiVo's stock price to drop below the note's $12.66 trigger price resulting in substantial investor losses. JP Morgan's prospectus didn't tell investors about EchoStar's pending petition to have the court reconsider its March 4, 2010 ruling even though the only way for the note to convert into TiVo stock and for investors to lose money was if EchoStar's petition was successful. The prospectus only offered the uninformative boilerplate statement, "*Since its inception, the reference stock has experienced significant fluctuations*".

C. JP Morgan overcharged for the TiVo litigation bet and other reverse convertibles

JP Morgan significantly overcharged investors for the TiVo-linked note. Bloomberg valued the note at only $945 per $1,000 and we value it between $945 and $960 depending on the volatility assumed.[15] Part of the $40 to $55 overcharge was the $17.50 selling concession that the underwriter, JPMorgan Chase, paid on a note that matured in only two months. On an annualized basis, the selling concession was 10.05%. In addition to steep selling concessions, other hidden embedded costs make reverse convertibles like this note worth much less than their offering price.

15. See Faux (Bloomberg 2010).

The JP Morgan note's $945 fair value on the issue date is the $106.94 present discounted value of the coupon payments to be received during the term of the note and the $838.06 present discounted value of the $839.60 expected maturity payment to be received on July 15, 2010. The $839.60 expected maturity payment is the weighted-average of a) $1,000 received if the note does not convert into TiVo stock and b) the $652.14 expected value of 59.24 shares of TiVo stock if the note does convert, weighted by the likelihood of a) and b).[16] *See* Table 2.

Table 2
JP Morgan's TiVo Reverse Convertible
Issue Date Present and Future Value

			Future Value	Present Value
Coupons Payments			$107.10	$106.94
Expected Maturity Payment	Payment	Probability		
Doesn't Convert	$1,000.00	54%	$538.90	
Converts	$652.14	46%	$300.70	
			$839.60	$838.06
TiVo Reverse Convertible			$946.70	**$945.00**

On the date JP Morgan issued this note, the *future expected* value of the coupon payments plus the expected maturity payment was only $946.70. That is, JP Morgan sold investors a note for $1,000 that exposed investors to substantial risks and yet had an expected total repayment of only $946.70 when it was scheduled to mature in 2 months. This note's -5.33% 2-month expected return amounts to a -28% annualized expected return and clearly demonstrates that this investment was per se unsuitable.[17]

We report the breakdown of the value of JP Morgan's TiVo reverse convertible into the value of the unsecured note and the value of the embedded option in Table 3. The component was worth $1,105.11 because of the very high coupon and the put option was worth -$160.11. Investors

16. The probability of the note converting and the average payment given the note converts are calculated from Monte Carlo simulations based on implied volatilities derived from prices of options on TiVo stock.

17. Some care is required when interpreting expected returns calculated "in the risk neutral world." These negative expected returns should be compared to the risk free rate of return. Incorporating the equity risk premium and the note's equity exposure would not change the $945.00 valuation but would increase the expected future value one or two percent.

who purchased this reverse convertible failed to appreciate the put option's cost.

Table 3
JP Morgan's TiVo Reverse Convertible
Note and Option Value

	Value
Coupon Payments	$106.94
Note Maturity Payment	$998.17
Note	$1,105.11
Put Option	-$160.11
TiVo Reverse Convertible	$945.00

The TiVo-linked reverse convertible was not the only problematic structured product recently issued by JP Morgan. In the first six months of 2010, JP Morgan issued at least 354 structured products – 133 of which were reverse convertibles linked to individual stocks. The average issue date value of JP Morgan's recent reverse convertibles is only $956.01 per $1,000. The linked stock price has already fallen below the trigger level in 30 of the 133 reverse convertibles issued by JP Morgan. *See* Table 4.

Table 4
JP Morgan's Reverse Convertibles
January 1, 2010 to June 30, 2010

Number of Issues	133
Aggregate Offering Value	$89.5 million
Average Implied Volatility	47.4%
Average Issue Date Value per $1,000	$956.01
Number Already Breaching Trigger	30

D. Barclays also issued a TiVo-linked reverse convertible

JP Morgan was not the only brokerage firm to issue a short-term reverse convertible linked to TiVo's stock after the March 4, 2010 court ruling caused TiVo's stock price to increase dramatically. Barclays issued a similar

reversed convertible on April 30, 2010.[18] Barclays' TiVo-linked reverse convertible was worth only $915.42 when Barclays sold it to retail investors. See Table 5 and 6.

Table 5
Of Barclay's TiVo Reverse Convertible
Issue Date Present and Future Value

			Future Value	Present Value
Coupons Payments			$45.04	
Expected Maturity Payment	Payment	Probability		
Doesn't Convert	$1,000.00	59.5%	$594.80	
Converts	$685.72	40.5%	$277.85	
			$872.65	
TiVo Reverse Convertible			$917.69	**$915.42**

The Barclay's TiVo-linked note was worth even less than the JP Morgan note because the Barclay's note only paid an 18% annualized coupon which provided very little compensation for the embedded put option on TiVo stock. Barclays also did not tell investors about EchoStar pending petition's to have the court reconsider the March 4, 2010 ruling that had caused TiVo's stock price to rise from $10 to $18 even though there was a substantial likelihood that EchoStar's petition would be successful and a successful petition would almost certainly cause TiVo's stock price to drop below the note's trigger price resulting in substantial investor losses.

Table 6
Barclay's TiVo Reverse Convertible
Note and Option Value

	Value
Coupon Payments	$44.93
Note Maturity Payment	$997.53
Note	$1,042.46
Put Option	-$127.04
TiVo Reverse Convertible	**$915.42**

18. www.sec.gov/Archives/edgar/data/312070/000119312510099015/d424b2.htm.

In the first six months of 2010, Barclays has issued at least 1,339 structured products – 952 of which were reverse convertibles linked to individual stocks. The average issue date value of Barclays' recent reverse convertibles is only $930.88 per $1,000. The linked stock price has already fallen below the trigger level in 271 of the 952 notes. *See* Table 7.

Table 7
Barclays' Reverse Convertibles
January 1, 2010 to June 30, 2010

Number of Issues	952
Aggregate Offering Value	$1.3 billion
Average Implied Volatility	46.4%
Average Issue Date Value per $1,000	$930.88
Number Already Breaching Trigger	271

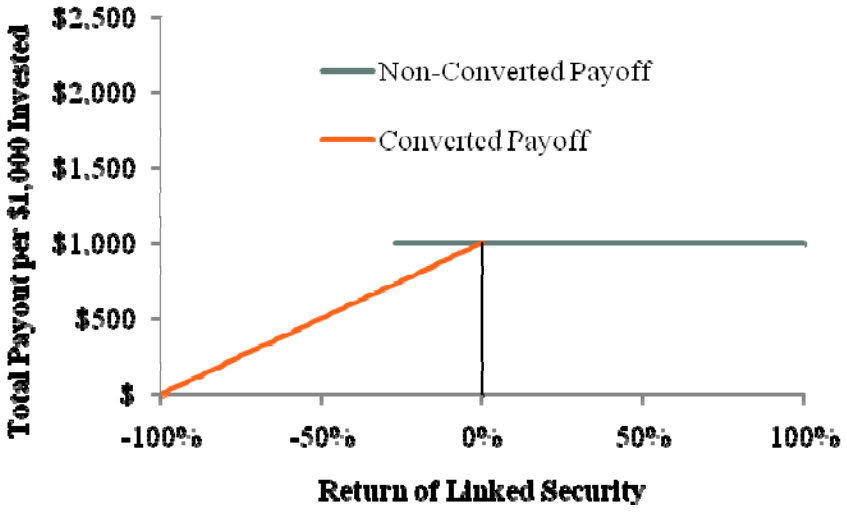
III. Three Reverse Convertibles Types

Reverse convertibles have been sold by many different brokerage firms in addition to JP Morgan and Barclays, including Citigroup, Morgan Stanley, Wachovia, Lehman Brothers, Royal Bank of Canada, and ABN Amro. Although many firms have branded their reverse convertibles, most are similar in structure.

A. Basic Reverse Convertibles

The basic reverse convertible design is an unsecured note issued by the brokerage firm with a short contingent put option on the referenced security. The put option can only be exercised by the brokerage firm if the referenced security's stock price falls below a threshold price at some point during the term of the note. This type of contingent option is typically referred to as a "knock-in" option. If the referenced security's price never drops below the threshold, the reverse convertible note will pay investors the face value of the note at maturity. If the price of the referenced security does drop below the threshold, the reverse convertible note will pay the lesser of the face value of the note and the market value of the number of shares of the referenced security which could have been purchased on the note's pricing date with $1,000. *See* Figure 2.

Figure 2: Maturity payoffs of a basic reverse convertible note.



On April 30, 2010 Barclays issued $750,000 of reverse convertible notes referencing the common stock of the Stillwater Mining Company (ticker: SWC).[19] Barclays' Stillwater-linked notes were sold in $1,000 units, matured on July 30, 2010 and paid a 12% annualized coupon. When the notes were priced, Stillwater's stock price was $16.51 and the threshold was set at $12.38 per share. There are three potential payouts:

1) If Stillwater's stock price does not fall below $12.38 before July 30, 2010 investors will receive the $1,000 face value of the note at maturity.

2) If Stillwater's stock price falls below $12.38 before July 30, but rebounds back above $16.51 on July 30, the investors will receive the $1,000 face value of the notes at maturity.

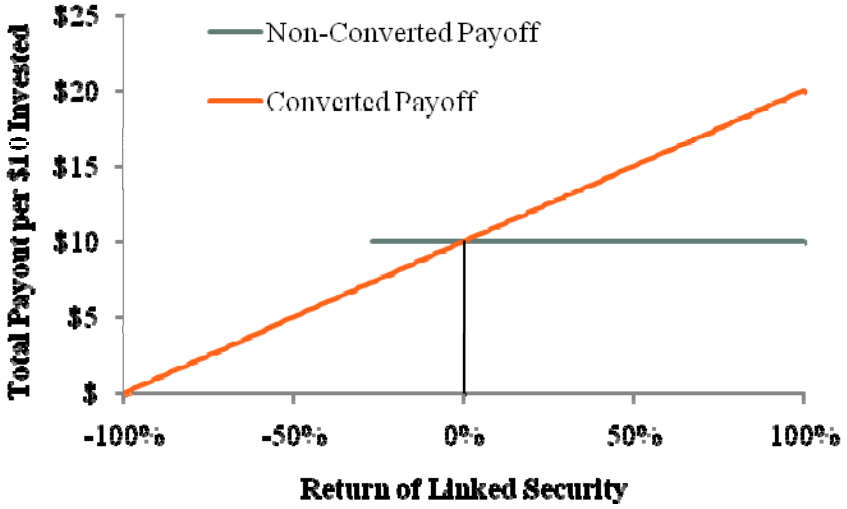
3) If Stillwater's stock price drops below $12.38 before July 30, 2010 and is still lower than $16.51 on July 30, investors will receive the market value of 60.57 shares of Stillwater, which will then be worth less than $1,000.

19. www.sec.gov/Archives/edgar/data/312070/000119312510099015/d424b2.htm.

B. ELKS®

ELKS® are reverse convertibles that have a contingent forward contract, instead of a put option, attached to the issuer's note. If the reference security's price falls below the threshold price, the note effectively converts into a non-dividend-paying equity investment in the reference security and the note's payment at maturity becomes a multiple of the reference security's price on the valuation date.[20] *See* Figure 3.

Figure 3: Maturity payoffs of an ELKS®.



On May 27, 2010 Citigroup issued $11.8 million of an ELKS® reverse convertible note linked to the price of Yahoo! stock (Ticker: YHOO), with a 12% coupon and a six month term.[21] Citigroup issued the note when Yahoo!'s stock price was $15.54 and set the threshold price at $12.43 or 80% of Yahoo!'s $15.54 initial price. This ELKS® had two potential payouts at maturity:

1) If Yahoo! stock price does not fall below $12.43 during the note's term, investors will receive the $10 face value of the note.

20. The multiple is equal to the face value of the note divided by the initial price of the reference security.

21. www.sec.gov/Archives/edgar/data/831001/000119312510129509/d424b2.htm.

2) If during the note's term, Yahoo!'s stock price falls below $12.43, investors will receive the market value of 0.2681 shares of Yahoo! which may be worth more or less than $10 depending on whether Yahoo!'s stock price is then greater or less than $15.54.

C. SPARQS®

SPARQS® are reverse convertibles that convert from equity-like payoffs to debt-like payoffs at the discretion of the issuer. If the issuer does *not* exercise its call option, the payout will be the value the coupons paid plus the value at the valuation date of the number of the reference security's shares which could have been purchased on the structured product's offering date for the face value of the note. If the issuer does exercise the call option, the note is liquidated on the call date and investors are paid an amount so that they earn a pre-specified annualized return (the "yield to call") on the note's face value. SPARQS® are similar to basic reverse convertibles since stock and short call options have payoffs which are quite similar to notes and short put options. In both cases, investors are exposed to the downside risk of the reference security with little or no participation in the security's upside.

