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VALUATIONS IN MASS TORT LITIGATION AIDED BY BEHAVIORAL LAW AND PROBABILITY

Bradley Stark & Alex Alvarez[1]

INTRODUCTION

Plaintiffs and their lawyers have been disappointed at the value received in mass torts such as the returns on cases involving recalled products and defective pharmaceuticals. Over the last few years, the securities arbitration practice for many Claimant's attorneys has evolved into a practice focused on particular defective financial products, such as misrepresented bond funds. This article explains the inadequate returns realized on cases like the 'Analyst' cases in the early 2000s, the recent spate of Morgan Keegan, Schwab and other defective product cases as well as any financial product wherein there is a plethora of similarly situated Claimants based upon an action of the Respondent.

In the first part of this paper we explain why mass tort defendants are inadvertently more efficient in their valuation and management of mass tort litigation and therefore receive an advantage beyond the merits of their cause. This advantage is not caused by any untoward conduct on the part of defendants but rather circumstances as delineated by principles of Behavioral Law and probability that explain the handicap imposed upon plaintiffs and their lawyers. A solution is proposed in the second part of this piece.

I. Behavioral Law Principles Applied To An Isolated Case Compared To Mass Torts

Several principles of Behavioral Law work to place both the defendant and plaintiff on similar footing in isolated cases but give an advantage to the defendant in mass torts. We will use several aspects of Prospect Theory, the foundation of Behavioral Finance, to understand why isolated cases feel different from groups of cases, though the probability of success for both are the same.

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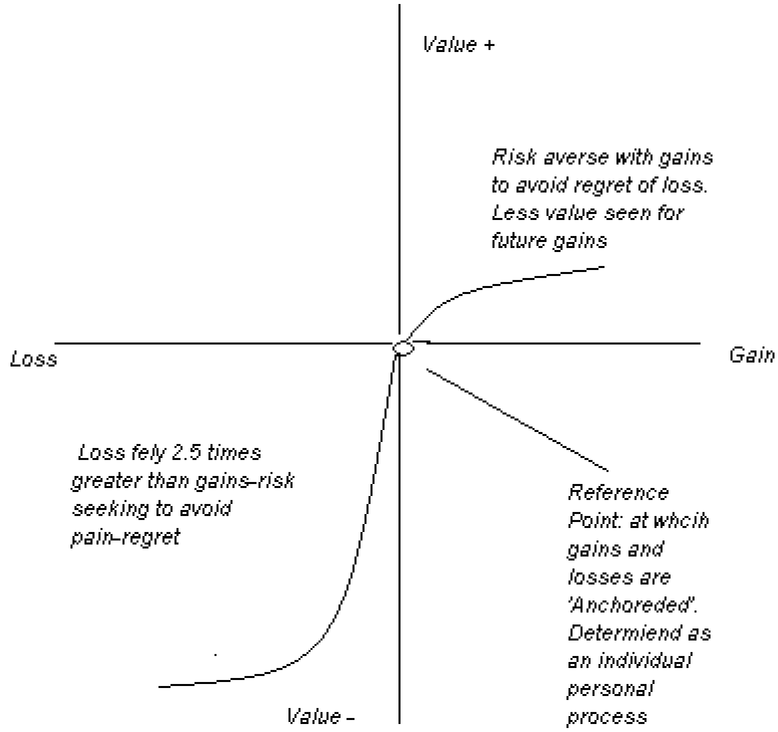
The first advances in a behavioral understanding of human decision making under conditions of risk, loss, gain and uncertainty began in the fields of sociology, psychology and anthropology. These insights are now being applied to financial markets and law in an attempt to explain anomalies. Behavioral Finance has quickly become a mainstream part of Finance and Economics. Many journal articles now offer both a rational and behavioral explanation for market anomalies. Behavioral Law is an outgrowth of Behavioral Finance and has quickly gained traction as a tool to understand litigation. Law journals are replete with examples of research in Behavioral Law.

Myopic Loss Aversion teaches that we are less likely to take a gamble, even when the odds are favorable, if there is only one gamble or opportunity. Regardless of the probability of success, humans have a tendency to be risk adverse when there is only one event. This occurs because the pain of loss is experienced 2.5 times as intensely as that of gain and one gamble or event is too isolated for the law of averages to be realized.

Pain in loss has 2.5 times the intensity of gains. [2] Below is a graph of this phenomenon. The seminal work in this area was done by Dr. Daniel Kahneman for which he won the 2002 Nobel Prize in Economics. The *kink* or Reference Point in the **Kahneman-Tversky Value Function** affects isolated individual bets but is not relevant when multiple bets are viewed collectively. For example, in studies wherein persons were shown 30 individual one-year stock returns, these people allocated 40% of their portfolio to stocks. When persons viewed stock returns collectively over a 30 year period, they allocated 90% of their portfolio to stocks.

2. Daniel Kahneman and Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 273 (1979).

Graph 1:



This fact makes lawyers and their clients less likely to gamble with one isolated trial, regardless of the probabilities of success for either party.[3]

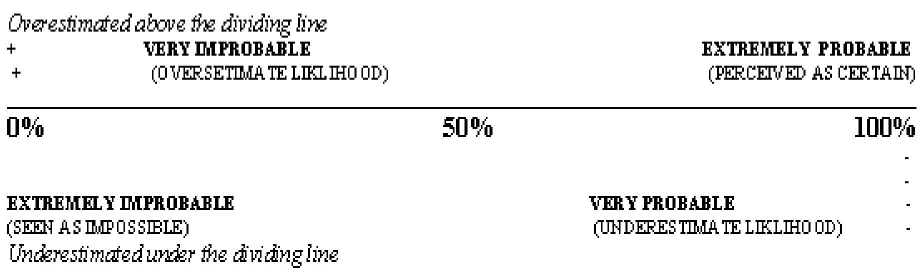
Prospect Theory also teaches that humans naturally overestimate the probabilities of a very unlikely event and underestimate the probability of very likely events. With the **Kahneman-Tversky Weighting Function**[4] an

3. "There is a human tendency to feel the pain of **Regret** at having made errors, even small errors, not putting such errors into a larger perspective." Robert J. Shiller, *Human Behavior and the Efficiency of the Financial System, in* HANDBOOK OF MACROECONOMICS (John B. Taylor and Michael Woodford, eds., 1999), *available at* http://www.econ.yale.edu/~shiller/ online/handbook.html. This leads to a **Modified Utility Function** "which is a function of the utility they achieve from a choice as well as the utility they would have received from another choice that was considered." *Id*.

4. Kahneman and Tversky, *supra* note 2.

individual views extremely improbable events as impossible and extremely probable events as certain. In addition, people overestimate the likelihood of very improbable (not extremely improbable) events. People also underestimate the likelihood of very probable (not extremely probable) events. This is reflected in the diagram below.

Kahneman-Tversky Weighting Function



Thus attorneys, clients, judges and mediators overestimate chances of winning when they have a very bad case and underestimate their chances of winning when they have a very good case.[5] This encourages settlements. For example, a defendant who has a 'slam dunk' case will still pay to settle and a plaintiff who similarly has a 'slam dunk' will accept a discount to settle it because each party does not accurately estimate their probability at trial. In addition, since there is only one trial, each party suffers from Myopic Loss Aversion and fears the isolated bet since losing will be felt 2.5 times greater than any gain.

Another factor is that neither the defendant nor plaintiff has an advantage in estimating the probability of success at trial. Both are equally in the dark as to the strength of opposing witnesses and trial tactics in a particular isolated case. No matter how experienced the client or lawyer, each would learn from trying the same case multiple times. Myopic Loss Aversion is probably a more powerful force in such a situation, but this aspect of

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5. An example of overestimation of an extremely unlikely event is airline traveler insurance against crashes. In 2006 there were 25 airliner accidents out of 11,200,000 flights. NATIONAL TRANSPORTATION SAFETY BOARD, AVIATION ACCIDENT STATISTICS, http://www.ntsb.gov/ aviation/aviation.htm. Thus people in 2006 who bought insurance did so when the probability of accident was .000223% probability. Flight insurance is a highly profitable product for the insurance industry. This explains how some credit card companies can afford to give away free flight insurance to customers.

Prospect Theory regarding over and underestimation of probabilities also encourages settlement.

These factors lead to a more 'level playing field' in an isolated case because they weigh equally upon each party and their lawyers. In a sense, both are similarly 'in the dark', evenly handicapped in shouldering the risk associated with an isolated case. This helps explain why so many cases settle.

This situation is drastically altered in the mass tort situation. From the perspective of the defendant, the cases are viewed with a greater degree of efficiency. There is no Myopic Loss Aversion since there are thousands of similar cases. There is no overestimation or underestimation of the probabilities of success for a given set of facts since the defendant has the knowledge of probabilities that comes from being the defendant in so many cases. There is no factual or legal scenario that can catch the defendant by surprise since so many cases are in litigation across the country. The defendant does not fear loss as deeply because the probabilities of loss are well understood, spread among the numerous cases so that the 'law of averages' will eventually be realized. The same is not true for the plaintiff.

As a result, the mass tort defendant can efficiently value their liability because, regardless of the outcome of the first 50 cases, over the course of hundreds or thousands of cases the laws of probability will prevail. By analogy, if trial is a coin flip contest and the defendant loses the first three flips, 5 of the first 7 flips of the coin, or 30 of the first 50 flips, the mass tort defendant knows that after a 1,000 flips it will, on average, win 500 flips. The same is not true for the mass tort plaintiff and their lawyer who has a small number of coin flips in which to find success or absorb financial loss.

The mass tort plaintiff continues to face Myopic Loss Aversion and the underestimation of likely probable litigation events described by Prospect Theory, as she does in an isolated case. In fact, a mass tort plaintiff's lawyer more greatly experiences the effects of these principles of Behavioral Law because of 'sunken costs'. Sunken costs are the costs of litigation for a volume of mass tort cases that cannot be recovered in the event of a loss. It is as if the mass tort plaintiff's lawyer is playing Poker and 'gone all in' or 'double or nothing' in handling the first few of a larger number of similar cases. The mass tort plaintiff's lawyer does not have a sufficient volume of cases to spread the risk of loss, to 'play the averages', but has committed large resources to the same type of cases. Unlike the mass tort defendant who has such a large volume of similar cases that the risk of any few loses is spread among a large volume of other cases, similar to an insurance company, the mass tort plaintiff's lawyer begins to contemplate financial ruin if she loses heavily in the first few trials.

Unlike the mass tort defendant, the mass tort plaintiff's lawyer needs to win quickly, needs to win early to recover sunken costs and recurring costs associated with other cases in litigation. This lawyer's resources are personal and finite. These principles explain in part why plaintiff lawyers are more risk adverse in taking to trial mass torts and why mass tort defendants are emboldened.

Other commentators have made a similar observation. "The practical implication of risk aversion is that repeat players tend to be risk neutral, allowing a portfolio approach toward risk management, a luxury that most people lack. The end result is that variance from unique risk can be reduced. Of course, the better repeat player focuses on the unique details of each case with an eye toward the aggregate whole, thus trading on information rather than noise. Risk-neutral parties, like insurance companies, will obtain a greater share of any settlement because they can extract yield from the differences in both risk preferences and risk discount. Likewise, if most corporations are repeat players, this fact has significant implications for whether corporate defendants in tort actions are appropriately deterred by tort law and its remedies. Thus, while this Article assumes a single play scenario, the most practical effect of a repeat play scenario is the shifting of the selection horizon to the left (against settlement) for a repeat player, which creates a valuational separation against a single play party".[6]

PRINCIPLES OF PROBABILITY APPLIED TO MASS TORTS

The mass tort plaintiff's lawyer also does not accurately understand the laws of probability.[7] For example, few plaintiff lawyers can accurately tell you the probability of losing the flip of a fair coin twice in a row or winning 1 out of 3 flips, given that a coin flip is a 50% probability event.[8] The answer for the last question is 75%, meaning that 25% of those flipping coins will have not won a coin flip after 3 flips. This has a devastating adverse effect on the mass tort plaintiff's lawyer. For example, in a situation where a mass tort plaintiff's lawyer has an inventory of cases, figures she will win

6. Robert J. Rhee, *A Price Theory of Legal Bargaining; An Inquiry into the selection of Settlement and Litigation Under Uncertainty*, 56 EMORY L. J. 686 (2006).