On March 24, 2008 Morgan Stanley issued $20 million of a 10% coupon paying SPARQS® with a $19.015 face value.[22] This note was issued with AT&T's stock as the reference stock and a term of 12 months. Morgan Stanley had the right to call the note any time during the last 6 months in exchange for a payment that would make the realized "yield-to-call" equal to 19%. This note has two potential payout scenarios:

1) If Morgan Stanley does *not* call the reverse convertible, the note-holder will receive coupon payments and the market value of 0.5 shares of AT&T.

2) If Morgan Stanley calls the reverse convertible, the note-holder will receive coupon payments due plus an amount sufficient to yield a 9.5% return (i.e., a 19% annualized return).

We analyze 101 SPARQS® issued by Morgan Stanley since June 2001 with an aggregate size of $2.97 billion. All are linked to the returns of single stocks. The SPARQS®'s average term is 1.1 years, with a maximum of two years. The notes' embedded call options have strike prices that generate annualized yields to call between 15% and 53% with a mean of 22.8%.

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22. www.sec.gov/Archives/edgar/data/895421/000095010308000803/dp09258_424b2-ps540.htm.

Table 8 reports summary statistics of a sample of additional reverse convertible note offerings between 2001 and 2010. Wachovia issued the most basic reverse convertibles in our sample by dollar value and Lehman Brothers issued the most by number of individual issues. Citigroup issued ELKS until it was acquired by Morgan Stanley and now Morgan Stanley issues ELKS®. Morgan Stanley issues SPARQS®.

Table 8
Additional reverse convertibles sample summary statistics

Issuers	Brand Name	Issues	$ Millions
UBS	Reverse Convertibles	32	$12
Lehman Brothers	Reverse Exchangeable Notes	78	$53
RBC	Reverse Convertibles	43	$67
Morgan Stanley	ELKS®	4	$148
Morgan Stanley	Reverse Convertibles Notes	41	$216
Wachovia	EYS®	50	$701
Morgan Stanley	SPARQS®	101	$2,970
Citigroup	ELKS®	96	$5,400

IV. Valuing Reverse Convertibles

We value a sample of 244 basic reverse convertibles, 100 ELKS® and 101 SPARQS® described in Table 8 and report the results in Table 9.[23] All 244 basic reverse convertibles were issued at a face value of $1,000, but our valuations show that on average they were worth substantially less than $950. Some Lehman Brothers' reverse convertibles were worth as little as $776.[24] On average, the reverse convertibles we analyzed paid investors including coupons much less than $1,000. Total payments made by issuers other than Lehman ranged from $798 per reverse convertible note to $979. We estimate the fair value of ELKS® at between $8.68 and $9.79 per $10. 86 of the 96 Citigroup offerings have matured and returned an average of only $8.8 per $10 note.

Following Henderson and Pearson (2010), we estimate the issue date valuation of SPARQS® using a finite-difference estimation method. The

23. *See* Deng, Guedj, Liu, Mallett, and McCann (2010) and Li (1998) for an extensive methodological discussion.

24. Lehman Brothers defaulted on all their 78 reverse convertibles in our sample. This highlights the inherent risk in reverse convertibles that investors may underestimate, default risk.

reverse convertibles expose investors to the downside market risk of the underlying security and the credit risk of the issuer. On average, the issue date value of the 101 SPARQS® is 93% of the SPARQS®'s issue price. The lowest issue date value is 78.6% of the issue price, and the highest issue date value is 99.2% of the issue price. Interestingly, SPARQS® are worth less on their issue date than basic reverse convertibles or ELKS®, perhaps because SPARQS® are much more difficult to replicate and price than basic reverse convertibles or ELKS®.

Table 9
Reverse convertibles sample pricing

Issuers	Issues	Positive returns	Price Issued	Average Fair Value	Range Fair Value	Average Payout
Basic Reverse Convertibles						
UBS	32	9[25]	$1,000	$953	$912-$982	$1,045
Lehman Brothers	78	0	$1,000	$937	$776-$991	$0
RBC	43	31	$1,000	$968	$927-$1,007	$970
Morgan Stanley	41	18	$1,000	$933	$877-$959	$798
Wachovia	50	35	$1,000	$938	$908-$972	$979
ELKS®						
Citigroup	96	42[26]	$10	$9.5	$8.68 – $9.79	$8.81
Morgan Stanley	4	NA	$10	$9.5	$9.36 – $9.68	NA
SPARQS®						
Morgan Stanley	101	NA	$100	$92.96	$78.4 - $99.2	NA

V. Risk Analysis

Reverse convertibles expose investors to significant downside risk and limited upside potential. We develop two measures based on negative and positive semi-variance to illustrate the risk of the reverse convertible. [27] The

25. Out of the 32 UBS Reverse convertibles, only 9 have matured and all those 9 issuances have had a positive return.

26. Only 86 of the 96 Citigroup ELKS® have matured and are used to calculate the return to investors. None of the Morgan Stanley Reverse convertibles have matured yet.

27. Semi-variance is a measure of the dispersion of all observations that fall below the mean or target value of a data set. Semi-variance is similar to variance; however, it only considers observations below the mean. Hence, semi-variance provides a measure for downside risk. By neutralizing all values above the mean, or

first measure, Relative Downside Risk (RDR), compares the reverse convertible's risk of earning less than the risk-free rate to the reference security's risk of earning less than the risk-free rate. An RDR of 0% means that the reverse convertible's return is never less than the risk-free rate or return. Conversely, an RDR of 100% means that the reverse convertible exposes investors to the same risk of earning less than the risk-free-rate that the investors would experience if they invested in the reference security.[28] We follow Nawrocki (1999) to calculate the RDR and use simulations to evaluate the RDR of reverse convertibles. We simulate 50,000 price paths for each structured product's underlying security, and use the simulated price paths to calculate 50,000 holding period returns for each reference security and its associated structured product. Table 10 presents summary statistics for the RDR of the 344 reverse convertibles in our sample. The data indicates that, on average, reverse convertibles are exposed to 74% of the reference security's downside risk.

Table 10
Relative Downside Risk ("RDR") and Relative Upside Potential ("RUP")

	RDR		RUP		Issues
	Range	Mean	Range	Mean	
Reverse convertibles	60%-88%	75%	8%-40%	18%	244
ELKS®	67%-84%	74%	11%-39%	24%	100

Relative Upside Potential (RUP) compares the reverse convertible note's possibility of earning more than the risk-free interest rate to the reference security's possibility of earning more than the risk-free rate. A RUP of 0% means that the reverse convertible note's return never exceeds the risk-free rate of return, regardless of what the reference security's return is.[29] A RUP of 100% means that investors enjoy the same upside potential above the risk-free-rate as if they had invested in the reference stock rather than the reverse convertible note.

an investor's target return, semi-variance estimates the dispersion of losses that a portfolio could incur.

28. The RDR of reverse convertibles is generally less than 100% because the reverse convertibles' trigger feature, which prevents the issuer from exercising its option(s) unless the reference security drops below a certain level, effectively protects investors from small losses sustained by the reference security.

29. Any investment with an RUP of 0% and a non-zero RDR would be a poor investment, as it would expose the investor only to potential losses but not commensurate the investor with any gains.

The RUP of basic reverse convertibles is generally substantially lower than 100% as reverse convertibles do not participate in any of the gains of the reference security. The RUP of reverse convertibles really measures how much the reverse convertible's coupon payments exceed the risk-free rate or return. The RUP of ELKS® reflects both the difference between the coupon payment and the risk-free rate of return and the ELKS® exposure to the reference security's upside potential.

It might seem that the average RUP of ELKS® would be substantially higher than that of basic reverse convertibles since the ELKS® allows an investor to participate in the reference security's gains if the reference security falls and then rises back above the issue-date price. However, we find that the RUPs of ELKS® and basic reverse convertibles are indistinguishable. This lack of upside benefit is because ELKS® have smaller coupon payments than basic reverse convertibles and because there is little value in the exposure to the reference security's upside potential once the security's price has fallen enough to cause the note to convert into stock.

On average, reverse convertibles share a large portion of the reference security's risk of returning less than the risk free rate, while sharing only a small portion of the likelihood of returning more than the risk free rate.

VI. Conclusions

Reverse convertibles are common structured products which have payoffs that are relatively easily replicated and hence are simple to value. After estimating the issue date value of 1,530 reverse convertibles we find that, on average, the reverse convertibles were only worth 94% of their offering price. Of these 1,530 notes, 409 have matured which allows us to calculate their realized yield to maturity. The yield to maturity, which is the discount rate that makes the present value of the reverse convertible note's actual cash flows equal to the note's issue price, is on average -25.6%. The realized yields to maturity range from -99.99% to 46.1%. These numbers highlight the high, unnecessary costs incurred by investors buying reverse convertibles.

The vast majority of reverse convertibles could have been replicated for less than the reverse convertible note's issue price. Given the complex nature of the products' payoffs, the unsophisticated clientele to which they were sold, and the lack of a secondary market to correct the mispricing, it is quite likely that these reverse convertibles were sold at a premium because investors did not fully the understand the products and their risks.

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Notes & Observations

THE LANDSCAPE OF BROKER-DEALER COMPLIANCE AND EXCEPTION REPORTING SYSTEMS

David Tilkin[1]

The landscape at all broker-dealers, self-clearing or otherwise, has changed completely since 2002. The change relates to the exacting process of how broker-dealers supervise registered representatives and their interaction with their customers...the public investor.

Since 2002 almost all broker-dealers have procured, developed or begun to utilize some form of compliance software or system that automates supervision, exception reporting, audit and account review. At many firms, the system is suitability-based, meaning that the analysis is sensitive to the financial position and demographics of the underlying client and household. At many broker-dealers this software system is the absolute foundation of supervision and utilized daily by branch managers, compliance personnel and sales leadership.

This new direction has significant implications for litigation, regulatory participation and expert witness strategy. To be most effective in the arbitration/litigation process it is critical to understand how these software systems function, the analysis that is executed in analyzing transactions, security positions and investment account activity. These systems also provide the oversight conducted against broker activity and behavior. If you don't possess working knowledge of these exception reporting systems, you'd better hope that your expert does. As much as 50% of the effort behind supervising broker activity and account condition depend upon these software systems. The systems themselves have become part of the day-to-day regimen of account review. The software systems represent the very foundation of broker-dealer supervision efforts. You need to know how to imbed that fact in the discovery process. Not knowing can place the attorney at a significant disadvantage.

On the other hand, to have an expert that is proficient with these software systems on your team gives you the advantage of understanding how

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1. David Tilkin, president of the Tilkin Group, is a twenty-plus year veteran of the securities industry, having worked on a branch and regional management basis for both Smith Barney and Wachovia. Mr. Tilkin is also the founder and past C.E.O. of Protegent, the first company to automate the process of broker-dealer exception reporting, audit, and account surveillance.

thousands of broker-dealers manage the exception reporting and supervision process. It allows you to extend discovery into the reality of day-to-day activity in the broker-dealer compliance process and procedure and enhances the opportunity for success.

As a securities litigator, the first question that needs to be asked of a brokerage firm is how is a broker-dealer's compliance software system distributed and how the roles, functions and responsibilities surrounding that system are delegated.

All compliance software systems are designed with a varying degree of flexibility as to how wide and deep into the field compliance technology can be placed. Ideally, as a senior level BD executive, you would want every branch manager and compliance officer to have access to daily exception reports and trade blotter review. Whether or not a system is deeply distributed and compliance responsibility delegated is a function of firm culture and the capacity of the hardware driving the system. In a larger brokerage, multiple users tapping into a system simultaneously can place significant strain on response times, greatly limiting user satisfaction and subsequent participation.

In an ideal situation, the compliance software system is distributed throughout the sales organization into every branch, satellite and remote location. This distribution will almost always lead to some degree of cultural change where the delegation of compliance responsibility increases to align with the compliance system. It does not make much resource sense to place advanced tools at a supervisor's disposal and not allow him/her to act on the information or to have poorly trained branch managers and system users. I have found many poorly trained managers and systems users in the past and the results are a system that is both undervalued and underutilized. This also raises the issue of compliance and exception reporting efficacy audits. There has been little to no investment made on the part of the securities industry in conducting efficacy audits of either procured compliance software systems or legacy systems already in place. Efficacy auditing will become a major factor in determining the long-term success of the financial and resource investment made in a compliance exception reporting system.

Brokerage firms have often delegated compliance responsibility simply as an act of insulating management up the chain-of-command from regulatory scrutiny. Before there was automated compliance software systems, branch managers and compliance officers were at tremendous risk for failure to supervise. Today, the delegation and subsequent risk still exists but for the most part there are tools to marginalize the exposure. Most importantly, any system is only as good as the users, and on this point we have seen a wide range of success and failure.

It is critical to understand what data drives a compliance software system and how the exception reporting mechanism operates. Much of what branch managers and compliance staff do during the day is reliant upon both of these components. Your understanding of compliance systems and software only advances your ability to successfully manage litigation from discovery to hearing.

The data that drives a compliance system is multi-source, meaning, it comes from a number of potential locations and is generally aggregated in a central database for use by the compliance system. Typical sources of data are the back-office system, new account system, varying research engines (Morningstar, etc.) and other legacy systems at the brokerage firm. The old adage "garbage in, garbage out" fully applies to broker-dealer compliance software and systems. If the data is old, poorly organized or faulty, the results within the exception reporting will be of that standard. Issues with data are the number one contributor to difficult software implementations and user dissatisfaction. Failure on the part of the brokerage firm to update client information on a regular basis can turn a compliance software system into a very bad messenger of ethical practice issues.

In an ideal situation, the compliance software system uses exception reporting that is suitability based. This means that every activity and transaction within a brokerage account is evaluated based on the financial, experiential and demographic characteristics of each individual investor. Some firms still utilize manual paper-based exception reporting that does not see beyond the actual trade and has no "insight" into the customer demographic. The chances that that firm will drive a much higher degree of customer complaints are very, very high.

Exception reporting is the cornerstone of every compliance software system. It is the process by which supervisors are notified of activities or transactions that violate firm rules, common sense investment strategy or standards established by securities regulators. In almost all cases, exception reporting is provided to branch managers and compliance personnel no later than trade date plus one. A trade done Monday afternoon would trigger an exception first thing Tuesday morning. As earlier mentioned, whether the exception reporting is or is not suitability based will to a large extent determine the value of the analysis.

Exception reporting is typically based on rules established at the time of software implementation and managed over time. The delivery of the exception reporting is almost always web based and delivered to managers and compliance staff over the corporate intranet. There could easily be hundreds of rules run every night against every account that experienced activity, a transaction or change in customer account profile information.

Those transactions could trigger additional analysis to look for patterns and trends. A good example would be a transaction that triggers an over-concentration alert in either a security or industry segment. In addition, the transaction may trigger an alert that identifies an increase to an already over-concentrated position. The management of the rules for the underlying system is generally stored in the database and managed by the brokerage firm.

Important points to remember: suitability based exception reporting that runs nightly after trade date and creates exception reporting the next day is capable of capturing 90% to 95% of the issues that initiate client complaints. The success of a compliance exception reporting system often comes down to the quality of management, supervision and the compliance process as to whether something finds its way to your desk.

For broker-dealer compliance software and systems, there are many critical components that contribute to the success and efficacy of the compliance system. The accurate replication of firm data, transaction, position, customer and securities information, is the fuel that drives every compliance system. A failure or inaccuracy in any of the aforementioned is a critical failure that will lead to faulty results and inaccurate information. My experience is that the most overlooked aspect of an effective compliance system is the design and implementation of both the delegation and distribution of the software itself. This is no small point because by delegation and distribution we mean: Who is using the system?...and.... How is it being used? This more than anything will have direct impact on the supervision of your clients' brokerage/investment accounts.

Many financial service firms think that the compliance software "job" is done with the procurement of a compliance software system and surprisingly little resources are applied to the implementation, training and deployment process. Mistakenly, many firms believe that a compliance software system is effective if it is only distributed to the upper tier of compliance oversight staff. This, more than any other deployment decision, will sidestep what is the very intent of the software. All designers of compliance systems intend for the software to contribute to creating a compliance culture. This can only be accomplished with fully distributing the software up and down the full chain of command and delegating supervisory responsibility along with the software down to the field level.

We are all familiar with the challenges of securing talented management personnel. This challenge is significant in the securities industry where the "best and the brightest" may not elect to assume the risk of management. Even the most talented managers and supervisors run the risk of being named on a failure to supervise issue. No amount of software will supplant lack of

management and supervisory talent. That being said, compliance software does create an environment that reduces risk of failure to supervise and supports ethical practice for public investment accounts. This is only accomplished through a fully delegated and distributed system. For this reason, you will find a lesser quality of management at firms that have not implemented an advanced compliance software system.

Compliance software and systems are only as effective as the degree to which the software is both delegated and distributed. Automated exception reporting has the most value when in the hands of those with field supervision responsibility. The topic of delegation and distribution provides significant opportunity and challenges in the discovery process. These systems create enormous amounts of discoverable information, including, but not limited to, exception reports, account, branch and broker audits. Knowing how to decipher a broker-dealer's software and system and its deployment provides valuable insight and opportunity in advancing a case, investigation, audit and litigation.

SOME QUESTIONS AND ANSWERS

Q. Most compliance software and systems are used only by firm compliance officers?

A. False. Most systems are designed to be deployed into the field for daily access and use by branch managers and branch administration and compliance personnel.

Q. Most broker-dealers have some form of automation for exception reporting and analysis?

A. True. In spite of the fact that there are 5,100 registered broker-dealers, most have some form of software automation for account risk and exposure. Many clearing firms offer some form of compliance automation to their correspondents.

Q. All exception reporting is suitability based?

A. This varies widely. Not all systems are able to take into consideration the demographic information about clients and households. Householding of accounts has been an ongoing challenge from a data and analysis perspective for broker-dealers. The “fly in the ointment” is also the quality and timeliness of a firm’s efforts to maintain a customer re-profiling process. Suitability or demographic information that becomes dated greatly diminishes the value of the compliance and exception reporting software.

Q. The most common forms of malfeasance are easily spotted by compliance automation software?
A. This also varies widely and depends to a certain extent on the amount of historical data that is initially loaded into the software system. The more historical data, the better but this process adds to the expense of implementation. Issues such as churning, excessive commission generation, over-concentration, switching, etc, are easily highlighted as issues for most compliance systems.
Q. Only self-clearing broker-dealers have automated exception reporting?
A. Not true. Many clearing firms provide their correspondent broker-dealers with added trade blotter analysis and exception reporting tools. First Clearing, Pershing, RBC Correspondent Services and others all provide added exception reporting capability.
Q. Most automated compliance systems can generate hard copy reporting?
A. True. Most systems have either direct report writing capability or link to other report writing applications. The amount of reporting varies, but almost all systems provide for some production of hard copy reporting.

EXAMPLES OF BRANCH OFFICE COMPLIANCE SOFTWARE SYSTEM DISCOVERY QUESTIONS

USERS

1. Do branch managers have access to a daily exception reporting system?
2. Is this system distributed over the web or in paper form?
3. Who is responsible for creating or generating the rules that drive the exception reporting and analysis?
4. Detail the users of your firm's branch compliance software system by both title and responsibility.
5. How often does your branch compliance software system provide for electronic exception reporting? Who is the reporting directed to? Detail both title and responsibility.
6. Are electronic exception reporting delivered to other personnel at your firm other than branch supervisory personnel? If so, to whom?

DATA

7. When the system was deployed, how many months of historical firm and client data was loaded into the system?
8. What is the source (s) of data that drives the compliance software system? Back office, third- party data provider, data warehouse, clearing firm? Does your compliance software systems rely on any third-party research and if so, which ones?
9. Does you daily exception reporting systems memorialize the actions of the reviewers and managers in response to exceptions?
10. Does the branch software compliance system automatically household accounts for analysis?
11. How does your firm maintain and control the rules and analysis that is executed in the branch compliance software system?
12. For what period of time is the information, analysis and exception reporting retained within the system?
13. Is the data that drives the system analysis input on a dynamic or batch basis? If batch, how frequently does the batch process run?

SYSTEM

14. How long has the company been using a branch automated exception reporting system?
15. Was the branch office compliance software system procured from an outside vendor or is it an existing legacy system developed in-house? If procured from an outside vendor, who is the vendor and what is the name of the software?
16. How are the rules that drive the exception reporting and analysis written, generated and tested?
17. Are the electronic trade blotters scrubbed for exceptions or do you use a flagging system for trades that might require incremental review?
18. Is the analysis and exception reporting of the branch software compliance system based on KYC (know your customer) standards? Are the KYC standards established at account opening? Are they updated over time? Does the software system look for inconsistencies with the KYC process? For example, liquid net worth versus investment objectives? What fields from the standard new account form are replicated in the branch compliance software system database?
19. What date was the branch compliance software system deployed to the field and respective branches?

REPORTING

20. Does your daily exception reporting system have the ability to generate reports? If so, does the system generate reports on accounts, households, brokers and branch?
21. Does the branch compliance software system allow you to run ad-hoc reporting and analysis?
22. Does your branch office compliance software system generate electronic trade blotters?
23. In what format can standard and ad-hoc reporting be generated in, e.g., PDF, HTML, TXT

TRAINING

24. How much training was provided to users of the system at the time of the initial implementation of your compliance software system? How much on-going annual training is provided?
25. Does your branch compliance software system have supporting documentation and manuals that are accessible or provided to users?
26. Are these manuals and documentation provided in hard copy or electronic form?
27. Were branch users trained on the branch compliance software system?

CONCLUSION

The landscape of compliance and exception reporting has changed significantly since 2002. Many brokerage firms were resistant to advancing their compliance and supervision efforts for years based on two factors: that the regulatory "bar" would be raised for firms using advanced compliance systems, and that the data, notes and documentation of the system would be discoverable. As it turns out, both of these facts have come to pass. Regulators have become very familiar with the software currently used by broker-dealers to manage exception reporting, and account review and these systems have become a treasure trove of documentation detailing the account review process and activity.

The value of a compliance and exception reporting system rests on a few factors: the degree to which the system is delegated and distributed, the quality of the data within the system, the existence of a compliance culture that supports usage and the level of training and support to users of the

system. A system that is procured and poorly implemented or trained will have little value to the overall mitigation of risk within public customer accounts.

Product complexity has brought a new challenge to compliance and exception reporting systems. This is obvious in cases such as the Morgan Keegan fund cases where the underlying capital market structure of the funds themselves would remain opaque at best to the compliance system. This is also true of other capital market instruments such as inverse exchange traded funds. Not only are branch managers poorly trained on the underlying capital market structures but the rules and analysis of compliance and exception reporting systems has not kept pace with product complexities.

Notes & Observations

AUCTION RATE SECURITIES – PUBLIC COMPANIES

John Fazio[1]

You will not find a reference to Auction Rate Securities in the index in the back of Charlie Gasparino's best selling book, THE SELLOUT.[2] However, there is an entertaining story in the beginning of his book that bears repeating under the axiom that history repeats itself. Gasparino tells the story of a young Wall Street trader who lost money in the bond market in 1977 and was screaming about getting whip chained. The trader's boss came up to him and told the trader that stuff like that happens all the time and that he can't tell the trader exactly why, but the one thing that he does know is that the word is "whipsawed" not whip chained.

Public companies that hold Auction Rate Securities ("ARS") are being whipsawed. They face a Hobson's choice between:

1. Holding their ARS to maturity (tying up their cash, receiving low interest rates, seeking alternative financing arrangements, and/or modifying their business plans and goals for the next 20-30 years) or,
2. Classifying their ARS impairment as "other-than-temporary" and taking the valuation loss as a charge to current earnings (tying up their cash, receiving low interest rates, seeking alternative financing arrangements, and/or modifying their business plans and goals for the next 20-30 years).

The long parenthetical expressions after (1) and (2) are identical and emphasize the dilemma in which public companies find themselves.

The staff of the Financial Accounting Standards Board has offered guidance on determining when an investment is considered impaired, whether the impairment is other than temporary, and the measurement of an

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1. John Fazio has worked on thousands of securities arbitration cases and has testified in hundreds of cases since 1990. Mr. Fazio was employed in the securities industry for 40 years as a regulator, a consultant, and an officer and employee of brokerage firms. Mr. Fazio is now an independent expert witness and can be reached at jbfazio@earthlink.net or by telephone at (480) 860-6831.

2. CHARLES GASPARINO, THE SELLOUT: HOW THREE DECADES OF WALL STREET GREED AND GOVERNMENT MISMANAGEMENT DESTROYED THE GLOBAL FINANCIAL SYSTEM (2009).

impairment loss.[3] While a full explanation of the accounting standards is beyond the scope of this article, and oversimplification can be dangerous, it might be said that there are three steps to be followed.

In applying the first step, an investment is impaired if the fair value of the investment is less than its cost. For an investment that is illiquid, special procedures must be followed to determine the fair value of the security; these are set forth in FASB 157 and are sometimes referred to as "mark to the market" accounting. [4]

Step two requires an assessment of whether the impairment is either temporary or other than temporary. When an investor has decided to sell an impaired available-for-sale security and the investor does not expect the fair value of the security to fully recover prior to sale, the impairment is deemed other-than-temporary for the period prior to sale.

Step three provides that when it is determined that the impairment is other than temporary, then an impairment loss must be recognized in earnings that is equal to the difference between cost and its fair value.

While every case is different, for many public companies, taking a multi-million dollar ARS loss would effectively displace their operating profits. Simply take the unrealized loss or the "impairment" on the ARS, divide it by the number of common shares outstanding, then compare the ARS loss per share to the last quarterly earnings per share reported by the company. The public companies find themselves between a rock and a hard place.

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Between December 2008 and July 2009, the SEC formalized complaints against large investment-banking firms describing the fraudulent tactics used to promote the sale of Auction Rate Securities.[5] Many of the same

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3. *Statement of Financial Accounting Standards No. 157, Fair Value Measurements* (Sept 2006), http://www.fasb.org/pdf/aop_FAS157.pdf.

4. *Id.*

5. *See, e.g.,* Press Release 2009-163: *SEC Charges TD Ameritrade for Auction Rate Securities Sales Practices* (July 20, 2009); Press Release 2009-127: *SEC Finalizes ARS Settlements With Bank of America, RBC, and Deutsche Bank* (June 3, 2009); Press Release 2009-17: *SEC Finalizes ARS Settlement to Provide $7 Billion in Liquidity to Wachovia Investors* (February 5, 2009); and Press Release 2008-290: *SEC Finalizes ARS Settlements With Citigroup And UBS, Providing Nearly $30 Billion in Liquidity to Investors* (December 11, 2008); http://www.sec.gov/investor/ars.htm.

investment-banking firms had reached an "agreement in principal" earlier with the SEC, which were finalized when the SEC complaints were filed. [6]

Some legal practitioners believe that the Consent Agreements were an admission to liability and that the sole issue in a claim before an arbitration panel would be damages. However, a careful reading of the Consent Agreements would indicate otherwise. By signing the Consent Agreements, the investment-banking firms did not concede liability.