7. Given the large number of risk managers, statisticians, MBAs and financial consultants at the disposal of corporate management, there is no doubt these probabilities are well understood by the mass tort defendant.

8. These probabilities and others are easily calculated. There are a number of free on line calculators for this calculation; see, e.g., http://www.stat.tamu.edu/~west/applets/binomialdemo.html.

50% of her cases, but tries the first 3 and loses them all, it is very likely that lawyer will want to dump her inventory, assuming the poor beginning was indicative of future results. However, according to the law of probability, there was a 25% chance the lawyer would lose all three but still win, on average, 50% of the cases tried. This is a windfall benefit for the mass tort defendant.

The Ballot Theorem is an example of this phenomenon. "Suppose that, in a ballot, candidate P scores p votes and candidate Q scores q votes, where p > q. The probability that throughout the counting there are always more votes for P than for Q equals (p - q)/(p + q)." [9] As an illustration of the usefulness of the Ballot Theorem, let's assume there are 100 trials and the Plaintiff P wins 70 of the 100 (win rate 70%). This means that there is a 40% chance that at all times the plaintiff has more wins throughout the 100 trials. This also implies that there is a 60% chance that at times plaintiff will have lost more trials than she has won despite the fact she will ultimately win 70 (70%) of the 100 trials! This illustrates the fallacy of inferring the strength of an inventory of cases based upon a few 'bellwether' cases.

Probability teaches us the optimal minimal number of trials a mass tort plaintiff lawyer should be willing to try so as to not become victim to these realities. Assuming the probability of winning a trial is 50%, considering the sunken costs associated with generating and preparing a group of similar cases, a review of a chart of the Cumulative Binomial Distributions for different probabilities (these are available in elementary texts on probability) of wins suggests that a lawyer should try 9 cases. After trying 9 cases there is a 91.2% chance she will win at least 3 trials, probably enough money to compensate for the lost trials and other sunken costs. Otherwise the lawyer runs the risk of a run of bad luck that leads to the erroneous thinking described above and the tendency to dump good cases. A chart of Cumulative Binomial Distributions allows the lawyer to calculate the 'sweet spot' so as to know the probabilities to ensure a recapture of sunken costs, given a probability of winning a type of case.

The next important consideration is how to calculate the probability of winning a mass tort case. Certainly, the defendant has a far superior understanding of this probability for 2 reasons. First, the defendant is defending similar cases around the country and is able to calculate a long run probability based upon these multiple trials around the country. Second, the defendant has the resources to mock try a type of case enough times to estimate a reliable probability. A simple sampling calculation can identify

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9. 1 WILLIAM FELLER, AN INTRODUCTION TO PROBABILITY THEORY AND ITS APPLICATIONS 69 (3rd ed. 1968).

how many mock trials are necessary to generate a reliable probability. Often we hear about the sampling error associated with a poll, whether it be an election, the president's popularity and so forth. The margin of error is a function of the sampling size. The larger the sample size, the more accurate the determined probability. Numerous websites provide that ability to calculate sample sizes and margins of error.[10]

For example, when the sample size is 10 events, the margin of error is +/- 30.99%. Think of how judges try a series of cases, usually less than 10, as bellwether cases in a mass tort. This tells us that as a bellwether of probability for the future success of the thousands of similar cases, any inference we can draw from trying 10 cases is within a wide range of +/- 30.99%. In concrete terms, if a judge tries 10 bellwether cases and the defendant and plaintiff split the results and each win 5 trials, all this tells us is that after trying a large sampling such as 100 cases we will find that the plaintiff or defendant may win as many as +/- 80.99% and as few as 19.01%. In other words, 10 bellwether cases tells us little about the probabilities of success for thousands of future trials.

Similarly, using the online sampling calculator cited above reveals that a sampling size of 45 events (of perhaps mock trials) can reduce this uncertainly to +/-14.61%, a more manageable and helpful guide towards determining the true value of a mass tort case at trial. Again, as plaintiffs it is reasonable to assume that the mass tort defendant has made these calculations and adjusted its litigation philosophy accordingly.

Having shown that bellwether cases in a multi-district litigation or a small group of cases within a jurisdiction provide very limited information from which a plaintiff can make a decision regarding the valuation of his cases, another problem facing the plaintiff's lawyer is the Cascade Effect. Think of a cascade as a herd mentality towards an inaccurate conclusion despite the fact that a majority of participants know the conclusion is erroneous.

> If, say, 60 percent of a group's members have been given information pointing them to the right answer (while the rest have information pointing to the wrong answer), there is still about a one-in-three chance that the group will cascade to a mistaken consensus. Cascades are especially common in medicine as doctors take their cues from others, leading them to overdiagnose some faddish ailments (called bandwagon diseases) and overprescribe certain treatments (like the tonsillectomies once popular for children). Unable to keep up with the volume of research, doctors look for

10. See, for example, http://www.csgnetwork.com/surveysizereqcalc.html.

> guidance from an expert — or at least someone who sounds confident. [11]

Thus, if the bellwether cases or first few statistically insignificant number of trials in a mass tort suggest weak damages or liability, despite the good judgment to the contrary on behalf of a majority of experienced lawyers, a minority can cause a Cascade towards an undervalued settlement.

Another difficult to comprehend or counterintuitive property of probability that benefits the mass tort defendant is that the chances of ruin for a party that has a less than 50% chance of winning decrease as the stakes are increased. "(I)f the stakes are doubled while the initial capital remains unchanged, the probability of ruin decreases for the player whose probability of success is $p < 1/2$ and increases for the adversary for whom the game is advantageous."[12]

This proposition has adverse implications for mass tort plaintiff's lawyer. Because the disposition of each case impacts the value of the remaining cases in the plaintiff lawyers' portfolio, in effect, the stakes are raised for the mass tort cases compared to individual cases within the plaintiff lawyer's office. Thus, the increased stakes of a mass tort again benefit the defendant in a mass tort even when the plaintiff has a greater probability of winning at trial.

OTHER WINDFALL BENEFITS THAT INURE TO MASS TORTS DEFENDANTS

Let's also assume that the mass tort defendant decides it will try every case. Of course this seldom happens, but it is the ability to try a case that brings the parties to the 'bottom line' for settlement purposes. Large defendants have this ability and plaintiffs do not.

If the defendant decides to try all cases, the defendant and insurer have an unlimited pool of defense lawyers to defend the cases. There is a real limit to the number of a cases one plaintiff's firm can try. This handicaps the mass torts plaintiff's lawyer from obtaining full value for her cases. The mass tort defendant, in a sense, 'calls the plaintiff's bluff' that she will try her cases. (During the 'tech wreck' some brokerage firms claimed they would try every arbitration.)

Another benefit that inures to the defendant is that not all injured people will realize they have a claim and a significant number will fail to bring suit for whatever personal reason. Already, the defendant garners this benefit. It

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11. Daniel B. Neill, *Cascade Effects in Heterogeneous Populations,* 17 RATIONALITY & SOCIETY 191 (2005).
12. Feller, *supra* note 9, at 346.

is also true that a significant number of undeserving cases will be filed by misinformed plaintiffs and counsel. These cases quickly attrite once it becomes clear what criteria are viable for purposes of settlement. This is another benefit that inures to the mass tort defendant.

In sum, the mass tort defendant is at a competitive advantage in mass tort litigation. This observation is supported by one commentator who notes that stock market estimations of future losses from mass torts tend to overestimate the ultimate liability of the mass tort defendant.[13]

SUMMARY

There is nothing improper in the benefits described above that inure to the mass tort defendant. These benefits do not flow from any unlawful conduct by defendant but rather from a greater efficiency in the estimation and management of litigation. Efficient litigation is the goal of the justice system and in this particular instance these realities serve to make the defendant more efficient than the plaintiffs in their litigation. This is a windfall benefit to the mass tort defendant as a result of these competitive advantages.

Plaintiffs in mass torts do not receive fair settlements. Plaintiff lawyers are simply unable to compete on equal footing with the mass tort defendant. Mass tort defendants are able to better ascertain and spread their risk of losing any one trial onto the group of trials, unlike the plaintiffs. It is as if the plaintiffs and defendant are running businesses in which, if the defendant loses, he spreads his risks as if insured but if the plaintiff loses, there is no insurance and the loss falls directly on the individual. The solution is to change the manner in which plaintiffs manage cases so that neither party has an unanticipated advantage and only the merits of the cases determine the outcomes.

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13. *See* Suresh Govindaraj, Bikki Jaggi, and Beixin Lin, *Market Overreaction to Product Recall Revisited--The Case of Firestone Tires and the Ford Explorer,* 23 REV. QUANTITATIVE FIN. & ACCT. 31 (2004).

II. How To Spread The Plaintiff's Unique Risks In Mass Torts

To alleviate the disadvantage weighing on plaintiffs and their lawyers, some form of risk spreading mechanisms are needed. By analogy, we will use the insurance industry as a risk spreading mechanism.

Insurance companies allow the insureds to share the risk amongst themselves by paying premiums that are pooled and used to compensate those who suffer loses. Most insurance companies then further spread these risks by further 'slicing, pricing, dicing and spreading the risk' of the policies and selling a portion of the risks to other insurance companies through reinsurance.

For example, if an insurance company with earthquake polices in San Francisco trades some of their risks for hurricane polices in Miami, because it is unlikely both a hurricane will hit Florida and an earthquake will strike San Francisco, each company has reduced their total risk to severe losses. Each company can now write more policies at a higher profit margin. The risk of insurance company insolvency and thus risk to homeowner that his claim will not be paid is also reduced.

Some insurance companies go a step further still and securitize some risks, sharing the risks with buyers in the bond markets. A good example of this is Catastrophe Bonds or 'cat bonds'. An enjoyable description of these risk spreading tools appeared in the New York Times Magazine, written by Michael Lewis, author of best seller "Liar's Poker". [14]

There are currently no such risk spreading mechanisms available to plaintiffs and their lawyers in mass torts. For example, The Rules Regulating the Florida Bar and uncertain case law prohibit sharing of fees, costs and thus risks by plaintiff's lawyer and plaintiffs with third parties uninvolved in the litigation.[15] The evolution of these rules is paved with good intentions.

These rules are intended to ensure an undivided, loyal and devoted relationship between the plaintiff and his lawyer and a devoted relationship of both to the cause in litigation. These rules work well for isolated cases, but these restrictions handicap both the plaintiff and her lawyer in mass tort litigation. They have the opposite of the intended affect by increasing the risks for the plaintiff and plaintiffs' lawyer, burdening both. Neither the plaintiff nor plaintiffs' lawyer can spread the risks associated with

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14. Michael Lewis, *In Nature's Casino*, N.Y. TIMES MAGAZINE (August 26, 2007), *available at* http://www.nytimes.com/2007/08/26/magazine/26neworleans-t.html.
15. Rules Regulating the Florida Bar, Rule 4-1.5, http://www.floridabar.org/divexe/rrtfb.nsf /WContents?OpenView.

representation in a mass tort case, while the defendant has little fear or interest in any one particular case since their risks are spread amongst thousands of cases. This leaves only the plaintiff and her lawyer burdened with the type of risks of mass tort litigation described earlier in this paper.

Our solution to this handicap that burdens the plaintiff in mass torts and handicaps her lawyer, is to change case law and The Rules Regulating the Florida Bar.[16] With and only with the permission of their clients,[17] lawyers in mass torts need to be allowed to spread risks to third parties who are able to help fund litigation and accept loses in return for a percentage of eventual fees and/or awards.

These third parties would be entitled solely to a portion of fees or awards and not be able to participate, in any manner, in any of the decisions related to the litigation. This is the same situation that occurs when a plaintiff's lawyer secures a loan from a bank to fund litigation. The bank has no influence on the litigation. The only difference would be that the lawyer would be able to share a portion of the fees and thus risk of loss with the financial institution so that a lawyer can then try or work with others lawyers in trying a sufficient number of cases necessary to avoid the risks of ruin from trying too few cases. Surely the lawyer can provide better representation, devoting all energies towards representation, if she no longer needs to worry about the financial ruin associated with loans, sunken costs and time associated with mass tort litigation.

Finance is replete with examples of providing capital and receiving a percentage of winnings without any manner of influence in decisions. Thus financing litigation should have an appeal to some money managers. For example, a Hedge Fund takes a percentage for management and another percentage for winnings while never revealing to the investor the nature of the investments. The only recourse is for the investor to withdraw their money, which is again often limited to specific time periods and circumstances.

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16. Sharing fees with a non-lawyer is strictly prohibited by Rules Regulating the Florida Bar, Rule 4-5.4, http://www.floridabar.org/divexe/rrtfb.nsf/WContents?OpenView.

17. For those plaintiffs who wish to have lawyers that are solely responsible for the financing of their case with no third party participation, this arrangement would remain available. Any spreading of the risk via sharing of fees with non-parties would require a written notice and affirmation by the client. The plaintiff's lawyer would be required to comply with disclosure rules similar to those pertaining to co-counsel relationships. The Rules Regulating the Florida Bar, Rule 4-1.5, http://www.floridabar.org/divexe/rrtfb.nsf /WContents?OpenView.

Similarly, in the bond market a bond holder extends a loan to a corporation or city or government in return for interest, or if a convertible bond in return for interest and/or a portion of future earnings via stock appreciation, in return for a loan. The holder of a bond or convertible bond has absolutely no ability to influence any decisions made by the corporate borrower and can not ask for the return of her money prior to the due date on the bond.

These third parties would be forbidden from ever having any influence whatsoever on litigation decisions and would merely share in the results of the litigation. Financial investments in which the investor has no influence whatsoever on the funded entity are too numerous to begin a recitation. The financial industry is exquisitely good at designing creative products that satisfy the investment objectives of all parties. We can be sure that such would be the case with financing plaintiffs in mass tort without in any manner having an ability to influence the litigation or the attorney client relationship.

From the perspective of the plaintiff, already some inroads have been made towards allowing the spreading of risks and the sharing of recoveries with third parties.[18] Several states allow champerty; several others, like Florida, appear to be open to the issue.[19] One Florida appellate court has enforced a third party contract for a percentage of a recovery.[20]

In addition to plaintiff lawyers, if plaintiffs were allowed to share awards with non-parties, then groups of plaintiffs could agree to pool their cases, like an insurance pool, and take their cases to trial. In this manner no one plaintiff runs the risk of loss due to the randomness associated with trials as described above. Instead, a pool of plaintiffs receive awards smoothed into

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18. Courtney R. Barksdale, Note, *All that Glitters is Not Gold: Analyzing the Costs and Benefits of Litigation Finance*, 26 REV. LITIG. 707 (2007); *see also,* R. H. Farnell, II, *Sleeping with the Enemy-Litigation Loan Agreements: Are They Legal?* THE FLORIDA BAR JOURNAL, Feb. 1998, at 28, *available at* http://www.floridabar.org/DIVCOM/JN/JNJournal01.nsf/Author/457643BDDAC70BA185256ADB005D619D (discussion of champerty in multiparty litigation).

19. Barksdale, *supra* note 18.

20. Barksdale, *supra* note 18, at 718. "In *Kraft v. Mason* a sister brought suit against her brother seeking a share of the proceeds from his settlement. The plaintiff had loaned her brother $100,000 he needed to continue his lawsuit. The agreement provided that the plaintiff would get 20% of the first $1 million, 6% of the next $4 million, and 3% of the amount recovered above $5 million. The appellate court concluded that since the plaintiff did not instigate the lawsuit, the defendant prepared the terms of the loan, and the plaintiff did not impose in the decision making of the defendant and his attorneys, the loan agreement was not champertous." *Id.*

an average return that is more reliable for each individual plaintiff. Of course, adjustments would be made for the merits and damages associated with each case as they are now with mass torts and class actions.

Some finance corporations offer loans to plaintiffs, secured by a future award. Because so few offer this service, at a minimum, it runs close to the line of champerty, plaintiffs are at a disadvantage in negotiating these loans. Needy plaintiffs often receive unfavorable terms. Allowing spreading of risks to third parties would make this loan market far more efficient for plaintiffs.

CONCLUSION

Allowing plaintiffs to spread their risks in mass torts to other plaintiffs and/or third parties would be in the best interests of all plaintiffs in a mass tort. Any plaintiff would be free to not participate in a risk-spreading vehicle.[21] Similarly, allowing the plaintiffs' lawyer in a mass tort to spread her risks and costs with other mass tort lawyers and/or third parties allows the lawyer to better serve the interests of the client. When the plaintiffs and/or their lawyers with the permission of their clients are able to spread their risks in a mass tort, the competitive advantage that inures to the defendant are greatly reduced. To do this, plaintiffs and their lawyers need to be able to 'slice, price, dice and spread' risk as do the defendants. Then, and only then, will the plaintiff receive justice in mass tort litigation. These proposed changes serve the best interests of the client.

These changes would also serve the better interests of justice. One purpose of tort litigation is to protect society from wrong doers.[22] This service is lost in mass torts when defendants secure an advantage that results is under compensated plaintiffs and thus less of a deterrent to bad acts.

21. No plaintiff or lawyer need participate in a risk spreading mechanism if they do not so desire.

22. As Supreme Court Justice Ginsburg noted, "[c]ontingency litigation garnering big fees has vindicated important interests." Ruth Bader Ginsburg, *In Pursuit of the Public Good: Access to Justice in the United States*, 7 WASH. U. J. L. & POL'Y 1, 12 (2001).

FIDUCIARY DUTY – NOW AND IN THE FUTURE

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The celebrated jurist Benjamin Cardozo opined that the fiduciary duty is "the duty of finest loyalty", and that a fiduciary "is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[2] The question most customers have is whether their broker is subject to this duty of finest loyalty, or if they are bound merely by the morals of the marketplace. Currently this is a very difficult question to answer, and will depend on whether the customer is dealing with a broker or an investment adviser, where the customer is located, the type of account the customer has, among other things. However, the answer may be made clearer in the coming months.

With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] ("Dodd-Frank") on July 21, 2010, the Securities and Exchange Commission (the "SEC") has been tasked with evaluating the effectiveness of the current legal or regulatory standards for brokers, dealer and investment advisers. Shortly thereafter, the SEC sought public comment on the issue. The next step will be for the SEC to decide what steps, if any, it should take to address the issues raised.

This article will examine the current standards applicable to brokers and investment advisers in their dealings with customers. It will then discuss what is required of the SEC pursuant to Dodd-Frank as well as various viewpoints on the topic.

I. The Current Standard

Brokers and investment advisors are regulated under two different regulatory schemes. As such, they are each held to different standards of

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2. Meinhard v. Salmon, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (N.Y. 1928).
3. Pub. L. No. 111-203, 124 Stat 1376 (2010).

conduct in their dealings with customers. Investment advisers are regulated by the Investment Advisers Act of 1940 (the "IAA")[4] and brokers are regulated by the Securities Exchange Act of 1934 (the "'34 Act")[5].

A. Investment Advisers

Notwithstanding that the IAA does not use the term "fiduciary" in the context of the standard applicable to investment advisers, case law has consistently held that "§ 206 [of the IAA] establishes 'federal fiduciary standards' to govern the conduct of investment advisers."[6]

Section 206 of the IAA[7] provides:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--
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> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
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> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
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> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

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4. 15 U.S.C. §§ 80b-1 *et seq.*
5. 15 U.S.C. §§ 78a *et seq.*
6. Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11, 17, 100 S. Ct. 242, 246 (1979) (citing to Santa Fe Industries, Inc. v. Green, 430 U.S.462, 471, n. 11, 97 S.Ct. 1292, 1300 (1977)); Burks v. Lasker, 441 U.S. 471, 481-482, n. 10, 99 S.Ct. 1831, 1839 (1979); Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192, 84 S.Ct. 275, 282-283 (1963).
7. 15 U.S.C. §80b-6.

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Therefore, if an account is being handled by an investment adviser pursuant to the IAA, the adviser has a fiduciary duty to the customer. In *Sec. & Exch. Comm'n v. Capital Gains Research Bureau, Inc.*[8], the Court explained, "The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser - consciously or unconsciously - to render advice which was not disinterested." The IAA specifically exempts brokers who provide investment advice, so long as the advice is solely incidental to the brokerage services, and the broker does not receive special compensation for the advice.[9]

B. Brokers

Brokers are not subject to a federal fiduciary standard. The '34 Act is worded differently from the IAA, and courts have not held that it creates a federal fiduciary standard for brokers. Rather, at the federal level, brokers are held to the "suitability" standard that has been created by the rules of the self-regulatory organization, the Financial Industry Regulatory Authority ("FINRA").[10] The suitability standard is set forth in FINRA Rule 2310[11], which states in relevant part:

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8. 375 U.S. 180, 191-92, 84 S. Ct. 275, 282-83 (1963).
9. 15 U.S.C. §80b-2(a)(11).
10. On July 30, 2007, FINRA was created through the consolidation of the National Association of Securities Dealers and the member regulation, enforcement and arbitration operations of the New York Stock Exchange. FINRA is the largest independent regulator for all securities firms doing business in the United States, and it oversees nearly 4,700 brokerage firms, and approximately 635,000 registered securities representatives. *See* www.finra.org (last visited September 9, 2010).
11. FINRA Rules are reviewed by, and ultimately approved by the SEC. *See* "FINRA Rulemaking Process", www.finra.org/Industry/Regulation/FINRARules/RulemakingProcess (last visited September 9, 2010).

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;
(2) the customer's tax status;
(3) the customer's investment objectives; and
(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Although brokers are subject to this suitability standard when recommending an investment to a customer, recommendations only account for a portion of the interaction between brokers and customers. Moreover, the suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer's best interest. Whether or not a broker owes a customer a fiduciary duty in addition to meeting the minimum suitability standard varies from state to state.

Certain states recognize a fiduciary duty in every broker – customer relationship. For example, in California, "[w]ith respect to stockbrokers it is recognized, 'The duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity.' *Meyer,* The Law of Stockbrokers and Stock Exchanges (1931) p. 253." *Twomey v. Mitchum, Jones & Templeton, Inc.*[12].

In other states, the duty a broker owes to a customer depends on the type of account the customer has. Many states recognize that brokers have limited duties when handling a non-discretionary account:

> Defendants' limited definition of a broker's duty to his customer is correct so long as the customer has a non-discretionary account with his broker, i.e., an account in which the customer rather than the broker determines which purchases and sales to make. In a non-discretionary account each transaction is viewed singly. In such cases the broker is

12. 69 Cal. Rptr. 222, 236 (Cal. Ct. App. 1968).