The Consent Agreements signed by some investment-banking firms excluded the obligation to buy-back ARS from customers who owned more than $10 million[7], or in some cases, $15 million[8]. The investment-banking firms also knew that by excluding their customers who owned more than $10 or $15 million in ARS from the settlement agreement, they could still placate the SEC by taking care of retail customers and at the same time minimize their own settlement costs.

Furthermore, the investment-banking firms also may have understood that some of their customers who owned more than $10 or $15 million were public companies and they might find themselves between a rock and a hard place if those public companies pursued litigation.

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6. *See, e.g.*, Press Release 2008-247: *Bank of America Agrees in Principle to ARS Settlement* (October 8, 2008); Press Release 2008-246: *SEC Division of Enforcement Announces ARS Settlement in Principle With RBC Capital Markets Corp*. (October 8, 2008); Press Release 2008-181: *SEC Enforcement Division Announces Preliminary Settlement With Merrill Lynch to Help Auction Rate Securities Investors* (August 22, 2008); Press Release 2008-176: *Wachovia Agrees to Preliminary Auction Rate Securities Settlement That Would Offer Approximately $9 Billion to Investors* (August 15, 2008); Press Release 2008-171: *UBS Securities LLC and UBS Financial Services, Inc. Agree in Principle to Auction Rate Securities Settlement* (August 8, 2008); Press Release 2008-168: *Citigroup Agrees in Principle to Auction Rate Securities Settlement* (August 7, 2008); http://www.sec.gov/investor/ ars.htm.

7. Consent of RBC Capital Markets Corporation, Securities & Exchange Commission v RBC Capital Markets Corporation (S.D.N.Y. May 14, 2009), http://www.sec.gov/investor/ars.htm.; Consent of Deutsche Bank Securities Inc., Securities & Exchange Commission v Deutsche Bank Securities Inc. (S.D.N.Y. June 1, 2009), http://www.sec.gov/investor/ars.htm.; Consent of Citigroup Global Markets Inc, Securities & Exchange Commission v Citigroup Global Markets Inc. (S.D.N.Y. December 13, 2008), http://www.sec.gov/investor/ars.htm.

8. Consent of Defendants Banc of America Securities LLC And Banc of America Investment Services, Inc., Securities & Exchange Commission v Banc of America Securities LLC And Banc of America Investment Services, Inc. (S.D.N.Y. May 22, 2009), http://www.sec.gov/litigation/ litreleases/2009/lr21066-boa-consent.pdf.

The investment-banking firms obviously bet that the public companies would not reflect an ARS loss in their financials and would be loathe to admit that their frozen ARS funds would cause them to alter their business plans. Thus, any public company that entered litigation in an effort to recover its losses (and liquidity) would probably lose when the case was heard. There have not been many of these cases, but history has proven this assessment accurate so far.

One recent FINRA decision noted that after 20 hearing sessions the Respondent filed a post-hearing brief regarding the Claimant's third quarter 10-Q report. The 10-Q and 10-Q's for all public companies are available for all to see on the SEC's website, EDGAR. The information contained in the 10-Q's is free discovery for the investment-banking firms.

Public companies may include "forward-looking statements" in their financial reports and other materials filed with the SEC about their current and expected performance trends, growth plans, business goals and other matters. The Private Securities Litigation Reform Act of 1995[9] provides a "safe harbor" for forward-looking statements to encourage reporting companies to provide prospective information about them as long as they identify the forward-looking statements and provide meaningful cautionary statements identifying important factors that could cause actual results to differ from projected results. [10]

The 10-Q filed by this particular claimant included forward-looking statements that indicated that the public company currently had the ability and intent to hold its ARS investments until their full value recovered, until the ARS reached maturity, or until the ARS could be sold in a market that facilitates orderly transactions, and that the "impairment" was temporary. The FINRA decision was a verdict for the defense.

Before a public company considers filing a claim against an investment-banking firm, it should first look at its own financial reports and determine whether the reports accurately reflect its situation. The senior executive officers of the public company may change forward-looking statements made at an earlier time. In changing the forward-looking statements or keeping them as is, the senior executive officers should remember that they must also sign a certification attesting to the accuracy of the annual report when it is filed with the SEC.

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9. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

10. *See, e.g.,* Paul Munter, '*Safe harbor' under the Private Securities Litigation Reform Act of 1995*, THE CPA JOURNAL (8/1/2000), http://www.allbusiness.com/legal/966592-1.html.

While this self-evaluation process may not be pleasant, especially in a weak economy and a recovering stock market, reviewing how management has previously accounted for its ARS investments and making appropriate changes (if required) may ultimately be in the best interests of its shareholders. After all, the real claimants in these matters are the shareholders of the public companies.

This is what the arbitration panel also saw when it reviewed the 10-Q for the public company previously mentioned:

> The total assets of the public company were $296.5 million. This figure included $111.8 million in frozen ARS. The ARS was marked down from $129.4 million; an "impairment" of $17.6 million was taken. Total revenues for the current year to date were $124.9 million. The net loss for the current year to date was $7.7 million; the loss for the previous year was $32.6 million. None of the losses included a penny of the ARS "impairment."

From what little is said in the arbitration decision, we do not know how the Claimant came to own $129.4 million in ARS, i.e., who said what to whom, etc. The auction rate securities did not sell themselves to the customer. Whatever was said, the panel did not hit the investment-banking firm with damages.

The fact that the management of a public company told the SEC and its shareholders that the frozen ARS would not impact operations and then filed an arbitration claim may be very troubling to an arbitration panel. But, it should be no more troubling than the investment-banking firm telling the panel that the ARS risks were disclosed and then having the panel discover later that the investment-banking firm let its sales force say anything it pleased. When all the facts in the case become known, they may not be very flattering to either side. The wisest path for both parties to take may be to settle the matter.

One recent study of SEC reporting companies found 396 holders of ARS, with the holdings having a total par value of $18.5 billion.[11] The study found that the vast majority of the holders took an "impairment" on their ARS holdings and that the aggregate impairment was $3.4 billion. Some holders took no "impairment" at all. The amount of the "impairment" varied significantly, but the average discount ranged from 15% to 30%.[12]

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11. *Auction Rate Securities Holders Survey*, Pluris Valuation Advisors LLC (March 29, 2010), http://www.plurisvaluation.com/site/ars/holders_survey.html.

12. *Id.*

For claimants who are public companies, ARS suits might be two-dimensional: in addition to the fraudulent practices described in the SEC complaints, the attorneys for the claimants need to consider what the institutional brokers employed by the investment-banking firms were telling their customers and what the institutional brokers were doing with those accounts. Both areas must be thoroughly examined.

The thrust of the defense strategy in ARS arbitrations is predictable: present evidence that shows the claimants were sophisticated, demonstrate that the frozen ARS hasn't caused the public company a loss or interfered with the claimant's business (by using the public companies' own financial reports), show that the public company received interest at a higher rate as compensation for the risk that an auction might fail (and the security would then become illiquid), and again show that there was adequate risk disclosure.

At hearing and in their pleadings, the investment-banking firm may describe the claimants as "institutions" as if that placed them in the same category as a Reporting Fed Dealer.[13] Yes, some executives at these companies were very smart, even astute, when it came to running the company's business, but the level of their sophistication fell short of the knowledge and sophistication of the investment-banking firms when it came to ARS. The investment-banking firms clearly possessed material non-public market information that the public companies that purchased and held ARS did not have.

Recall the discussion above about how the public company's records may hurt its chances of winning an arbitration. Other records, however, might help its chances of winning. In a contentious arbitration, what the documents reveal may be a double-edged sword. The following inquires might be made about the public company's records.

> Can the data on the customer's financial records be traced back to the data shown on the reports given to the customer by the investment-banking firm?
>
> Did the investment-banking firm supply the customer with reports other than the monthly account statements that indicated the ARS had short "duration" or short effective maturities? This may have misled investors into believing that ARS were in fact short-term securities.
>
> Did the investment-banking firm need to figure out the monthly interest income accruals on the ARS for the public company?

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13. Generally, banks and securities broker-dealers that trade in U.S. Government securities with the Federal Reserve Bank.

Were there e-mails between the public company and the investment-banking firm? Did the statements made in the e-mails contradict the disclosures that the investment-banking firms made about ARS?

Looking at the types of investments held by the public company, did the ARS represent a concentration?

How were the ARS investments classified for balance sheet purposes in the financial reports for the period before the auction markets froze? What did the accompanying notes to the financial statements say about the ARS?

Was the ARS "traded" by the public company? How did the public company select which ARS to buy and which to sell?

Did the "trading" make sense considering the operating cash flows of the public company?

Did the public company have a formal investment policy? Did the investment-banking firm obtain possession of those policies during the new account process? Are the stated maturities of the ARS consistent with the customer's internal investment policies?

This brings us to the investment-banking firm's argument that ARS paid a higher interest rate as compensation for the risk that the auction market could freeze and the securities could become illiquid. The investment-banking firm may use short-term money market rates as the basis for comparison for the period prior to February 2008. This might be a tactical mistake as using short-term interest rates could be interpreted as an admission that ARS was sold to the customer as a short-term security.

The appropriate interest rate comparison should be to other securities having the same ratings and stated maturities, not short-term money market rates, and what the rates paid on those securities were after the auction market froze needs to be considered. Customers may have bought ARS with the idea that it would hold the investment for a short period of time. Investors now know that they may have to hold the same security for the next 20 to 30 years and will receive significantly less interest than the rate pegged on the day the ARS was bought. It does not look like investors will receive much of anything as compensation for the risk they took.

One of the areas that the panel will be most interested in is how the ARS was sold to the customer. Some investment-banking firms had a "portal" on their internet websites showing what ARS issues were available for sale. Others firms did not have a "portal" and directed customers to speak to their brokers.

Did the ARS trade confirmations indicate that the purchases were unsolicited? Because ARS are esoteric investments, the "unsolicited"

notation on the purchase confirmations must be questioned. The potential problems in this area for the investment-banking firm are many. The "unsolicited" notation might misrepresent the transaction, the unsolicited notation may have been used to conceal commission-driven transactions or even worse, may have been used to conceal solicited transactions that could be deemed unsuitable, and the failure by the investment-banking firms to question the "unsolicited" notation itself could represent an obvious failure to supervise.

Many of the ARS securities that became illiquid in February 2008 were municipal securities; counsel for both parties should be familiar with the rules and regulations that apply. While most of the frozen ARS were purchased when the *old* NASD institutional suitability interpretation was in place, NASD rules do not apply to municipal securities. IM-2310-3 sets forth the NASD's position and should be read in its entirety.[14] In the middle of the first paragraph, the NASD states that the interpretation is applicable to all debt securities, except municipals. A footnote at the bottom of the page indicates that rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.[15]

MSRB Rule G-19 prohibits a dealer from recommending transactions in municipal securities to a customer unless the dealer makes certain determinations with respect to the suitability of the transactions.[16] Specifically, the dealer must have reasonable grounds for believing that the recommendation is suitable based upon information available from the issuer of the security or otherwise and the facts disclosed by the customer or otherwise known about the customer.

MSRB rules have a twist when it comes to disclosure. Rule G-17, the MSRB's fair dealing rule, encompasses two general principals.[17] First, the rule imposes a duty on dealers not to engage in deceptive, dishonest, or unfair practices. Second, the rule imposes a duty to deal fairly. As part of the dealer's obligation to deal fairly, the MSRB has stated that the dealer's affirmative disclosure obligations require dealers to "disclose, at or before

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14. NASD Rules, IM-2310-3 "Suitability Obligations to Institutional Customers" http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3641.

15. *Id.*, n.1.

16. MRSB Rule G-19, "Suitability of Recommendations and Transactions; Discretionary Accounts" http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-19.aspx.

17. *See* "Rule G-17 Interpretation – Notice Regarding Rule G-17 on Disclosure of Material Facts," (March 20, 2002) http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2#_ftn3.

the sale of municipal securities to a customer, all material facts concerning the transaction, including a complete description of the security."[18] These obligations apply even when a dealer is acting as an order taker and effecting non-recommended secondary market transactions. [19]

The SEC described material facts as those "facts which a prudent investor should know in order to evaluate the offer before reaching an investment decision." [20] Furthermore, the United States Supreme Court has stated that a fact is material if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.[21]

The reasonable investor would not have purchased ARS if told in advance that the investment-banking firms that had supported the ARS auction process for many years, now had to stop because they had capital problems. Without additional disclosure, the inference is that nothing had changed since the day that the investment-banking firms had first posted their disclosure statements back in 2006.

Further, MSRB Rule G-17 would seem to require the investment-banking firms to disclose to customers that they would likely withdraw their support from the auction market and that in the absence of their continued support the auctions would likely fail and ARS would likely become illiquid. There is a world of difference between saying the auction market could fail and the auction market would likely fail.