> bound to act in the customer's interest when transacting business for the account; however, all duties to the customer cease when the transaction is closed. Duties associated with a non-discretionary account include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis. *Cash v. Frederick and Co.*, 57 F.R.D. 71 (E.D.Wis.1972); *Hanly v. S.E.C.*, 415 F.2d 589 (2d Cir. 1969); (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests, *Richardson v. Shaw*, 209 U.S. 365, 28 S.Ct. 512, 52 L.Ed. 835 (1908); *Robinson v. Merrill Lynch*, 337 F.Supp. 107 (N.D.Ala.1971), Aff'd, 453 F.2d 417 (5th Cir. 1972), and cases cited therein; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security, *Hanly v. S.E.C.*, *supra*; *Cash v. Frederick and Co.*, *supra*; (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security, *Chasins v. Smith Barney & Co.*, 438 F.2d 1167 (2d Cir. 1971); *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963); (5) the duty not to misrepresent any fact material to the transaction, *Carras v. Burns*, [516 F.2d 251, 258 (4th Cir. 1975)]; *Shorrock v. Merrill Lynch*, CCH Fed.Sec.L.Rep. P 96,251 (D.Or., Nov. 18, 1977); and (6) the duty to transact business only after receiving prior authorization from the customer, *Robinson v. Merrill Lynch*, *supra*.

Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.[13] Like the suitability obligation, the duties discussed above relate to all transactions within the customer's account, not just those that are recommendations.

When the broker is handling a discretionary account[14], courts have routinely held that the broker has a fiduciary duty to the customer. In *Leib*, the court specifically set forth the duties the brokers owe customers:

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13. 461 F. Supp. 951, 952-53 (E.D. Mich. 1978), *aff'd sub nom.* Leib v. Merrill Lynch, Pierce, Fenner & Smith Inc., 647 F.2d 165 (6th Cir. 1981).

14. FINRA Rule 2510 pertains to discretionary accounts, and provides in part that "[n]o member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any

> Unlike the broker who handles a nondiscretionary account, the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense. Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history, *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978); (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests (see in this regard, *Robinson v. Merrill Lynch*, [337 F.Supp. 107 (N.D.Ala.1971)]); (3) keep his customer informed as to each completed transaction; and (5) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged, *Stevens v. Abbott, Proctor and Paine*, 288 F.Supp. 836 (E.D.Va.1968). [*sic*]

Some courts have also recognized that other circumstances create a fiduciary relationship. In *Marchese v. Nelson*[15], the court set out a brief survey of various judicial approaches to determine whether a fiduciary relationship has been created:

> The *Hotmar* [*v. Listrom & Co.*, 808 F.2d 1384, 1386 (10th Cir.1987)] court, in finding no fiduciary relationship, analyzed whether the broker agreed to manage or otherwise control the account, or rather, whether he merely rendered advice. *Id.* at 1387. Finding no agreement by the broker to monitor his clients' nondiscretionary accounts, the court found no fiduciary relationship. *Id.*
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> [T]he *Baker* [*v. Wheat First Sec.*, 643 F.Supp. 1420, 1429 (S.D.W.Va.1986)] court found a fiduciary relationship where the broker exerted "de facto control" over the account. *Baker*, 643 F.Supp. at 1429. To the *Baker* court, such de facto control existed when "'the client routinely follows the recommendations of the broker.' " *Id.* (quoting *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir.1980)).

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transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account." FINRA Rule 2510(a).

15. 809 F.Supp. 880, 893 (D. Utah 1993)

> …
> Finally, other courts assume the existence of a fiduciary relationship even if the account is [non]discretionary [sic], and then analyze the facts to determine the scope of the duty and whether the broker breached the duty. See, e.g., *Romano v. Merrill, Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5th Cir.1987) (interpreting federal securities law). Applying this analysis, the Romano court found no breach where the customer, an alert and vigilant businessman, controlled his nondiscretionary account and made all decisions regarding activity in the account. *Id.* (citations omitted).

In *Leib*, the court observed that although an account may be non-discretionary, a broker may nonetheless have handled the account in a manner more closely akin to a discretionary account. "Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation."[16] *Leib* then set forth several factors courts should consider in determining whether the broker has usurped control over the account:

> In determining whether a broker has assumed control of a non-discretionary account the courts weigh several factors. First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly young, *Kravitz v. Pressman, Frohlich & Frost*, 447 F.Supp. 203 (D.Mass.1978), old, *Hecht v. Harris*, *supra*, or naive with regard to financial matters, *Marshak v. Blyth Eastman Dillion & Co., Inc.,* 413 F.Supp. 377 (N.D.Okl.1975), the courts are likely to find that the broker assumed control over the account. Second, if the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence. *Kravitz v. Pressman*, *supra*; *Hecht v. Harris*, [430 F.2d 1202 (9th Cir. 1970)]. Conversely, where the relationship between the broker and the customer is an arms-length business relationship, the courts are inclined to find that the customer retained control over the account. *Shorrock v. Merrill Lynch*,

16. 461 F.Supp. at 954.

> [CCH Fed.Sec.L.Rep. P 96,251 (D.Or., Nov. 18, 1977)]. Third, if many of the transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker. *Hecht v. Harris*, *supra*. Fourth, if the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction, the courts will usually find that the customer, by maintaining such active interest in the account, thereby maintained control over it. *Robinson v. Merrill Lynch*, *supra*.

de Kwiatkowski v. Bear, Stearns & Co., Inc.[17] also set forth 'special circumstances' which can create a fiduciary duty on the part of the broker:

> The transformative "special circumstances" recognized in the cases are circumstances that render the client dependent – a client who has impaired faculties, or one who has a closer than arms-length relationship with the broker, or one who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker. The law thus imposes additional extra-contractual duties on brokers who can take unfair advantage of their customers' incapacity or simplicity. See, e.g., *Societe Nationale D'Exploitation Industrielle Des Tabacs Et Allumettes v. Salomon Bros. Int'l Ltd.,* 251 A.D.2d 137, 674 N.Y.S.2d 648, 649 (App.Div.1998) (referring to the broker's "requisite high degree of dominance and reliance"); *Leib,* 461 F.Supp. at 954 (referring to heightened duties where "broker has usurped actual control," such as a case involving a 77-year-old widow); *cf. Robinson,* 337 F.Supp. at 113 (absent an express advisory contract, there is no fiduciary duty on part of broker-dealer "unless the customer is infirm or ignorant of business affairs").

In addition to the nature of the account and the relationship between the broker and the customer, the type of fees a customer pays is another factor in determining whether or not a fiduciary duty exists. As noted earlier, the IAA exempts brokers who provide investment advice so long as the advice is incidental to the brokerage services, and the broker does not receive special compensation for the advice. In 1999, the SEC expressed concern that because brokerage firms were now offering fee-based accounts in addition to

17. 306 F.3d 1293, 1308-09 (2d Cir. 2002).

commission-based accounts, they would be subject to the IAA.[18] The SEC recognized that customers were getting the same services regardless of the broker's compensation scheme. Ultimately, the SEC adopted a rule ensuring that brokerage firms offering fee-based accounts would not be subject to the IAA.[19] However, in 2007, the Court of Appeals for the D.C. Circuit held that the SEC did not have authority to broaden the exception set forth in the IAA, and it struck down the rule.[20] Hence, brokers who offer fee-based accounts are deemed to receive special compensation under the IAA and are required to be registered as investment advisers and as such, are subject to the fiduciary obligations of the IAA.[21]

II. The Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank was signed into law by President Obama on July 21, 2010. The final version of the bill was a compromise between the House and the Senate versions. "Changes to the standards of conduct applied to broker-dealers and investment advisers were present in both the House and the Senate versions of financial regulatory reform. However, the House and the Senate had different approaches to this issue. The House approach was to harmonize the fiduciary standard for brokers, dealers, and investment advisers. The Senate approach was to have the SEC conduct a study to evaluate the effectiveness of existing standards of conduct for brokers, dealers, and investment advisers."[22]

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18. S.E.C. Notice of Proposed Rulemaking, 64 Fed. Reg. 61,228 (Nov. 10, 1999).

19. The Commission adopted final rule 202(a)(11)-1 under the IAA on April 15, 2005. *See S.E.C. Rel. No. 34-51523,* available at www.sec.gov/rules/final/34-51523.pdf. However, the Commission did not take any actions against firms which offered fee-based accounts between the issuance of the proposed rule in 1999 and the adoption of the final rule in 2005.

20. Financial Planning Ass'n v. Securities and Exchange Commission, 482 F.3d 481 (D.C. 2007).

21. It should be noted that the IAA only confers a limited private right of action. *See* Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11,24, 100 S.Ct. 242, 349 (1979) ("For the reasons stated in this opinion, we hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable.").

22. MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., R41381, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: STANDARDS OF CONDUCT

Section 913 of Dodd-Frank is entitled, "Study and Rulemaking Regarding Obligations of Brokers, Dealer, and Investment Advisors." Pursuant to subsection (b), the SEC is required to conduct a study to evaluate:

> (1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission and a national securities association, and other Federal and State legal or regulatory standards; and
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> (2) whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.

Subsection (c) sets forth fourteen items that the SEC should consider when conducting the study, and includes the catchall of anything not explicitly set forth that the SEC deems necessary and appropriate. As summarized by the Congressional Research Service:

> Subsection (c) sets out what the SEC is required to consider in conducting the study: (1) the effectiveness of current legal or regulatory standards of care which have been imposed by the SEC or a national securities association and other federal and state legal or regulatory standards; (2) whether there are legal or regulatory gaps, shortcomings, or overlaps in the standards of conduct for protecting retail customers that should be addressed by rule or statute; (3) whether retail customers understand that there are different standards of care applicable to brokers, dealers, and investment advisers in the provision of personalized investment advice about securities to retail customers; (4) whether the existence of different standards of care concerning the quality of personalized investment advice that retail customers receive

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OF BROKERS, DEALERS, AND INVESTMENT ADVISERS (2010), available at www.cq.com/displaycrsreport.do? docid=3729478.

> is confusing to them; (5) the resources and activities of the SEC, the states, and a national securities association to enforce the standards of care, including the effectiveness of examinations of brokers, dealers, and investment advisers in determining compliance with regulations, the frequency of examinations, and the length of time of the examinations; (6) the substantive differences in regulating brokers, dealers, and investment advisers in their providing personalized investment advice and recommendations about securities to retail customers; (7) specific instances concerning personalized investment advice about securities in which regulation and oversight of investment advisers provide greater protection than regulation and oversight of brokers and dealers and instances in which regulation and oversight of brokers and dealers provide greater protection than regulation and oversight of investment advisers; (8) existing legal or regulatory standards of state securities regulators and other regulators intended to protect retail customers; (9) the potential impact on retail customers of imposing upon brokers and dealers the standard of care applied under the Investment Advisers Act; (10) the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" in the Investment Advisers Act; (11) the varying level of services provided by brokers, dealers, and investment advisers to retail customers; (12) the potential impact on retail customers that could result from changing the regulatory requirements or legal standards of care affecting brokers, dealers, and investment advisers concerning their obligations to retail customers about investment advice; (13) the potential additional costs to retail customers concerning the potential impact on the profitability of their investment decisions and to brokers, dealers, and investment advisers resulting from changes to the regulatory requirements or legal standards affecting brokers, dealers, or investment advisers; and (14) any other consideration that the SEC considers necessary and appropriate in determining whether to conduct a rulemaking.

Subsection (d) gives the SEC six months from the enactment of Dodd-Frank to submit its report to both the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives. Subsection (e) requires the SEC to seek public comments in preparing its report. Subsection (f) permits the SEC to "commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers" which addresses the standard of care a broker has towards a customer. Subsection (g) amends both the '34 Act and the IAA to allow the SEC to issue rules governing the standards of care owed by both brokers and investment advisers.[23] However, subsection (g) specifically states that "[n]othing in this section shall require a broker or dealer or registered representative to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities."