A number of important ARS cases are in the various stages of completion. While the battle lines have long been drawn, it will be interesting to see how those cases will ultimately be decided. [22]

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18. *Id.* at ¶ 2.

19. *Id.*

20. Municipal Securities Disclosure, Securities Exchange Act Release No. 26100 (September 22, 1988) 53 Fed. Reg. 37778-01, n.76**.**

21. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S.Ct. 2126, 2132 (1976).

22. The opinions stated in this article are those of the author and should not be construed as legal or financial advice. The subject matter involving ARS is extremely complex, crosses over into many areas and cannot be fully discussed in a single document the size of this article. Public companies contemplating ARS litigation should seek competent legal counsel. The facts and circumstances of every arbitration case are different. Due diligence does not assure immunity from errors.

Notes & Observations

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Elliott C. Levinthal, Rhoda L. Levinthal, and the Elliott C. and Rhoda L. Levinthal Revocable Trust dated 10/09/80 v. First Republic Securities Company, LLC

American Arbitration Association (AAA) Case No. 30 435 Y 00218 09

In July 2007, Claimants invested $3 million in Respondent's "Tender Option Bond" program. This program, which Respondent named the "TW Tax Advantaged Fund LLC," involved a leveraged arbitrage strategy that included trades of long municipal bonds, short-term notes, and interest-rate derivatives or swaps. Claimant Elliott C. Leventhal is a professor emeritus of mechanical engineering at Stanford University. Coincidentally, Mr. and Mrs. Levinthal endowed Levinthal Hall, a lecture hall at the Stanford Humanities Center.

During a few days in late February and early March 2008, the Fund "suddenly collapsed in such a way that Respondent concluded that its best- and perhaps its only-option was to liquidate the Fund entirely and to return the scant remains to its investors, including Claimants." As a result of Respondent's actions, Claimants lost $2,100,000.00, which represented approximately 70 percent of their investment, virtually overnight.

Claimants raised the following claims: (1) Breach of fiduciary duty; (2) Negligence; (3) Negligent misrepresentation; (4) Breach of contract; (5) Fraud and deceit; (6) Violation of the California Elder Abuse & Dependent Adult Protection Act, California Welfare & Institutions Code, Section 15657.5; (7) Violation of various provisions of the California Corporations Code; and, (8) Violation of certain FINRA Rules.

Respondent denied Claimants' claims and raised various affirmative legal and equitable defenses.

Award: The arbitration panel found that: (1) Respondent failed to perform proper due diligence in designing the Fund, (2) Respondent failed adequately to train its sales agents; (3) Respondent failed adequately to supervise its sales agents in their dealings with Claimants concerning the Fund; (4) Respondent made, and suffered its agent to make, recommendations of an investment, namely the Fund, that was entirely unsuitable for Claimants in light of their investment history, objectives and

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

risk tolerance; (5) Respondent's warnings concerning the risks inherent in an investment in the Fund indeed had a dramatic ring, but without more they were destined to be-as they proved to be-ineffectual; and (6) Respondent's responsible agents failed to keep Claimants informed timely and accurately of significant adverse events in the life of the Fund of which Respondent was fully aware, about which Claimants could only have learned otherwise by making essentially random inquiry. Based upon these findings, the Panel awarded Claimant $2.1 million in compensatory damages, plus reimbursement of $78,153 in arbitrators' fees and expenses (in total, Respondents were ordered to pay $131,606.62 in arbitrators' fees and expenses).

Claimants' Counsel: Cary S. Lapidus, Esq., Law Offices of Cary Lapidus, San Francisco, California

Respondents' Counsel: Lawrence E. Fenster, Esq. and Matthew C. Plant, Esq., Bressler, Amery & Ross, New York, New York.

Claimants' Experts: Dr. J. Craig McCann (Securities Litigation & Consulting Group), Gregory C. Tevis, and Richard Libby.

Respondents' Experts: Nat Singer, Swap Financial Group, LLC

Arbitrators: Francis O. Spalding (Chairperson), Bruce W. Belding, and D. Steven Blake.

This award is significant because it represents an award of 100% of Claimants' loss. The arbitration panel issued a 15-page reasoned award. Some of the excerpts are discussed below.

Although the Panel found that Claimants were not "uninformed or naive investors," and that the evidence showed that Claimants were "on many occasions far too willing to accept representations that a person of his background, intelligence, education and position should certainly have inquired into more carefully," the Panel also found that "[t]he entire thrust of modern securities law, however, as it relates to dealings between industry professionals and their retail customers, stands against the notion of equality of responsibilities on both sides of that relationship" and that "[a]n investor may put his or her head in the sand, but only after the professional has done everything within reason to bring to the investor a full, fair and balanced understanding." The Panel found that in this case, "the catalog of opportunities missed or omitted for bringing such an understanding to the investor is far too full to meet that standard."

The Panel also found that it "heard no evidence concerning any realistic advance recognition by Respondent's staff of any specific risks or patterns of risk like those that became all too apparent after the Fund's collapse." Nevertheless, the Panel found Respondent liable.

The Panel expressly found that the training materials that Respondent provided its representatives "were entirely inadequate both in scope and in content." In addition, the Panel found that the broker's "testimony at the hearing... made it evident, even with every opportunity for *post hoc* embellishment, [that] she still scarcely understood the Fund." The Panel also expressly stated that:

> It is possible that an investment in the Fund might have been suitable----or at least that it might have been made suitable-for Claimants, since Claimants are intelligent and experienced, not to mention independent-minded, investors. But Claimants were entitled to receive-and should have been required by Respondent to receive-an expansive and thoroughgoing explanation of the Fund from agents of Respondent who were fully trained and highly skilled in communicating about complex investments before being permitted to invest in the Fund-an investment product of a type and complexity that, broad as their experience was, Claimants were never shown to have ever encountered before. What Respondent offered Claimants by way of education about the Fund as an investment vehicle, as established in the evidence, was fleeting and slapdash. An investment in a highly complex and concededly risky product like the Fund, sold in this fashion, is by definition unsuitable for any investor with Claimants' investment history and characteristics.

Lastly, despite its determination that had Claimants "could have been brought to an adequate understanding of the possible consequences of such an investment," if they had actually reviewed the PPM in full detail," the Panel found that this "did not happen." Rather, the Panel determined that "[h]asty and imprecise conversations and sketchy and potentially ambiguous e-mail exchanges were far from enough to accomplish that result-a result that Respondent was duty bound to achieve," and that "[a] free-standing doomsday warning unrelated in any adequate way to the actualities of the Fund-much less the mere use of such terms as 'risk' and 'leverage'--does not suffice to discharge Respondent's obligations to insure that its customer is actually apprised of the suitability and risk of investments offered to them by Respondent."

William H. Monroe and Barbara S. Monroe, et al. v. Hantz Financial Services, Inc.

FINRA Case No. 09-03846

Claimants invested money with one of Respondent's representatives. The representative was also Claimants' best friend and neighbor. Claimants alleged that over the course of their relationship, the broker converted approximately $425,000 from them, which represented approximately 90% of Claimants' investable funds. The broker did so by taking withdrawals from Claimants' annuities and promising to reinvest the withdrawn amounts in other investments. The broker also gave Claimants falsified statements that purported to show these other "investments."

Claimants alleged the following claims: (1) Federal securities fraud; (2) Violation of the Michigan Uniform Securities Act; (3) Breach of fiduciary duty; (4) Constructive fraud; (5) Failure to supervise; (6) Respondeat superior; (7) Negligence and negligent supervision; and, (8) Breach of contract. In their Statement of Claim, Claimants sought general and compensatory damages of $1,000,000, plus unspecified other relief.

Respondents denied the claims and raised various affirmative defenses.

Award: The Panel ordered Respondent to pay Claimants $425,766.00 in compensatory damages, $19,000 in costs, $375.00 for Claimant's filing fee, and $141,922.00 in attorneys' fees pursuant to case law and the Michigan Uniform Securities Act.

Claimants' Counsel: Mark E. Maddox, Esq., Maddox Hargett & Caruso, P.C., Fishers, Indiana

Respondent's Counsel: Bradley J. Schram, Esq., Hertz Schram, PC, Bloomfield Hills, Michigan

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

Respondent's Expert: None

Arbitrators: James L. Karpen (Public Chairperson), John F. Burns (Public), and Jennifer Ann Schandler (Non-Public)

This case is significant because the Panel ordered Respondent to pay Claimants 100% of the amount of money Claimants' alleged the broker had converted. In addition, the Panel awarded attorneys' fees equal to one-third (1/3) of the compensatory damages, plus nearly $20,000 in costs.

Rose Miniaci, et al. v. Morgan Keegan & Company, Inc.
FINRA Case No. 08-03677

Claimants are a wealthy and well-regarded family in their community. One of the Claimants is an attorney and another was a successful businessman who had also been involved in real estate. In addition, Claimants had signed new account forms that stated their primary investment objective was "speculation." Claimants invested money in three Morgan Keegan/RMK funds: (a) the RMK Select Intermediate Bond Fund; (b) the RMK Advantage Income Fund; and, (c) the RMK Mutti-Sector High Income Fund. Claimants focused their case on the broker and were able to prove that he did not understand the RMK funds and that he was misled by Morgan Keegan as to the safety of the funds.

Claimants alleged the following claims: (1) Unsuitability; (2) Breach of fiduciary duty; (3) Negligence; (4) Negligent supervision; (5) Fraud; (6) Breach of contract; (7) Violation of Section 11 of the Securities Act of 1933; (8) Violation of Section 12(a)(2) of the Securities Act of 1933; (9) Misrepresentation; and, (10) Violation of the Florida Securities and Investor Protection Act (Florida Statutes, Chapter 517). Claimants sought an order of rescission and/or compensatory damages in excess of $1 million, as well as unspecified punitive damages, interest, costs, attorneys' fees, and other relief.

Respondents denied the claims and raised various affirmative defenses.

Award: The Panel found Morgan Keegan liable on the claims of negligent supervision, misrepresentation, and unsuitability, and ordered it to pay a total of $1,080,108.38 in compensatory damages, inclusive of interest, to the five separate Claimants. The Panel denied the parties' requests for attorneys' fees.

Claimants' Counsel: Jeffrey Erez, Esq. and Jeffrey R. Sonn, Esq., Sonn & Erez PLLC, Fort Lauderdale, Florida.

Respondent's Counsel: Bradley B. Rounsaville, Esq. and T. Louis Coppedge, Esq., Maynard, Cooper & Gale, P.C, Birmingham, Alabama

Claimant's Expert: Dr. J. Craig McCann (Securities Litigation & Consulting Group).

Respondent's Experts: Steven Scales (Secure Financial Services) and Christopher Laursen (NERA Economic Consulting)

Arbitrators: Burt R. Rose (Chairperson), Stanley M. Goldberg (Public), and Michael S. Davidoff (Non-public).

This case is significant because it represents a full recovery of losses, despite the fact that Claimants were wealthy and despite two Claimants' professional experience and despite the Panel's decision to deny the admissibility of regulatory complaints against Respondent.

The Official Unsecured Creditors' Committee of Bayou Group, LLC v. Goldman Sachs Execution & Clearing, L.P. and Spear Leeds & Kellogg, L.P.

FINRA Case No. 08-03904

Claimants, who were creditors of the failed Bayou Hedge Funds, filed a Complaint in bankruptcy court simultaneous to filing the Statement of Claim. Respondents agreed to arbitration. The case(s) arose from Respondents' role as a prime broker and clearing broker for the hedge funds, which "were run as a massive Ponzi scheme in which massive trading losses were camouflaged from investors by the creation of false financial statements and misrepresentations about the funds' investment performance."[2] The Complaint further alleged that from 1999 through 2005, Respondents earned millions of dollars in fees as prime broker and clearing broker for the funds. Claimants alleged that Respondents knew or should have known of the fraud and despite this, "continued to provide the lucrative prime brokerage and clearing services" to the funds and that Respondent's "transfers of cash into their margin accounts with [Goldman], and [Goldman]'s provision of margin, were integral facets" in the Ponzi scheme. Claimants also alleged that because Respondents had access to the funds' trading records, it knew or should have known of the fraud and failed to investigate it. Respondent had access to Bayou's trading records. These records reflected significant losses. Bayou's marketing materials also contained misrepresentations related to the Fund's returns. Respondent also had copies of these materials.

Claimants raised the following claims: (1) Fraud; (2) Failure to investigate the fraud; and, (3) Fraudulent transfers. Claimant requested compensatory damages in the amount of $20,580,514.78 with interest, and attorneys' fees.

Respondent denied Claimants' claims and raised various affirmative legal and equitable defenses.

Award: The Panel awarded Claimant $20,580,514.52 in compensatory damages.

Claimants' Counsel: John G. Rich. Esq. and Ross B. Intelisano, Esq., Rich & Intelisano, LLP, New York, New York.

Respondents' Counsel: Eric A. Bensky, Esq. and Howard Schiffman, Esq., Schulte Roth & Zabel LLP, Washington, D.C.

Claimants' Experts: Bob Conner and Courtney Bellaire (Thornapple Associates).

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2. All quotations refer to the Complaint filed in *In re Bayou Group, LLC, et al.*, No. 06 B 22306 (ASH), (Bankr. S.D.N.Y. May 30, 2008).

Respondents' Experts: Richard Lindsey (Bear Stearns Securities Corp. – formerly)

Arbitrators: Lucas A. Ferrara (Chairperson), Joseph F. Grassi (Public), and Vincent Cannaliato, Jr. (Non-public).

This award is significant because it represents 100% of the amount Claimants requested. In addition, this award is the largest compensatory damages award issued against Goldman Sachs in arbitration. According to Claimant's counsel, it is also the first win in any court or arbitration forum by investors against a clearing or prime broker related to a hedge fund Ponzi scheme based upon fraudulent transfer theories.

Racetrac Petroleum, Inc. v. Bear Stearns & Co., Inc., et al.

FINRA Case No. 07-03561

Claimant is a multi-billion private company that invested in the Bear Stearns High Grade Structured Credit Strategies L.P. Hedge Fund. The company also signed risk disclosures related to its investment in the Fund. Due to confidentiality issues, the majority of the background facts cannot be disclosed. The case related to the misrepresentations and omissions related to the risks associated with the Fund, the hidden subprime mortgage exposure, and false representations of risk management.

Claimant asserted the following causes of action: (1) Fraud under the Securities Exchange Act of 1934; (2) Fraud under Title 10, Chapter 5 of the Georgia Code; (3) Fraud under other applicable statutes; (4) Common law fraud; (5) Misrepresentation and material omission; (6) Breach of fiduciary duty; (7) Breach of contract; (8) Unsuitability; (9) Aiding and abetting; (10) Gross negligence; (11) Negligence; (12) Failure to supervise; (13) Control person liability; and, (14) Respondeat superior. Claimant requested compensatory damages in the amount of $5,000,000.00, attorneys' fees and treble damages pursuant to Section 10-5-14 of the Georgia Code. O.C.G.A §10-5-14 (2007), rescission, pre- and post-award interest, costs, expenses, expert fees, FINRA fees, punitive damages and such other relief available by applicable statute or law.

Respondent denied Claimants' claims and raised various affirmative legal and equitable defenses.

Award: The Panel found Respondents Bear Stearns & Co., Inc, Bear Stearns Securities Corp. and Bear Stearns Asset Management jointly and severally liable for misrepresentation and material omission, negligence, failure to supervise, and respondeat superior and ordered Respondents to pay Claimant compensatory damages in the amount of $3,431,889.00.

Claimants' Counsel: Ross B. Intelisano, Esq. and John Rich, Esq., Rich & Intelisano, LLP, New York, New York.

Respondents' Counsel:

For Respondents Bear Stearns & Co., Inc., Bear Stearns Securities Corp., and Bear Stearns Asset Management, Inc.: Marshall Fishman, Esq. and Gabrielle Gould, Esq., Kramer Levin Naftalis & Frankel, LLP, New York, New York.

For Respondent Ralph Cioffi: Marc A. Weinstein, Esq., Hughes Hubbard & Reed LLP, New York, New York.

For Respondent Richard Marin: Andrew J. Levander, Esq., Dechert LLP, New York, New York.

For Respondent Ray McGarrigal: Cori Browne, Esq., Driscoll & Redlich, New York, New York.

For Respondent Matthew Tannin: Nina M. Beattle, Esq., Brune & Richard LLP, New York, New York.

Claimants' Experts: Professor Hugh Cohen of Applied Financial Research LLC and Emory University

Respondents' Experts: Dr. Andrew Carron (NERA Economic Consulting) and Todd Kesselman (Precision Capital).

Arbitrators: Ann H. Orr (Chairperson), Jerome Jack Shure (Public), and Kenneth Alexander Campbell (Non-public).

This award is significant because despite the fact that Claimant was a multi-billion dollar private company and that Claimant signed risk disclosures, the Panel found the misrepresentations and omissions strong enough to overcome the risk disclosure and entered an award that represented approximately 68% of Claimant's net out of pocket loss. In addition, the award was rendered after the criminal acquittals of portfolio managers Ralph Cioffi and Matthew Tannin.

Harriet Gale and Irving Harris v. Dawson James Securities, Inc.

FINRA Case No. 09-00874

Claimants are both in their 80's and retired. Approximately 80% of their respective accounts had been invested in AAA-rated tax-free municipal bonds, and the remainder had been predominantly invested in investment grade corporate bonds. In May, 2008, Respondent's representative/broker solicited each Claimant to invest $50,000 in Main Street Natural Gas, Inc. Series 2008A bonds. The broker described the bonds as "tax-free municipal bonds" issued by Main Street Natural Gas, Inc. The broker failed to disclose critically important information about the Main Street bonds, namely the fact that they were guaranteed by Lehman Brothers. This transaction occurred

approximately one month after the bonds were originally issued. Claimants were not provided with a prospectus prior to purchasing the bonds. Upon receipt of the prospectus after purchase, Mr. Harris called the broker to inquire about the reference to Lehman Brothers in the prospectus summary page. The broker said that Lehman Brothers was "just the underwriter".

Main Street Natural Gas, Inc. Series 2008A bonds are "pre-paid natural gas bonds." This type of bond did not exist prior to 2005-06, when The Energy Policy Act of 2005 authorized entities such as Main Street to use their tax-exempt status as a vehicle to facilitate tax-exempt borrowing in order to obtain a long-term natural gas supply.

Main Street is a municipal gas entity operating as a part of the Georgia Gas Authority. Main Street raised approximately $700mm for the bond offering. Main Street paid the proceeds to Lehman Brothers Commodity Services (LBCS), a subsidiary of Lehman Brothers Holdings, Inc. (Lehman Brothers), in exchange for a 30 year supply of natural gas at a fixed price. Main Street then sold the natural gas it purchased from LBCS to its municipal customers, and used the proceeds to repay the bondholders. Main Street would also engage in commodity swap agreements with London based Calyon Bank, to hedge against changes in the price of natural gas.

Pursuant to the terms of the offering, LBCS' obligations to Main Street were guaranteed by its parent company, Lehman Brothers. In addition, if any of Main Street's municipal customers defaulted on their obligations to purchase gas from Main Street, Lehman ultimately guaranteed those obligations. LBCS (and Lehman Brothers) also guaranteed Main Street against potential default by Calyon Bank on its obligations pursuant to the commodity swap agreements. Therefore, even though Main Street was the issuer of the bonds, it was not a guarantor of the bonds, and had no financial obligation to the bondholders because all guarantees were by Lehman Brothers. Furthermore, although the Main Street bonds are categorized as "tax-free municipal bonds issued by Main Street", the credit rating on the bonds was based solely and exclusively on the creditworthiness of Lehman Brothers.

The broker also failed to disclose that in the week prior to issuance/sale of the bonds, Lehman Brothers was downgraded by multiple ratings agencies and that, as a result, the agencies also downgraded the bonds. In addition, the broker failed to disclose critical information contained in research reports that highlighted several negative factors that were specific to the bond issue.

In the spring of 2008, fears relating to Lehman Brothers' financial condition spread. Neither Respondent nor the broker ever mentioned the name Lehman Brothers to the Claimants. The Claimants believed that they were safely invested in tax-free municipal bonds backed by the Georgia Gas

Authority. In fact, Claimants learned that Lehman Brothers was the guarantor only after Lehman Brothers filed for bankruptcy and the bonds plummeted in value. Ultimately, the bonds defaulted in October 2008. Unlike other brokerage firms, who typically include some indication of a third-party guarantor on their account statements and trade confirmations (*i.e.*, "AA-, GTD by LEH"), Respondent's account statements and trade confirmations contained no reference to Lehman Brothers.

Claimants alleged the following claims: (1) Breach of fiduciary duty; (2) Negligence; (3) Negligent Supervision; (4) Fraud; and, (5) Breach of contract. In their Statement of Claim, Claimants sought compensatory damages of between $100,000 and $500,000, punitive damages, interest, costs, and other equitable relief. At the close of the hearing, Claimants requested rescission of the sale.

Respondents denied the claims and raised various affirmative defenses, including: (1) they sent the Claimants a prospectus, which disclosed Lehman Brothers' role; (2) the bonds satisfied the Claimants' criteria (*i.e.*, they were AA-rated, tax-free municipal bonds); and, (3) Lehman Brothers' accounting fraud (Repo 105) caused the bonds to lose value, and Respondent could not possibly have known about Lehman Brothers' accounting fraud.

Award: The Panel found Respondent liable for breach of fiduciary duty and breach of contract and ordered Respondent to rescind the transaction and to pay Claimants $11,000.00 in compensatory damages and $300.00 for Claimant's filing fee.

Claimants' Counsel: Stefan M. Apotheker, Esq., Sonn & Erez PLLC, Fort Lauderdale, Florida.

Respondent's Counsel: Neil S. Baritz, Esq. and Robert C. Harris, Esq., Baritz & Colman LLP, Boca Raton, Florida.

Claimant's Expert: None.

Respondent's Expert: None.

Arbitrators: David P. Slater (Chairperson), Jay E. Eckhaus (Public), and Robert H. Hagan (Non-public).

This case is significant in that the arbitration panel ordered full rescission, rather than damages, based upon its finding of breach of fiduciary duty (rather than negligence).

CASES & MATERIALS

Jason A. Richardson[1]

PRIOR TO ARBITRATION

Compelling Arbitration: Arbitrability of Claims against Broker/Dealers in Selling Away Cases

Lincoln Fin. Advisors Corp. v. Healthright Partners, LP
No. 2:09CV 650 DAK (D. Utah Jan. 22, 2010)

An investor may be deemed to be a "customer" of a brokerage firm, even when the investor did not maintain an account with the firm and bought securities that were not authorized by or reported to the firm.

This case was before the court on a motion to compel arbitration filed by Defendants Healthright Partners, LP and Grant R. Gifford. In September 2009, Lincoln – a FINRA member firm – filed a declaratory judgment action seeking a declaration that, pursuant to FINRA rules, Defendants were not "customers" of Lincoln and that Defendants therefore could not require Lincoln to participate in the FINRA arbitration process which the Defendants had already initiated. In their Motion to Compel Arbitration, Defendants sought a ruling that they were customers of Lincoln and that Lincoln must therefore participate in the FINRA arbitration process.

Lincoln's registered representative, Scott B. Gordon, was the firm's Salt Lake City branch manager. The dispute at issue in the FINRA arbitration complaint was essentially whether Lincoln failed to supervise Mr. Gordon, who allegedly defrauded the claimants in connection with the sale of $3,375,000 worth of stock in a company that Gordon ran called HealthRight, Inc.

The claimants alleged that they trusted Mr. Gordon because he was a manager and "Co-Regional CEO" for Lincoln, and they were not aware that their HealthRight investments were not approved investment products. The claimants alleged that they were "pitched" on this investment in Lincoln's offices, and all of the sales presentations were made by Mr. Gordon, who

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[1] Jason A. Richardson is an attorney in 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.

handed them his Lincoln business card and emphasized his managerial position at Lincoln to gain their trust. They further alleged that Mr. Gordon assisted in raising capital for claimants and establishing a limited partnership for them. Finally, the claimants alleged that they lost their investments with HealthRight as a result of unscrupulous conduct by Mr. Gordon.

According to Lincoln, Mr. Gordon was terminated by Lincoln in September of 2006, shortly after Lincoln learned of his actions in promoting and selling HealthRight stock, among other actions. Lincoln alleged that the claimants had never held an account with Lincoln and they had never paid investment fees or commissions to Lincoln. Lincoln also argued that HealthRight stock and investments were not authorized as investments by Lincoln, Mr. Gordon's sales of HealthRight stock to the claimants were not approved by Lincoln, the sales were not reported to Lincoln, and the shares were never held in any Lincoln brokerage account. Also, Lincoln never received any commissions or fees as a result of Mr. Gordon's sales of HealthRight stock.

The court held that Lincoln must submit to arbitration because (1) as a member of FINRA, Lincoln was required to submit this dispute to arbitration in its own forum, and (2) FINRA's Code of Arbitration Procedure and cases involving similar facts define the term "customer" very broadly, finding that when an investor deals with a member's agent or representative, the investor deals with the member itself. The court noted that this was a classic "selling away" case, and at the time Mr. Gordon solicited this investment, he was the branch manager and regional Co-CEO of Lincoln's Salt Lake City office, and therefore an "associated person" of Lincoln. Thus, the court ordered that the motion to compel arbitration be granted.

Compelling Arbitration: Arbitrability of Claims against Broker/Dealers by Customers of Independent Investment Advisors

Charles Schwab & Co., Inc. v. Reaves
No. CV-09-2590-PHX-MHM (D. Ariz. Feb. 3, 2010)

Investors who have provided funds to an independent investment advisor for deposit in the advisor's personal brokerage account are not considered "customers" of the brokerage firm, and accordingly, lack standing to enforce the advisor's arbitration agreement with the firm.

The central figure in this case is a non-party, Debbie Bennett, who was the second wife of a Phoenix dermatologist who was 17 years younger than her husband and who was a housewife with no securities licensing.

According to complaints levied against her, Mrs. Bennett was "a very attractive woman" who "dressed in the finest, most expensive designer clothing," "adorned herself in thousands of dollars of expensive jewelry," and "portrayed herself as a 'gifted' securities trader." Based on her "glittering image," she was able to persuade friends, family, and charity sponsors to "invest" with her. Ultimately, her "investments" turned out to be nothing more than a Ponzi scheme, and many people lost a great deal of money. These individuals sued Mrs. Bennett, who ultimately declared bankruptcy.