III. Concerns and Responses

In 2009, the Treasury Department issued a report entitled "Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation".[24] The Report essentially addresses numbers (3) and (4) of subsection (c) of section 913 of Dodd-Frank:

> Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give "incidental advice" in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer's relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer's fiduciary.
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> From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing "incidental advice" appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of

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23. *See id.*

24. http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (June 17, 2009).

> trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same

SEC Chairman Mary Schapiro made similar observations when she testified on July 22, 2009 before the United States House of Representatives Committee on Financial Services[25]:

> Many investors do not recognize the differences in standards of conduct or the regulatory requirements applicable to broker-dealers and investment advisers. When investors receive similar services from similar financial service providers, it is critical that the service providers be subject to the same standard of conduct and equivalent regulatory requirements, regardless of the label attached to the providers.
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> I therefore believe that all financial service providers that provide personalized investment advice about securities should owe a fiduciary duty to their customers or clients and be subject to equivalent regulation. As such, I support the standard contained in the Department of the Treasury bill recently put forth entitled the "Investor Protection Act of 2009." That bill explicitly would enable the Commission to promulgate rules to provide all broker-dealers and investment advisers providing investment advice to retail customers act solely in the interest of their customers or clients without regard to the financial or other interests of the financial service professional. The establishment of this investor-focused approach as a consistent standard for all broker-dealers and investment advisers providing investment advice would represent a significant step forward in the protection of retail investors.

On July 27, 2010, the SEC published its request for public comment[26] as it was required to do pursuant to §913(e) of Dodd-Frank. By the date comments were due, August 30, 2010, thousands of comments were posted

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25. *Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing Before the House Committee on Financial Services*, 111th Cong. (2009) (statement of Mary L. Schapiro, Chairman, S.E.C.); a copy of the statement is available at www.sec.gov/news/testimony/2009/ts072209mls.htm.
26. *S.E.C. Release No. 34-62577; IA-3058,* "Study Regarding Obligations of Brokers, Dealers, and Investment Advisers", available at www.sec.gov/rules/other/2010/34-62577.pdf.

on the SEC's website. Many organizations commented, including PIABA[27], SIFMA[28], AARP[29], NASAA[30], and the Investment Adviser Association[31]. Each of these organizations supports a uniform standard for brokers and investment advisers, but their opinions vary in terms of what that really means.

CONCLUSION

It would be pure speculation at this point to try to determine what the SEC will do in response to the study it is now conducting. One would hope that the issues raised in connection with the confusion faced by customers every day could be resolved. It seems easy to simply create a true uniform fiduciary standard that would apply to any financial professional who does business with a retail customer. The argument that doing so would be cost prohibitive to brokerage firms, or that the diversity of products currently offered to customers would suddenly dry up, lacks support. As set forth above, in California, brokers are fiduciaries in the true sense. Yet that fact has not caused brokers and brokerage firms to flee the state. On the contrary, customers have the same opportunities to invest in California that they have in New York. The only difference is that customers in California are protected by the law and are not tasked with trying to determine what duties their broker may owe them.

In a speech given at the Consumer Federation of America 21st Annual Financial Services Conference on December 3, 2009, Chairman Schapiro[32] described the risks of maintaining the status quo:

> So, imagine an investor walking down Main Street in the town where you grew up. He steps into the office of the local securities professional and is handed a business card.
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> But he doesn't look to see whether it says broker-dealer or investment adviser. Chances are he doesn't know the difference. Or even care. All he wants is helpful, investor-focused advice, a fair deal and a professional he can trust.

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27. www.sec.gov/comments/4-606/4606-2737.pdf.
28. www.sec.gov/comments/4-606/4606-2553.pdf.
29. www.sec.gov/comments/4-606/4606-2549.htm.
30. www.sec.gov/comments/4-606/4606-2607.pdf.
31. www.sec.gov/comments/4-606/4606-2563.pdf.
32. www.sec.gov/news/speech/2009/spch120309mls.htm.

> These seem to me to be reasonable expectations. But today that investor — whether he knows it or not — is treated differently depending on what that business card says. If it's a broker-dealer, he's sold a product that is, "suitable" for him. If it's an investment adviser, he gets treated under a higher standard — the fiduciary duty standard — meaning that the investment adviser has to provide advice that puts the investor's interest first.
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> Investors today should not be treated differently based on what door they walk into — or based on what is written on the business card they are handed.
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> Instead, I believe that all securities professionals should be subject to the same fiduciary duty — and that all investors receiving advice should rest assured that the advice they get is being given with their interest at heart.
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> But, to be effective, the fiduciary duty needs to be meaningful and uniform across all securities professionals. It cannot be weakened or diluted just so that it can be applied broadly.

The SEC's report is required to be submitted to the two committees by January 2011. Hopefully, by that time, the SEC will have begun the rulemaking process to adopt rules that will impose a strong, uniform fiduciary standard on both brokers and investment advisers.

THE PROHIBITIVE COST DOCTRINE: AN EFFECTIVE MEANS OF CHALLENGING THE ENFORCEMENT OF AN ARBITRATION AGREEMENT

Seth Nadler [1]

I. Introduction

The prohibitive cost doctrine is an infrequently employed, yet viable weapon that practitioners may use to challenge the enforcement of arbitration clauses. This article will first describe the doctrine and then provide practitioners with a step-by-step guide to implement it. The article will then provide a series of case illustrations demonstrating the evidentiary showings that are necessary and sufficient to prevail under the doctrine and explain the pitfalls that frequently befall plaintiffs seeking to invoke the doctrine.

Eight years ago, the U.S. Supreme Court, in *Green Tree Financial Corp. v. Randolph*,[2] recognized that arbitration provisions that impose prohibitive costs upon litigants are not enforceable. Judges in subsequent federal cases devised an analytical framework to evaluate whether a particular arbitration provision imposes such prohibitive costs. Many states have incorporated this cost-based analysis into their evaluations of claims of substantive unconscionability. Moreover, these state courts employ *Green Tree* even when the claims arising under the arbitration provision are based entirely in state law, as opposed to the federal statutory claims at issue in *Green Tree*. In light of state courts' reliance upon *Green Tree* in such circumstances, the prohibitive cost doctrine articulated in *Green Tree* provides practitioners with a potent weapon with which to challenge the enforceability of expensive arbitration agreements.[3]

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1. Seth Nadler received his J.D. *cum laude* from Cornell Law School, in May, 2010. As a student in the Cornell Securities Law Clinic, Mr. Nadler argued before the California Appellate Division on behalf of *amici curiae* in the matter of *Parada v. Superior Court*, 98 Cal.Rptr.3d 743 (4th App. Dist. 2009). The following article is a product of the successful litigation in this matter.
2. 531 U.S. 79, 97 (2000) [hereinafter "*Green Tree*"].
3. An important note in the investment agreement context is that the effectiveness of the doctrine directly hinges on the expenses imposed by the arbitral forum. Thus, while plaintiffs have successfully overcome arbitration agreements mandating arbitration governed by the AAA and JAMS, it is highly unlikely that a court would sustain a challenge to an investment agreement calling for arbitration presided over by a significantly less expensive forum.

II. *Green Tree* and Adoption by State Courts

A. Prohibitive Cost Doctrine

In *Green Tree*, the U.S. Supreme Court recognized that circumstances may arise such that "the existence of large arbitration costs could preclude a litigant…from effectively vindicating her federal statutory rights in the arbitral forum."[4] However, in *Green Tree*, the plaintiff challenging the validity of the arbitration clause on the basis of cost, "failed to make any factual showing that [the arbitral forum for which she submitted prospective costs] would conduct the arbitration, or that if it did, she would be charged the filing fee or arbitrator's fee that she identified."[5] Indeed, "[t]he record reveals only the arbitration agreement's silence on the subject [of arbitration fees], and that fact alone is plainly insufficient to render [the arbitration clause] unenforceable."[6]

The U.S. Supreme Court concluded that "where, as here, a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs."[7] Although the *Green Tree* court allocated the burden of proof to the party challenging the validity of the arbitration clause, it did not reach a decision with respect to "[h]ow detailed the showing of prohibitive expense must be before the party seeking arbitration must come forward with contrary evidence."[8]

Following quickly upon the heels of *Green Tree*, the Fourth Circuit, in *Bradford v. Rockwell Semiconductor Systems, Inc.,*[9] devised a series of analytical inquiries which have been widely adopted in evaluating challenges to arbitration provisions under *Green Tree*.[10] The *Bradford* court framed the inquiry as "whether the arbitral forum in a particular case is an adequate and accessible substitute to litigation."[11] To resolve this issue in a given case, the court endorsed a "case-by-case analysis that focuses, among other things, upon the claimant's ability to pay the arbitration fees and costs, the expected

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4. *Green Tree*, 531 U.S. at 90.
5. *Id*. at 90 n.6.
6. *Id.* at 91.
7. *Id.* at 92.
8. *Id.*
9. 238 F.3d 549 (4th Cir. 2001).
10. *Id*. at 557-59.
11. *Id.* at 556.

cost differential between arbitration and litigation in court, and whether that cost differential is so substantial as to deter the bringing of the claims."[12]

Although some jurisdictions have declined to apply this test, *see, e.g., Morrison v. Circuit City Stores, Inc.,*[13] many jurisdictions have embraced the *Bradford* approach.[14]

Moreover, many of these jurisdictions have adjusted the *Bradford* test, eschewing any requirement on the part of the claimant "to demonstrate that the unaffordable arbitration costs exceed the projected overall costs of litigation."[15] Instead, they emphasize the plaintiff's ability to pay the arbitral fees and costs.[16]

B. Many States Apply Green Tree to State Law Claims

The initial reaction among the states following the *Green Tree* ruling was to view the decision as creating a highly limited prohibitive cost doctrine that applies only to federal statutory claims.[17] However, in recent years, many states have begun to apply the doctrine directly to *state common law* claims (in addition to state statutory claims). Moreover, some states, most notably California, which have been reluctant to apply *Green Tree* directly to non-federal statutory claims, have adopted a variant of the *Green Tree* doctrine, which they incorporate into their state law substantive unconscionability determinations.

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12. *Id.*
13. 317 F.3d 646 (6th Cir. 2003).
14. *See, e.g,.* Veliz v. Cintas Corporation, No. 03-01180(SBA), 2005 WL 1048699, at *4 (N.D. Cal. May 4, 2005) (applying California law); Brady v. Williams Capital Group, L.P., 878 N.Y.S.2d 693, 698-99 (1st Dep't 2009) (noting the New York Court of Appeals' recent adoption of this approach); Doyle v. Finance America, LLC, 173 Md. App. 370, 390-91 (Md. App. 2009); Oklahoma Oncology & Hematology v. US Oncology, Inc., 160 P.3d 936, 949 (Okla. 2007); Post v. Procare Automotive Service Solutions, 2007 WL 1290091 at *4 (Ohio App. 8 Dist. 2007); Zuver v. Airtouch Communications, Inc., 103 P.3d 753, 763 (Wash. 2004).
15. *Gutierrez*, 7 Cal. Rptr. 3d at 284.
16. *Id.* ("[A]n ability-to-pay test is consonant with the Legislature's preference.").
17. *See, e.g.,* Cruz v. PacifiCare Health Systems, Inc., 66 P.3d 1157, 1163 (Cal. 2003).

California's treatment of the *Green Tree* doctrine is a bit muddled.[18] In some cases, such as *Ting v. AT&T, Green Tree* was applied directly to state common law and statutory claims. However, the most recent court to address the issue directly, the California Court of Appeal, in *Parada v. Superior Court*, offered a somewhat inconsistent approach to *Green Tree*. First, the court reviewed the *Green Tree-Bradford* line and concluded that it is a free-standing doctrine to be applied exclusively when a contract is governed by the FAA, and that its analysis is distinct from California's approach.[19] It then concluded that the proper approach to contracts governed entirely by California law was articulated in a California appeals case , *Gutierrez v. Autowest, Inc.*.[20] The *Parada* Court's conclusion appears to introduce a distinction without a difference, since the *Gutierrez* test is materially identical to the *Green Tree* approach[21], and even appears to be fashioned directly from the *Green Tree* ability-to-pay test. *Id*. Moreover, in its application of the *Gutierrez* test, the *Parada* Court expressly grounded its conclusion of substantive unconscionability in non-California decisions applying the *Green Tree* doctrine. These developments suggest that, outside of the employment context, arbitration agreements governing consumer and investment contracts are subject to a direct *Green Tree* analysis when they fall within the scope of the FAA, and a *Green Tree*-derived state law substantive unconscionability analysis, when they do not.

No fewer than **nine** states, including New York, Illinois, and Texas, apply *Green Tree* to cases involving state common law claims.[22]

In addition to the aforementioned states, the Court of Appeals of Oregon, on multiple occasions, has applied *Green Tree* when resolving disputes over

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18. *cf* Ting v. AT&T, 182 F. Supp. 2d 902, 921 (N.D. Cal. 2002), *aff'd in part and rev'd in part on other grounds*, 319 F.3d 1126 (9th Cir. 2003), *with* Parada v. Superior Court, 98 Cal.Rptr.3d 743, 760-65 (Cal. Ct. App. 2009).

19. *See Parada,* 98 Cal.Rptr.3d 743 at 762.

20. 7 Cal. Rptr. 3d 267 (Cal. Ct. App. 2003).

21. See *Gutierrez*, 7 Cal. Rptr. 3d at 284.

22. *See, e.g.,* Bess v. Directv, Inc., 885 N.E.2d 488, 498 (Ill. App. Ct. 2008) (applying *Green Tree* with respect to state common law and statutory claims); In re December Nine Company, Ltd., 225 S.W.3d 693, 702-03 (Tex. App. 2006) (applying *Green Tree* where plaintiff brought state-based wrongful discharge suit); Miller v. Arnold Worldwide, LLC, No. 604937/05, 2006 WL 2818492, at *3 (N.Y. Sup. Ct. Aug. 28, 2006) (applying *Green Tree* to various state contract and civil rights claims and concluding that "plaintiff [fails to] demonstrate[ ] that arbitration is, due to its expense, unconscionable in this instance").

the unconscionability of arbitration clauses in connection with state law claims.[23]

The Supreme Court of North Carolina has also endorsed this approach to *Green Tree*.[24] So, too, has the Court of Appeals of Indiana.[25] The Court of Appeals of Georgia accords in this approach.[26] Indeed, Kentucky appears to be the only state which has refused to apply *Green Tree* to state law claims.[27] The much more prevalent approach nationwide has been to employ *Green Tree* and its progeny in such circumstances.

In light of these developments, the broader reach of the *Green Tree* prohibitive cost doctrine renders it a valuable tool for individuals seeking to get out from under oppressive arbitration agreements.

C. The Prohibitive Cost Doctrine Applies to Arbitration Clauses in Investor Context

Although individual litigants have attempted to assert that the prohibitive cost doctrine should not apply in the investor context, no court has adopted—nor even contemplated—such a distinction. Whenever the question has arisen, every court has responded by applying *Green Tree* and its progeny in the investor context.[28]

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23. *See* Motsinger v. Lithia Rose-Ft, Inc., 156 P.3d 156, 161-62 (Or. Ct. App. 2007) (applying *Green Tree* to wrongful termination claims under state law); Vasquez-Lopez v. Beneficial Oregon, Inc., 152 P.3d 940, 951-52 n.5 (Or. Ct. App. 2007) ("*Green Tree* deals with federal civil rights statutes, but we see no reason why it should not be extended to state law.").

24. *See* Tillman v. Commercial Credit Loans, Inc., 655 S.E.2d 362, 370-73 (N.C. 2008) (applying *Green Tree* analysis to alleged violations of North Carolina's Unfair and Deceptive Trade Practices Act and contract claims).

25. *See* Roddie v. North American Manufactured Homes, Inc., 851 N.E.2d 1281, 1285 (Ind. Ct. App. 2006) (performing cost analysis pursuant to *Green Tree* with respect to contract claims).

26. *See* Crawford v. Great American Cash Advance, Inc., 644 S.E.2d 522, 525 (Ga. Ct. App. 2007) (applying *Green Tree* to counterclaim against lender alleging violations of Georgia Payday Loan Act).

27. *See, e.g.,* Stutler v. T.K. Constructors, Inc., 448 F.3d 343, 346-47 (6th Cir. 2006) (applying Kentucky law).

28. *See* Guadagno v. E*Trade Bank, 592 F. Supp. 2d 1263, 1272 (C.D. Cal. 2008) (applying *Green Tree* in evaluating substantive unconscionability of arbitration clause governing plaintiff's interest-earning account); *see also* Pacific Life Insurance Co. v. Heath, 370 F. Supp. 2d 539, 545-46 (S.D. Miss. 2005) (applying *Green Tree* to suit involving sale of plaintiff's variable annuities); Pet Quarters, Inc. v. Badian,

III. Applications of the Prohibitive Cost Doctrine

A. Detailed Showings of Financial Resources and the Costs Imposed by the Arbitral Form

Individuals seeking to challenge an arbitration provision must provide the court with ample evidence demonstrating their inability to afford the arbitration costs. Litigants must offer a detailed financial snapshot, including their total annual income, monthly expenses, the value of critical assets, such as houses and automobiles, the amount of equity held in these assets, and personal developments, like impending marriage separations, which bear directly upon their ability to absorb such prodigious arbitration costs.[29]

In addition to the comprehensive showing of their financial resources, litigants must provide the reviewing court with detailed descriptions of the costs imposed by the designated arbitral forum. Litigants must make clear that the costs submitted are costs that they are highly likely to incur, as opposed to constituting merely "an abstract and speculative risk that the claimant might, under some circumstances, incur prohibitive costs…."[30]

Typically, this is successfully done by attaching as exhibits documents from the arbitration forum summarizing (i) the deposits required for each arbitrator; (ii) the average hourly rates that arbitrators employed by that forum typically charge; and (iii) a calculation enumerating the expenses likely to be incurred for a single day of arbitration, as well as an estimate as to the total cost of the arbitration depending upon the likely number of hearing days required. Of course, these calculations must take into account any fee-splitting arrangements called for by the agreement, and, if the agreement does require fee-splitting, the financial information submitted as to the individual's ability to pay the arbitral fees must reflect an inability to pay the fees *in light of the fee-splitting provision*.

An important consideration to keep in mind as to the likelihood of success in proceeding under the prohibitive cost doctrine is the number of arbitrators that the agreement calls for, and the extent to which the agreement

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No. 4:04-CV-697, 2006 WL 1307669, at *3-4 (E.D. Ark. May 9, 2006) (applying *Green Tree* to securities fraud claims); Ritch v. Eaton, No. 02-7689, 2002 WL 32107628, at *3-4 (E.D. Pa. Dec. 9, 2002) (applying *Green Tree* to plaintiff's claims against financial advisor, including suitability of investments and misrepresentation).

29. Counsel should be mindful, however, of financial privacy laws that require redaction of such material, as well as the ability of third parties to exploit such information if filed in open court.

30. *Bradford,* 238 F.3d at 557.

provides for fee-splitting. Naturally, the fewer the number of arbitrators mandated by the agreement, and the greater costs the party seeking to enforce the agreement is willing to incur, the less likely a court is to strike down an agreement due to prohibitive costs. However, an important limitation on this general rule is that courts are hesitant to allow for post-contract attempts to reduce the costs called for by the express language of the agreement. Attempting to "rewrite" the fee requirements of the arbitral forum is a common tactic employed by parties seeking to compel arbitration, and it has met with significant resistance.[31]

Another critical issue that often arises, and one that imposes a unique burden in the investment context, is the point in time at which courts determine a party's ability to afford the arbitration fees. Generally, courts require parties to provide evidence of their ability to pay at the time in which they enter the contract.[32] This requirement is particularly challenging to investors because, unlike the traditional arbitration agreements contained in employment and consumer contracts, investors typically enter into long term investment relationships for an indeterminate period of time. Moreover, the purchase of a fixed commodity has a wholly determinable impact on a purchaser's assets around which the purchaser may sensibly proportion their remaining assets. An investment contract is necessarily speculative in nature and does not allow for reasonable foreseeability on the part of the investor. Essentially, the investor places a (usually significant) portion of their assets in the hands of an investment agent for an indeterminate amount of time, during which, the investor remains at the mercy of the manager. Almost always, an investor initiates an arbitration proceeding only after sustaining heavy investment losses. Thus, it is precisely at the point in time in which the investor faces high arbitral fees when he or she can least afford to pay them. Evaluating an investor's ability to pay arbitral fees at the time at which the investor enters the agreement, therefore, makes little sense practically and thoroughly distorts the extent to which the investor is precluded from bringing claims to recover the money he has lost.

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31. *See, e.g., Morrison*, 317 F.3d at 676-77 ("[C]ourts should not consider after-the-fact offers by employers to pay the plaintiff's share of arbitration costs where the agreement itself provides that the plaintiff is liable…[The drafter] is saddled with the consequences of the provision *as drafted*."); Murray v. United Food and Commercial Workers International Union, 289 F.3d 297, 304 (4th Cir. 2002) (drafter "may not rewrite the arbitration clause…in order to claim that it is an acceptable one"); Kinkel v. Cingular Wireless, LLC, 857 N.E.2d 250, 259 (Ill. 2006).

32. *See, e.g., Parada,* 98 Cal.Rptr.3d , at 767.

Fortunately, despite this bleak picture, some courts have shown a willingness to infer an inability to pay at the time the agreement was entered into while relying upon purely post-contract financial data.[33] Although at least one court, the Fifth Circuit, has refused to consider post-contract financial data,[34] this decision has incurred heavy scholarly criticism.[35]

B. Case Illustrations of Successful Invocations of the *Green Tree* Prohibitive Cost Doctrine

Case law plainly holds that where a litigant supplements their claims of substantive unconscionability with the financial data described above, and accurate summaries of forum costs for the contractually-mandated arbitration forum, the litigant has discharged its burden of production under *Green Tree*. For example, a court found a claimant's declaration sufficient to nullify an arbitration agreement where the claimant described for the court her weekly income and child support payments, student loans and monthly expenses, and the value of assets including her automobile, as well as information pertaining to the costs of arbitration, including the initial filing fee, the fees arbitrators typically command under the particular forum at issue, and a

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33. *See, e.g., id.; see also* Brief of Respondent in *Gutierrez* at *3, *Gutierrez v. Autowest, Inc.*, 7 Cal. Rptr. 3d 267 ("Mr. and Mrs. Gutierrez both work for PG&E, earning a total net monthly income of approximately $4300…After expenses, they save a few hundred dollars per month and *at the time of the petition to compel arbitration*, they had a total of $3,000 in savings and Mrs. Gutierrez was pregnant.") (emphasis added).

34. *See* Overstreet v. Contigroup Companies, Inc., 462 F.3d 409 (5th Cir. 2006).