After Mrs. Bennett filed for bankruptcy, some of the individuals who had lost money to her, as well as the trustee of the bankruptcy trust, filed a FINRA arbitration claim against Charles Schwab, a FINRA member firm. Mrs. Bennett apparently used her personal Schwab account to invest at least some of the investor's funds. However, Mrs. Bennett and her husband were the sole account holders of the Schwab account, and Schwab alleged that it was not aware that Mrs. Bennett was using the Schwab account to invest money belonging to anyone other than the Bennetts. According to Schwab, all of the funds turned over by the investors to Mrs. Bennett were first deposited into a Wells Fargo bank account in the name of Deborah Bennett and/or her husband, James Alva Bennett. The money would then be transferred from their personal Wells Fargo account to their Schwab account. The investors raised the following claims against Schwab in the arbitration claim: aiding and abetting breach of fiduciary duty, aiding and abetting fraud, aiding and abetting securities fraud and negligence.

Charles Schwab filed a motion for preliminary injunction with the court, arguing that the investors had no right to arbitrate their claims because they were not parties to any arbitration agreement with Schwab. Schwab also argued that the investors were not "customers" of Schwab, and therefore had no basis to rely on or enforce the arbitration agreement signed by Mrs. Bennett.

The court found that the investors were not "customers" of Schwab, noting that rather than standing in Mrs. Bennett's shoes, the defrauded investors were attempting to bring claims against Schwab for negligently failing to supervise her dealings to their detriment. The court found that none of the investors' claims were brought on behalf of Mrs. Bennett; they were brought on behalf of the investors themselves as none of the claims were premised upon any injury to Mrs. Bennett, but upon their own alleged injuries. Finally, the court found that while the bankruptcy trustee may have the right to pursue claims previously owned by the Bennetts, the claims asserted in the FINRA action were not on behalf of the Bennetts, but on behalf of the Bennetts' investors, and therefore not arbitrable.

Challenging Unconscionable Arbitration Agreements

Lhotka v. Geographic Expeditions, Inc.
No. A123725 (Cal. Ct. App. Jan. 29, 2010)

An arbitration agreement may be unconscionable, and therefore unenforceable, when it is one-sided and presented to a customer as mandatory, unmodifiable, and no different than what the customer would find from an alternative provider.

This case involves a wrongful death action brought by the survivors of a Geographic Expeditions ("GeoEx") customer who died on a Mount Kilimanjaro expedition. At trial, the court ruled that the agreement to arbitrate contained in GeoEx's release form was unconscionable. The release form, signed by the deceased prior to the expedition, contained both an arbitration agreement and a limitation of GeoEx's liability. Specifically, the release form provided that the venue for any arbitration hearing would be San Francisco, California (note: the decedent was a resident of Colorado), and the maximum amount of recovery was limited to the sum of the land and air cost of the customer's expedition (here, $16,831). When presented with the release form, the deceased was also given a letter from GeoEx's president which stated that the release form was mandatory, and nearly identical to forms used by competitors.

The court found that the arbitration agreement was procedurally unconscionable given that GeoEx's customers were required to sign an unmodified release form in order to avail themselves of the company's services, and more importantly, the decedent was told that all competitors used similar forms. Accordingly, the court concluded that the customer lacked bargaining power.

Next, the court found that the arbitration agreement was substantively unconscionable, calling it a "heads I win, tails you lose" arbitration clause. The court noted that the limitation of liability provision did not allow even a theoretical possibility that the injured party could be made whole, and that by restricting the venue to San Francisco, any recovery the injured party might obtain would be devoured by the expense incurred in pursuing the remedy. In addition, the agreement failed to provide a reciprocal limitation on damages or indemnification obligations.

Under California law, a court has discretion to either sever an unconscionable provision from a contract and enforce the remaining provisions, or refuse to enforce the entire contract. Here, the court found that it was within the trial court's discretion to conclude that the release form was so permeated by unconscionability that the interests of justice would not be

furthered by severing the damages limitation clause and enforcing the remainder.

Enforcing Arbitration Agreements: Lost or Destroyed Original Agreement

Capps v. Blondeau
2010 NCBC 7 (No. Carolina Business Ct., Apr. 13, 2010), 07 CVS 16486.

A party moving to compel arbitration fails to meet its burden of proof demonstrating the existence of an arbitration agreement where the evidence consists only of "specimen" copies of the agreement and testimony from the plaintiff, who was suffering from dementia, and the broker, who pled guilty to investment advisory fraud.

The plaintiff in this case is Martha Capps, an elderly woman suffering from dementia. Capps, through her guardian ad litem, filed an action against several defendants, including her former advisor, Harold Blondeau, and brokerage firm, Morgan Keegan, alleging misconduct in connection with her assets. Specifically, Capps alleged that Blondeau defrauded her by funneling millions of dollars from her accounts to a charitable foundation Blondeau controlled, and that Blondeau misappropriated the funds to his own personal use.

Morgan Keegan filed a motion to compel arbitration, alleging that Capps had signed an arbitration agreement that governed the disputes raised in Capps' complaint. However, Morgan Keegan was unable to produce the actual agreement it purported was signed by Capps. Instead, Morgan Keegan produced a mosaic of different documents that, it argued, when pieced together, demonstrated the existence of an arbitration agreement. Specifically, Morgan Keegan produced a copy of a signature page with Capps' alleged signature, and "specimen copies" of the firm's client agreement forms. The specimen copies utilized a variety of different spacing and fonts that were dissimilar to the purported signature page. Morgan Keegan conceded that it could offer no explanation for why it had destroyed the very agreement it now sought to enforce. Additionally, Morgan Keegan offered deposition testimony from Capps and her former advisor, Blondeau, to substantiate the existence of the arbitration agreement.

The Court found that the documentary evidence and witness testimony offered by Morgan Keegan was not persuasive and that they had failed to meet their burden on the threshold issue of whether an arbitration agreement existed. While the Court acknowledged that specimen copies could be used

as secondary evidence to prove the contents of lost or destroyed contracts, the Court found that the documents proffered by Morgan Keegan were "so problematic as to be inconclusive," and that Morgan Keegan's record keeping "was sloppy and fragmented at best." Further, the Court stated that "if a party wishes to rely on such evidence, it must do better than what has been presented here." The Court found Blondeau's testimony to lack credibility, given that he had pled guilty to investment advisory fraud in federal court in charges related to Capps' account, and noted, "his personal interest in this matter is obvious, and his testimony is unreliable."

The Court ultimately denied Morgan Keegan's motion to compel arbitration, allowing Capps to proceed with her claims in court.

Enforcing Arbitration Agreements: Retroactive Application of Arbitration Agreement

Moran v. Edward D. Jones & Co., LP
2010 Okla. Civ. App. 36 (Feb. 25, 2010).

Arbitration agreements will not apply to previously closed accounts with different account owners unless expressly stated in the agreement.

Amanda Moran was a customer of Edward Jones and the beneficiary of a custodial trust managed by her father, a registered representative of Edward Jones. In April 2009, Moran filed a petition in court against the brokerage firm alleging that on March 23, 1996, her father, acting in his capacity as an employee of Edward Jones, wrongfully took $25,836 out of the custodial trust account to purchase a vehicle for his own use. The custodial trust account was closed in July 1997, and the assets then transferred to a new joint account with her father. Edward Jones filed a motion to compel arbitration.

In support of its motion to compel, Edward Jones produced arbitration agreements signed by Moran in June1997 and January 2004. Moran argued that the dispute arose because of facts and events that occurred prior to the execution of the 1997 agreement and in connection with a closed account, and that nothing in the language of the arbitration agreements state it modifies, supersedes, or retroactively applies to a prior, unrelated closed account between the parties. Accordingly, Moran contended, the 1997 and 2004 arbitration agreements were not applicable to her claims.

The Court found that although the language contained in the arbitration agreements is broad and purports to cover all of Moran's account with Edward Jones, it does not contain language indicating an intent by the parties

to retroactively modify Moran's previous, closed custodial trust account. Without specific language indicating such an intent by the parties, the Court said, it could not retroactively apply the arbitration agreement to the custodial account.

DURING THE ARBITRATION

Court Authority to Compel FINRA (a non-party) to Comply with Subpoena Issued by FINRA Arbitration Panel

Empire Financial Group, Inc. v. Penson Financial Services
No. 3:09-CV-2155-D (N.D. Tex. Mar. 3, 2010)

A court has no authority to enforce an order of an arbitration panel compelling the production of documents by a non-party who has not been subpoenaed to testify at an arbitration hearing.

This case arises from an ongoing FINRA arbitration proceeding between Empire Financial Group, a now-defunct broker/dealer, and Penson Financial Services, Empire's clearing firm. In 2009, Empire filed a Statement of Claim against Penson, alleging, *inter alia*, that Penson breached a clearing agreement, gave knowing assistance to the raiding of Empire's trading desk, participated in civil theft, conspired with others to close Empire, made false and misleading statements to Empire's principal regulatory agency, and extorted substantial sums from Empire. Further, Empire asserted that, during FINRA's various investigations, FINRA conspired with Penson to undermine Empire.

During the course of the proceedings, Empire properly submitted a request to the Panel Chairperson to issue a subpoena to FINRA seeking seven categories of documents, as well as an order compelling FINRA to produce documents. The order states that it is issued in "accordance with NASD Rule 12513 of the Code of Arbitration Procedure." In essence, the order required FINRA, a non-party, to engage in pre-hearing production of documents akin to producing documents in civil discovery. The order did not compel a FINRA witness to testify or bring documents to an evidentiary hearing.

After receipt of the subpoena, FINRA notified Empire that it objected to the order on grounds of "investigatory file privilege," and that it would not produce documents. Empire then filed a motion with the district court to compel FINRA to comply with the order.

The court found that no provision of the FINRA Code explicitly authorizes a court to enforce a subpoena or discovery order. Rather, the court noted that arbitrators themselves are responsible for enforcement of subpoenas and discovery orders pursuant to Rule 12512(c). Turning next to application of the Federal Arbitration Act ("FAA"), the court noted that the Circuit Courts are split regarding (1) whether arbitrators are authorized to order document production from non-parties apart from doing so in connection with the attendance of a non-party witness at an arbitration hearing, and (2) whether district courts are authorized to enforce such orders under Section 7 of the FAA. (Note: The Fifth Circuit has not yet decided these questions). Section 7 provides:

> The arbitrators selected . . . may summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document, or paper which may be deemed material as evidence in the case. . . . Said summons . . . shall be served in the same manner as subpoenas to appear and testify before the court.

This court adopted the reasoning of the Second and Third Circuits, and held that Section 7 of the FAA does not explicitly authorize arbitrators to compel production of documents from a non-party, unless they are doing so in connection with the non-party's attendance at an arbitration hearing.

AFTER THE ARBITRATION

Vacatur: Arbitrators Exceeding Their Powers

Raymond James Financial Services, Inc. v. Bishop
No. 09-1038, slip op. (4th Cir. Feb. 22, 2010)

An arbitration panel exceeds its powers, as proscribed by the Federal Arbitration Act, when it bases its award on issues outside the scope of the arbitration agreement.

This case involved an appeal of a trial court's order to vacate an award of compensatory damages rendered by an NASD arbitration panel based on the panel's finding that the arbitrators had exceeded their powers in making the award. The arbitration award was in favor of three financial advisors, Thomas Bishop, Steven Hamant and Timothy Scanlon, who asserted claims relating to wrongful termination against Raymond James.

In 2001, Bishop left the employ of a brokerage firm and entered into a written "Independent Sales Associate Agreement" with Raymond James, and later became a branch manager for the firm in Richmond, Virginia. Soon afterward, at Bishop's urging, Hamant and Scanlan joined Raymond James by entering into similar agreements. The agreements contained a provision that required five days written notice of intent to terminate the arrangement.

In 2003, Raymond James received several serious complaints of misconduct from competing financial advisors with respect to the operation of Bishop's office. In connection with the complaints lodged against the Richmond branch, Raymond James' in-house lawyers provided defense to the three advisors in NASD arbitration proceedings. In April 2004, Raymond James notified Bishop that the branch would be closed and that his registration with the firm would be terminated in five days. The firm's notice left open the possibility that the three advisors may be able to affiliate with a different Raymond James branch, and the firm subsequently extended the time for the branch closing. However, by June 2004 the advisors voluntarily terminated their agreements with the firm.

In July 2005, the three advisors filed a consolidated arbitration demand against Raymond James, seeking damages relating to wrongful termination. The Panel granted the advisors' request for compensatory damages, and drafted a written opinion explaining the rationale for their decision. The panel's explanation stated that it based its award primarily on Raymond James' "unauthorized practice of law by employing staff counsel to advise and represent [the advisors] in their individual capacities" in NASD arbitrations. After appeal to the trial court by Raymond James, the arbitration panel issued a supplemental letter opinion stating bases for its award, which primarily concerned Raymond James' use of staff lawyers to represent the advisors in arbitration proceedings, and its belief that the firm had engaged in the unauthorized practice of law.