35. *See* Ryan M. Turley, Note, *Only the Rich Can Afford a Remedy: The Unconscionable Enforcement of Arbitration Provisions Against the Indigent*, 2007 J. DISP. RESOL. 611, 611-23 (2007) (contrasting the 5th Circuit's approach to such language from California's in *Gutierrez* and concluding that the *Overstreet* court "not only misapplied Georgia Law but rendered a holding that both disregards the foundational public policy behind the doctrine of unconscionability and does violence to the fundamental right to due process of law"); Donald R. Philibin, Jr. et al., *Alternative Dispute Resolution*, 40 TEX. TECH L. REV. 445, 456 (2007) (finding "the bottom line outcome of Overstreet to be inconsistent with a statement in Green Tree Financial Corp. v. Randolph that 'existence of large arbitration costs could preclude a litigant…from effectively vindicating her federal statutory rights in the arbitral forum'…[O]ther courts may reach different outcomes by applying Texas law to a slightly thicker record") (internal citations omitted).

reasonable estimate of the total cost that an arbitration would impose on the claimant.[36]

However, beyond a clear delineation of the burden of production under this test, it is difficult to articulate many uniform rules as to judicial analysis of this evidence. This is in part due to the relative dearth of decisions where a court has found that a claimant has met their burden of production such that a *Green Tree* analysis is warranted. Regardless, a review of the handful of decisions in which reviewing courts have applied the prohibitive cost doctrine reveals a "sliding scale," with a claimant's inability to pay on one pole and the extent of the costs imposed by the arbitral forum on the other. As one might suspect, the more compelling a claimant's evidence is as to one of the poles, the less the remaining evidence need be as to the other.

For example, in one case, the terms of the arbitration provision were so oppressive that the court did not even rely upon the claimant's showing of financial hardship in order to strike down the arbitration agreement.[37] On the other hand, where a claimant demonstrated a high inability to pay any arbitral fees, the reviewing court determined that the claimant satisfied their burden under *Green Tree* despite failing to provide *any* evidence relating to the average cost of an arbitrator, since the claimant did provide evidence of substantial filing fees.[38] Moreover, where the claimants offered an uncontested affidavit of poverty and the cost of arbitration was determined to be at minimum $4,195, a court invalidated a cost-splitting provision.[39]

Another important point for claimants to emphasize to the reviewing court is that a *Green Tree* analysis should <u>not</u> take into account the potential value of the claims sought. Frequently, a party seeking to compel arbitration will attempt to compare the expected fixed forum costs with the potential value of the compensatory and/or punitive damages that the other party seeks to bring under the contract. Such a comparison is not called for under the *Bradford* test, nor is it prescribed in any variation that has been fashioned by

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36. *See* Camacho v. Holiday Homes, Inc., 167 F. Supp. 2d 892, 894-95 (W.D. Va. 2001); *see also* Phillips v. Associates Home Equity Services, Inc., 179 F. Supp. 2d 840, 846-47 (N.D. Ill. 2001) (plaintiff's showing under *Green Tree* sufficient where plaintiff presented court with value of initial filing fee, evidence of the range of arbitrator's fees for that forum, and financial evidence that she could not afford such fees) .

37. *See* Popovich v. McDonald's Corp., 189 F. Supp. 2d 772, 778 (N.D. Ill. 2002).

38. *See* Mendez v. Palm Harbor Homes, Inc., 45 P.3d 594, 605-06 (Wash. Ct. App. 2002).

39. Sprague v. Household International, 473 F. Supp. 2d 966, 976 (W.D. Mo. 2005).

any court. Moreover, some courts have implicitly rejected such a comparison.[40]

C. Why do Most Prohibitive Cost Challenges Fail?

Many of those litigants who have raised unsuccessful challenges to arbitration provisions have not come close to putting forth evidence as comprehensive and on-point as the submissions recommended above. These failed challenges can be easily categorized into three groups. Claimants who have: (i) Failed to disclose sufficiently their financial resources and assets and/or the reasonably anticipated arbitration costs; (ii) received an offer from the defendant to undertake payment of any arbitration fees which would impose prohibitive burdens on the plaintiff; and (iii) relied exclusively on a fee-splitting provision or silence with respect to fee allocation as the sole basis for alleging prohibitive costs.

The first category, comprised of claimants who failed to adequately convey to the court their financial circumstances and arbitration costs, is entirely avoidable. Unsuccessful cases falling within this category typically involve claimants who have failed to offer any financial evidence at all,[41] or the evidence they did submit failed to present "a full picture of [their] financial condition such that the court could evaluate [their] ability to pay the costs of arbitration."[42] Often, these failures have arisen despite having been

40. *See Popovich*, 189 F. Supp. 2d at 776 (invalidating the arbitration provision despite the fact that "[i]n [the claimant's] amended complaint, [claimant] seeks $20 million in damages"); *see also Phillips*, 179 F. Supp. 2d at 846 (court grounded its conclusion of substantive unconscionability exclusively in costs imposed by the arbitral forum and accepted as sufficient a mere "affidavit stating that [the claimant] 'cannot afford to pay' the filing fees and other costs, and that she is in 'severe financial straits'").

41. *See, e.g.*, Faber v. Menard, Inc., 367 F.3d 1048, 1054 (8th Cir. 2004) ("[Plaintiff] has also failed to provide evidence of his particular financial situation.").

42. Rollins, Inc. v. Foster, 991 F. Supp. 1426, 1438 (M.D. Ala. 1998); *see also* Century Satellite, Inc. v. Echostar Satellite, L.L.C., 395 F. Supp. 2d 487, 492-93 (S.D. Tex. 2005) ("[Plaintiff] makes no representation, however, as to [plaintiff's] total assets or other resources, and provides no information regarding its corporate structure, whether it is closely held, and what ability it has to raise the needed funds to pursue its sizable claims…[Plaintiff] submits no balance sheets, audited financial statements, or other proof to establish its total financial capacity.").

provided discovery on the very question of affordability.[43] Not surprisingly, those claimants who failed to demonstrate adequately their financial hardship also failed to articulate sufficiently the costs they would be required to absorb under the mandatory arbitration provisions.[44]

A second category of unsuccessful challenges arises when the litigant seeking to invoke the arbitration provision has agreed to cover a significant amount, or in some cases, *all* of the challenging claimant's arbitration costs.[45] However, while courts have relied upon these post-contract revisions to preserve the validity of the arbitration agreement, in none of these cases is it

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43. *See* Livingston v. Associates Finance, Inc., 339 F.3d 533, 557 (7th Cir. 2003) ("[T]he Livingstons… have failed to provide any evidence of their inability to pay such costs, even though the district court permitted discovery on that very question.").

44. *See e.g. Rollins, Inc.*, 991 F. Supp.at 1438-39 ("[T]here is no information in the record concerning the costs of the arbitrator's fees, which represents the crucial difference between arbitration and litigation."); *Livingston*, 339 F.3d at 557 ("[T]he Livingstons have not offered any specific evidence of arbitration costs that they may face in this litigation, prohibitive or otherwise…[T]heir only 'evidence' of prohibitive arbitration costs is an unsubstantiated and vague assertion that discovery in an unrelated arbitration matter disclosed fees of nearly $2,000 per day."); Price v. Taylor, 575 F. Supp. 2d 845, 854 (N.D. Ohio 2008) (noting that the plaintiff "simply asserts that the Agreement requires that she pay costs for claims in excess of the loan amount while the defendants must only pay for one day of hearing fees…Nor does [plaintiff] present any evidence regarding the cost of arbitration for similar cases. By merely pointing out the provisions she finds unfair, [plaintiff], at most, suggests a risk of incurring extra costs under arbitration"); *Faber*, 367 F.3d at 1054 ("[Plaintiff] has not provided the evidence necessary to estimate the length of the arbitration and the corresponding amount of arbitrators' fees (e.g. sophistication of the issues, average daily or hourly arbitrator costs in the region).").

45. *See, e.g.,* Large v. Conseco Finance Servicing Corporation, 292 F.3d 49, 56-57 (1st Cir. 2002) ("[N]o such showing [of prohibitive costs] is possible because Conseco has agreed to cover the costs of arbitration. Conseco's offer to pay the costs of arbitration and to hold the arbitration in the Larges' home state of Rhode Island mooted the issue of arbitration costs."); Anders v. Hometown Mortgage Services, Inc., 346 F.3d 1024, 1026 (11th Cir. 2003) ("[A]ny problem involving whether the plaintiff can afford the cost of arbitration is no problem in light of the defendant's stipulation to pay the plaintiff's costs of arbitration."); In re Currency Conversion Fee Antitrust Litigation, 265 F. Supp. 2d 385, 411-12 (S.D.N.Y. 2003) ("[D]efendants have offered to pay all arbitration fees, hearing fees, and arbitrators' fees…Thus, plaintiffs cannot possibly show that the arbitration costs could preclude them from effectively vindicating their federal statutory rights in arbitration.").

facially apparent that the unsuccessful party asserted the rules against post-contract redrafting, articulated above.[46]

Finally, those claimants who based their prohibitive costs claims strictly on the presence of fee-shifting provisions or silence with respect to division of fees frequently came away disappointed.[47] This is hardly surprising as a core holding of the U.S. Supreme Court in *Green Tree* was that "the arbitration agreement's silence on the subject [of fees]…is plainly insufficient to render it unenforceable."[48] Nonetheless, many claimants have continued, unsuccessfully, to base their prohibitive cost claims on the contractual division of fees.

It should seem apparent that although many prohibitive cost arguments end in failure, most of these challenges are practically doomed from the start. Litigants should easily emerge from the first category of unsuccessful challenges if they present a complete financial snapshot and provide the court with sufficient documentation of the costs they are contractually bound to incur. Similarly, although category two could prove treacherous, there is sufficient case law to refute convincingly attempts at post-contract revision. Finally, knowledge of the principles underlying the *Green Tree* doctrine will ensure that litigants do not ground their challenges in arguments already taken up and dismissed by *Green Tree* and its progeny.

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46. *See supra* note 31.
47. *See e.g.* Sims v. Clarendon National Insurance Company, 336 F. Supp. 2d 1311, 1323 (S.D. Fla. 2004) (rejecting plaintiff's argument "that since the Arbitration Agreement is silent with regard to who will pay the costs of arbitration, then it is substantively unconscionable"); *Pacific Life Insurance Co.*, 370 F. Supp. 2d at 545-46 ("Heath also contends that the arbitration agreement is substantively unconscionable because it 'does not indicate who will bear the rather steep cost of arbitration proceedings'…The United States Supreme Court has held, however, that 'that fact alone is plainly insufficient.'") (internal citations omitted); *Bess v. Check Express*, 294 F.3d at 1303 (reversing district court's holding that arbitration clause was unconscionable because plaintiff failed to put forth "any findings about how these fees and costs would be allocated or what amount Colburn might actually be expected to pay").
48. *Green Tree*, 531 U.S. at 91.

IV. Conclusion

The recent expansion of the *Green Tree* doctrine to state statutory and common law claims, as well as the manner in which courts have applied its principles, suggests that the prohibitive cost doctrine can serve as an effective means of defeating unreasonable, expensive arbitration provisions. Clearly, however, factors such as the terms of the agreement and the financial resources available to a particular claimant will significantly impact the effectiveness of this doctrine in a given case.

Notes & Observations

MODERN PORTFOLIO THEORY, THE PRUDENT INVESTOR RULE AND FIDUCIARY INVESTING

James W. Watkins, III[1]

Given the volatility of today's stock market, the subject of fiduciary investing is a timely topic. A fiduciary relationship creates the highest duty imposed by law, requiring that a fiduciary always put a client's interests first and act solely on the client's behalf.[2]

The financial services industry often relies on Modern Portfolio Theory ("MPT") and the Prudent Investor Rule ("Rule")[3] in providing investment advice. When advisers are questioned about the quality of their investment advice, they often invoke the "total portfolio" position adopted by MPT and the Rule as justification for their advice. Many financial advisers use MPT-based asset allocation software programs to develop their asset allocation recommendations.