The trial court found that the arbitrators exceeded their powers as proscribed by the Federal Arbitration Act, and manifestly disregarded the law by basing an award for wrongful termination on unrelated facts concerning the alleged unauthorized practice of law – a matter the court found to be outside the scope of the parties' arbitration obligations. The Fourth Circuit affirmed the trial court's opinion, finding that by rendering an award whose underlying legal basis exceeded the bounds of arbitrable employment-related disputes, the panel exceeded its powers.

RECENT FINRA PUBLICATIONS

Regulatory Notice 10-17: Hearing Locations
Amendments to the Arbitration Rules on Hearing Locations
Effective Date: May 3, 2010

Effective May 3, 2010, the Codes of Arbitration Procedure for Customer and Industry Disputes are amended to expand the criteria for selecting a hearing location for arbitration proceedings. Rules 12213(a) and 13213(a) are amended to permit certain parties to request in-state hearing locations.

Prior to this amendment, the rules governing the selection of hearing locations provided that the Director of FINRA Dispute Resolution would select the hearing location closest to the customer's residence at the time of the events giving rise to the dispute (or in the case of industry disputes, closest to the associated person's place of employment at the time of dispute). As a result, customers and associated persons have sometimes been required to participate in hearings held in out-of-state locations that were determined to be closer in proximity than otherwise available in-state locations.

Rule 12213(a) of the Customer Code, as amended, expands the criteria for hearing location selection in customer cases. The Rule now provides that the Director will select the hearing location closest to the customer's residence at the time of the events giving rise to the dispute, *unless the hearing location closest to the customer's residence is in a different state*. If that is the case, then the customer may request a hearing location in the state where the customer resided at the time of the events giving rise to the dispute.

Rule 13213(a) of the Industry Code now provides that the Director will select the hearing location closest to where the associated person was employed at the time of the events giving rise to the dispute, *unless the hearing location closest to the associated person's employment is in a different state*. If that is the case, then the associated person may request a hearing location in the state where he or she was employed at the time of the events giving rise to the dispute.

Note that under both Rules, the Director will still continue to select hearing locations without regard to state boundaries. The amendments to the Rules merely permit customers or associated persons to request different hearing locations, which the Director is supposed to grant if the criteria in the amended Rules are met. Additionally, in the event that a party wishes to change hearing locations after an arbitration panel is appointed, a request must be submitted to the panel rather than the Director.

Regulatory Notice 10-18: Master Accounts and Sub-Accounts
FINRA Issues Guidance on Master and Sub-Account Arrangements

FINRA issued Regulatory Notice 10-18 to remind brokerage firms of their duties and responsibilities when maintaining master/sub-account arrangements for customer accounts, and specifically stated that firms may be required to recognize sub-accounts as separate customer accounts for the purposes of applying FINRA rules, the federal securities laws and other applicable federal laws.

Many brokerage accounts take the form of a master/sub-account arrangement in which the beneficial ownership interests in the sub-accounts may or may not remain unknown or undisclosed to the firm. For example, investment advisors or introducing firms may create master accounts that maintain many sub-accounts for fully disclosed beneficial owners. Under such circumstances, the firm is aware of the identity of each beneficial owner, and the firm must recognize each sub-account as a separate customer account for purposes of applying FINRA rules and applicable laws. Alternatively, certain registered investment advisors may employ sub-accounts for each account it advises without identifying the beneficial owner of each account, and certain registered broker-dealers may obtain clearing services for customer accounts without disclosing the identities of sub-account owners to the clearing firm. In such circumstances, FINRA has allowed firms to elect to treat a master/sub-account as having a single beneficial owner.

Regulatory Notice 10-18 reminds firms that if a firm has actual notice that the sub-accounts of a master account have different beneficial ownership (whether the identities are disclosed or not) or the firm is on inquiry notice as to the fact of multiple beneficial ownership, the firm is required to inquire further and satisfy itself as to the beneficial ownership of each sub-account. When a firm then becomes aware of the identities of the beneficial owners of such sub-accounts, it will be required to recognize the sub-accounts as separate customer accounts for purposes of applying FINRA rules, the federal securities laws and other applicable federal laws.

FINRA clarifies what constitutes "inquiry notice" by providing several examples, including:

- the sub-accounts are separately documents and/or receive separate reports from the firm;
- the firm addresses the sub-accounts separately in terms of transaction, tax or other reporting;

- the services provided to the sub-accounts engender separate surveillance and supervision for compliance purposes;
- the sub-accounts incur charges for commissions and clearing fees based upon the activity specific to the sub-account;
- the firm has evidence of financial transactions or transfers of assets or cash balances that would reasonably evidence separate beneficial ownership;
- the number of sub-accounts maintained is so numerous as to reasonably raise questions concerning whether such accounts represent separate owners.

Regulatory Notice 10-22: Regulation D Offerings
Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulatory D Offerings

FINRA reminds brokerage firms of their obligation to conduct reasonable investigations of securities and issuers in connection with recommending private placement investments exempt from registration pursuant to Regulation D. A broker-dealer has a duty – enforceable under applicable securities laws and FINRA rules – to conduct a reasonable investigation of securities that it recommends, including those sold in a Regulation D offering.

Regulation D provides exemptions from certain registration requirements found in Section 5 of the Securities Act of 1933 ("the Act"). However, this exemption does not extend to the anti-fraud provisions of the Act or FINRA rules. The SEC and federal courts have long held that a brokerage firm that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it. As explained in the Regulatory Notice, "this duty emanates from the BD's 'special relationship' to the customer, and from the fact that in recommending the security, the BD represents to the customer 'that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation." Brokerage firms are warned that failure to comply with this duty can constitute a violation of the anti-fraud provisions of applicable securities acts, Rule 10b-5, and FINRA Rules 2010 and 2020.

Brokerage firms may not blindly rely on the issuer for information concerning a company in lieu of conducting its own reasonable investigation, and the firm is not excused from its duty to investigate by the fact that it is selling a product to a sophisticated or knowledgeable investor. The SEC

advises issuers to provide the same information to both accredited and non-accredited investors alike, in view of the anti-fraud provisions. Further, the firm must conduct a reasonable investigation in connection with each offering, notwithstanding that a subsequent offering may be for the same issuer.

While the scope of each investigation may be different depending on the size and nature of the offering, a brokerage firm in a Regulation D offering should, at a minimum, conduct an investigation concerning:

- the issuer and its management;
- the business prospects of the issuer;
- the assets held by or to be acquired by the issuer;
- the claims being made; and
- the intended use of proceeds of the offering.

The firm is required to implement a supervisory system that reasonably ensures that the investigations are carried out appropriately, and documented in records that are to be retained after the offering.

WHERE WE STAND

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

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

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

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

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1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact 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. 34-61517/SR-FINRA-2010-006- Proposed Rule Change to Amend the Codes of Arbitration Procedure to Provide for Attorney Representation of Non-party Witnesses in Arbitration* was submitted to the Securities and Exchange Commission by Scott R. Shewan on April 28, 2010.

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

RE: File No. SR-FINRA-2010-006; Proposed Rule Change to Amend the Codes of Arbitration Procedure toProvide for Attorney Representation of Non-party Witnesses in Arbitration

Dear Ms. Murphy:

On behalf of the Public Investors Bar Association ("PIABA"), I thank the Commission for this opportunity to comment on the above-referenced rule change proposal that would amend Rules 12601 and 13602 of the Code of Arbitration Procedure, and thereby provide for attorney representation for non-party witnesses in arbitration. I apologize for the tardiness of this letter, but we understand the Commission will still consider late comments.

PIABA is a national, not-for-profit bar association comprised of more than 460 attorneys, including law school professors and former regulators, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. Accordingly, our members and their clients have a strong interest in FINRA rules that govern the arbitration process and impact fairness concerns of the public investor.

PIABA does not support the proposed rule change in its current form. In addition, we propose additional language for inclusion in the present rule change proposal or in a subsequent rule filing. The current rule proposal unnecessarily grants virtually unfettered discretion to the arbitrators appointed in a case to define the scope of participation for an attorney representing a non-party witness. PIABA believes that there should be only limited discretion in allowing participation of counsel who does not represent a party to an arbitration action, and that such participation should be strictly limited to the protection of that attorney's client's interests.

While PIABA does not oppose allowing a non-party witness' attorney to be *present* if desired, PIABA believes that the witness' attorney should not be permitted to *participate* in the hearing or advocate any particular position on behalf of a party. Counsel for non-party witnesses should clearly be permitted to appear only on behalf of his or her client, and accordingly be permitted to raise an objection only on behalf of the third party witness, with those objections based solely on generally accepted privileges that have gained acceptance in federal and state courts, such as, but not limited to, attorney-client privilege, work product doctrine, spousal privilege, clergy privilege, and the accountant-client privilege. Counsel should also be permitted to take such actions necessary to protect client interests, but should be careful not to overstep and engage in advocacy on behalf of any of the parties.

While third party witnesses have certain interests that should be protected, fairness to the parties to the proceeding, and their chosen attorneys, dictates that an attorney representing a non-party who appears solely during that witness' testimony should not be permitted to interject argument on the issues in the case, or offer input or assistance to counsel for any party. Adoption of the current rule proposal should clarify that counsel for non-party witnesses may not advocate for any party, and may be present only during his or her client's testimony.

PROPOSED LANGUAGE:

To protect the interests of the parties, PIABA suggests the language below be incorporated into the ultimate rule:

Remove: "The panel will determine the extent to which the attorney may participate."

Replace with: "Participation of counsel for non-party witnesses will be limited to advocacy on behalf of his or her non-party client, and counsel should not be permitted to engage in argument, questioning, or advocacy on behalf of any party to the proceedings."

We welcome any questions you may have regarding our position. Please do not hesitate to contact me should you have any questions or wish to discuss this matter.

Respectfully submitted,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Scott R. Shewan
President

The following PIABA Comment Letter regarding *Release No. 34-61217/SR-FINRA-2009-073- Proposed Rule Change to Amend the Hearing Location Rules of the Codes of Arbitration Procedure for Customer and Industry Disputes* was submitted to the Securities and Exchange Commission by Scott R. Shewan on January 19, 2010.

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

Subject: File No. SR-FINRA-2009-073, Hearing Locations

Dear Ms. Murphy:

On behalf of the Public Investors Bar Association ("PIABA"), I thank the Commission for this opportunity to comment on the above-referenced rule change proposal regarding the selection of hearing locations in customer arbitrations under Rule 12213(a) of the Code of Arbitration Procedure. PIABA supports the proposed rule changes as written and commends FINRA for submitting the amendments. In addition, we propose added protections for inclusion in the present rule change proposal or in a subsequent rule filing.

PIABA is a national, not-for-profit bar association comprised of more than 460 attorneys, including law school professors and former regulators, located in 45 states, the District of Columbia and Puerto Rico. Members of PIABA devote a significant portion of their practice to the representation of public investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Collectively, PIABA members have represented tens of thousands of investors in securities arbitrations throughout the country. PIABA members and our clients have a strong interest in FINRA rules which impact the protection of the public investor and govern the arbitration process.

FINRA's proposed amendments to Rule 12213(a) would permit public investors to chose an arbitration forum in their state of residence even if that hearing location is not the closest one to the customer's residence at the time of filing the arbitration.. PIABA agrees that the customer should be able to elect either the hearing location closest to where the customer lives or another location within the customer's state of domicile, even if the latter may not be the closest in proximity to a FINRA hearing location. PIABA agrees with FINRA that the proposed rule change would serve to promote greater investor protection and public interest. The proposed rule change provides public investors with more control over where their arbitration would be heard, thus encouraging investors to avail themselves of the dispute resolution process when needed.

We also suggest an improvement to this rule proposal. We request that the following be included in a future FINRA rule filing and encouraged as a matter of immediate FINRA DR practice (just as the current rule proposal codifies existing practice). Specifically, PIABA proposes that the amendment should also allow, at the customer's election, for the possibility of a final hearing to be held in the state where (1) the account(s) in question were held; (2) the broker is located; or (3) the client resided when the disputed events occurred. These added venues can provide practical and equitable options that are eminently consistent with principles of full and fair hearings. Moreover, such a rule change would be consistent with state and federal procedural law, which generally provides such a choice of venue to the plaintiff.

Here are just a few instances of how the added venues can offer more complete investor protections. For example, if a senior citizen maintained an account in New York City, then retired to a remote part of Florida not necessarily close to FINRA sites, and the broker continued to operate in NYC where the misconduct occurred, there could be benefit to all parties for the hearing to be held in NYC. Under current rules, and the proposed rule change, this scenario is not addressed. However, it is a scenario that arises not infrequently in our mobile society.

The benefits of added hearing locations could be substantial. Consider for example the cases where third party subpoenas are

needed to persons not associated with FINRA members, such as advisors or accountants, residing in the state where the customer formerly lived. An arbitrator in the customer's current state of residence cannot generally reach those third parties by subpoena. In addition, some investors might have better access to counsel, through clinical legal aid or otherwise, in states where the account was domiciled. By including the foregoing three choices, in addition to those already listed in the current rule proposal, public investors would be most efficiently and fairly served.

PIABA believes that its proposed additions to the amendment would facilitate an even more efficient administration of the arbitration process as is likely intended by FINRA but not heretofore addressed.

We thank the Commission for its consideration of PIABA's comments. While we support the proposed amendments, we submit that at the earliest time, FINRA should expand the criteria for a customer's designation of hearing locations, in accordance with the proposals above.

Very truly yours,
Scott R. Shewan
President