While most financial advisers are aware of the "total portfolio" approach of MPT and the Rule, they are often unfamiliar with other key tenets of MPT and the Rule. Consequently, many financial advisers are unaware that their practices may be totally inconsistent with MPT and the Rule, leaving them exposed to liability for financial losses sustained by their clients.

MPT

MPT was introduced in 1952 by Dr. Harry Markowitz, who was awarded a Nobel Prize for his work with MPT.[4] Prior to MPT, portfolios were constructed based upon the risk and return of investments. With MPT, Markowitz suggested that covariance, or the correlation of returns between investments, should be considered in the construction of investment portfolios.

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2. In re Sallee, 286 F.3d 878, 891 (6th Cir. 2002).
3. RESTATEMENT (THIRD) OF TRUSTS: THE PRUDENT INVESTOR RULE § 90 (2007).
4. Harry M. Markowitz, *Portfolio Selection,* 7 J. FIN. 77 (1952); HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (2nd Ed. 1991).

While MPT has been legitimately criticized for various reasons[5], consideration of the correlation of investment returns still remains a valuable factor in investment management. By combining investments that have a low, or even negative, correlation of returns, a financial adviser can effectively provide downside protection for an investment portfolio.

THE PRUDENT INVESTOR RULE

The Rule is a part of the Restatement (Third) of Trusts. The Rule establishes standards for the prudent investment of trust assets. While the Rule itself is not law, forty-four states and the District of Columbia have adopted the Uniform Prudent Investor Act, the codification of the Rule.[6] Even though the Rule speaks in terms of a trustee's fiduciary duties, the Rule has basically been applied as the standard of conduct for all financial fiduciaries.

> § 90 [1992 § 227]. General Standard of Prudent Investment
>
> The trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
>
> (a) This standard requires the exercise of reasonable care, skill and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suited to the trust.
>
> (b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless under the circumstances, it is prudent not to do so.
>
> (c) In addition, the trustee must:
>
> (1) conform to fundamental fiduciary duties of loyalty and impartiality;
>
> (2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and

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5. RICHARD O. MICHAUD, EFFICIENT ASSET MANAGEMENT: A PRACTICAL GUIDE TO STOCK PORTFOLIO OPTIMIZATION AND ASSET ALLOCATION 36 (1998).
6. Uniform Law Commissioners, *A Few Facts About The Uniform Prudent Investor Act,* http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-upria.asp.

> (3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.[7]

Three points emphasized by the Rule are the importance of acting prudently, the importance of diversification, and the need to consider the contribution of each investment to the portfolio as a whole. A fiduciary's duties apply not only to the initial investment process, but also to the fiduciary's ongoing duty to monitor the portfolio and make portfolio adjustments if and as appropriate.[8] The duty to monitor also applies to situations where a fiduciary outsources actual management of a portfolio to a third party.[9]

The Rule stresses that it is not intended to endorse or exclude any specific financial theory.[10] Nevertheless, there are obvious similarities between the Rule and MPT, most notably the emphasis on diversification and the importance of the correlation of investment returns as a factor in portfolio management.

MPT AND FIDUCIARY STATUS

The mere reliance on MPT in the diversification process raises potential liability issues for financial advisers. Very few financial advisers know much more about MPT beyond how to use software programs. Consequently, advisers generally cannot and do not attempt to explain to clients the methodology they used in preparing their asset allocation recommendations or the potential risks involved.

It is well established that investment advisers,[11] financial planners,[12] and stockbrokers handling discretionary accounts[13] are fiduciaries. Some states impose fiduciary status on all stockbrokers, regardless of whether the customer's account is discretionary or non-discretionary. Other states base the determination of a stockbroker's fiduciary status on non-discretionary accounts by considering the facts of each case.

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7. RESTATEMENT (THIRD) OF TRUSTS, § 90.
8. RESTATEMENT (THIRD) OF TRUSTS, § 80 cmt. d(2), § 90 cmt. e(1).
9. *Id.*; Liss v. Smith, 991 F. Supp. 278, 312 (S.D.N.Y. 1998).
10. RESTATEMENT (THIRD) OF TRUSTS, § 90 cmt. e(1).
11. S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194, 84 S.Ct. 275 (1963).
12. Investment Advisers Act Rel. No. IA-1092 (October 8, 1987).
13. McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750, 766-67 (3d Cir. 1990); Leib v. Merill Lynch, Pierce, Fenner & Smith, 461 F. Supp. 951 (E.D. Mich. 1978).

A common theory for fiduciary liability on non-discretionary brokerage accounts is to assert that the stockbroker had de facto control of the account. There is precedence holding that a broker has control over a non-discretionary account when a customer lacks the experience or knowledge to evaluate the broker's recommendations and independently assess the suitability of same.[14] Since very few investors are familiar with or understand the concept of MPT, it should be argued that a stockbroker who used MPT in connection with a non-discretionary account had control over the account.[15]

MPT AND RISK TOLERANCE

Evaluating a client's risk tolerance level is a critical step in the diversification process. Errors in risk tolerance evaluation and unsuitability issues are common allegations in arbitration cases.

Financial advisers often base their risk tolerance analysis on questionnaires. While these questionnaires may provide some useful information, reliance on such questionnaires can be dangerous due to the questionable quality of the questions on such questionnaires and the ease of manipulating and misinterpreting such questionnaires.[16] Furthermore, such questionnaires typically only address a client's willingness to assume investment risk. Both MPT and current legal standards agree that a proper risk tolerance analysis requires an analysis of both a client's willingness and ability to bear investment risk.[17]

MPT presents another risk tolerance issue. MPT views a client's risk tolerance level as a relative measurement, based on the assumption that investors are willing to assume greater risk as long as the potential reward compensates them for such additional risk. Not only does this seem to be inconsistent with the "willingness and ability" tests, it is also contrary to current legal standards that view a client's risk tolerance level as an absolute measurement. For the courts to hold otherwise would deny an investor any

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14. Follansbee v. Davis, 681 F.2d 673, 677 (1982).
15. Roger W. Reinsch, J. Bradley Reich and Nauzer Balsara, *Trust Your Broker?: Suitability, Modern Portfolio Theory, and Expert Witnesses,* 17 ST. THOMAS L. REV. 173, 187 (2004).
16. Michael E. Kitces, *Rethinking Risk Tolerance*, FINANCIAL PLANNING, March 2006, 54-59, available at http://www.financial-planning.com/news/rethinking-risk-tolerance-618581-1.html.
17. Markowitz, *Portfolio Selection*, *supra* note 4, at 6; *In re James B. Chase*, NASD Disciplinary Proceeding No. C8A990081 (September 25, 2000).

meaningful way to ensure that their true risk tolerance desires and financial condition are respected.

THE DUTY TO DIVERSIFY

For financial fiduciaries, diversification requires more than the common concept of diversification in terms of number of investments alone. As Markowitz pointed out, effective diversification requires the "right kind" of diversification for the "right reason,"that" it is not enough to invest in many securities. It is necessary to avoid investing in securities with high covariances among themselves."[18]

The Rule agrees with this position, stating that

> " [R]easonably sound diversification is fundamental to the management of risk,…"[19]
>
> " Thus effective diversification depends not only on the number of assets in [an investment} portfolio but also on the ways and degrees in which their responses to economic events tend to cancel or neutralize one another…."[20]
>
> " Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill."[21]

Both MPT and the Rule stress the importance of the correlation of returns of investments in the diversification process. Factoring in the correlation of returns, however, presents challenges for financial advisers, as well as potential liability exposure.

COMPUTERIZED ASSET ALLOCATION LIABILITY

The use of asset allocation software programs ("software programs') is pervasive in the financial services industry. Most of these software programs are based on MPT or the Capital Asset Pricing Model ("CAPM"), a variation of MPT. CAPM was developed by Dr. William F. Sharpe, who was awarded a Nobel Prize for his work with CAPM.

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18. Markowitz, *Portfolio Selection*, *supra* note 4, at 89.
19. RESTATEMENT (THIRD) OF TRUSTS, § 90 cmt. e(1).
20. RESTATEMENT (THIRD) OF TRUSTS, § 90 cmt. g.
21. RESTATEMENT (THIRD) OF TRUSTS, § 90 cmt. e(1).

Most commercial software programs only allow MPT-based calculations based on generic asset categories. If a customer decides to implement the financial adviser's asset allocation recommendations, most commercial software programs do not allow the adviser to go back and rerun the asset allocation calculations based on the client's actual investments. Consequently, neither the adviser nor the client knows whether the actual portfolio's risk/return projections are consistent with the original asset allocation projections that convinced them to purchase the investment products.

As part of our forensic financial planning process, we go back and perform an asset allocation analysis based on the actual investment products sold to an investor. Not surprisingly, we often find significant differences between the risk/return projections of the original asset allocation recommendations and the investment portfolio actually implemented. This may further explain why financial advisers do not go back and perform a post-implementation portfolio analysis.

The fact remains that given MPT's emphasis on the importance of diversification and the correlation of returns, the failure to perform a post-implementation analysis based on the investor's actual investments leaves a financial adviser exposed to potential liability, especially when they relied on MPT in other phases of the advisory process.[22] Depending on the level of inconsistency between the original projections and the post-implementation projections, it can be argued that the financial adviser's acts are equivalent to fraud, a sophisticated form of bait-and-switch.

Another issue with computerized asset allocation is the "black box" mentality of some financial advisers, with the financial adviser blindly accepting the recommendations of a software program. While MPT proposes the concept of an "optimized" portfolio, Markowitz also warned that the "optimized" portfolio is not always suitable for a client in light of their financial needs and/or financial situation.[23]

Financial advisers and compliance personnel often try to defend computerized asset allocation recommendations by pointing to NASD Notice to Members 04-86, which approved the use of investment analysis tools by member firms. While the Notice did allow use of such tools, the Notice is actually directed more to the disclosure requirements that are required when using such tools rather than the viability or value of such tools. The Notice clearly states that any member using investment analysis tools remains

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22. WILLIAM F. SHARPE, INVESTORS AND MARKETS: PORTFOLIO CHOICES, ASSET PRICES, AND INVESTMENT ADVICE 206-209 (2006).
23. Markowitz, *Portfolio Selection*, *supra* note 4.

responsible for ensuring compliance with all applicable securities law and regulatory rules, especially the suitability[24] and fair dealing/good faith rules.[25]

As mentioned previously, MPT has been the target of legitimate criticism. Most of the criticism of MPT has centered on issues such as the validity of the input data, the inherent bias of the calculation process toward certain types of investments, the tendency for counterintuitive recommendations and the overall inherent instability of the MPT process. These issues have lead one asset allocation expert to refer to MPT-based software programs as "error-estimation maximizers."[26] The financial services industry is well aware of these issues. They simply hope that the plaintiffs' securities bar does not recognize and capitalize on them.

STATIC ASSET ALLOCATION LIABILITY

Correlation of returns, like returns and risk measurements, are constantly changing. Furthermore, recent studies have shown that in many cases the correlation of returns between asset classes has increased as volatility in the stock markets has increased, effectively negating the benefit of low or negative correlations.[27]

The relative instability of the correlation of returns suggests that asset allocation recommendations should be dynamic to protect investors by adjusting to changes in the economy and/or the stock market. Markowitz never stated that asset allocations should be static. Sharpe has stated that the asset allocation process must be dynamic to respond to changes in the market and the economy.[28]

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24. NASD Conduct Rule 2310, Recommendations to Customers (Suitability); IM-2310-2, Fair Dealing with Customers.
25. NASD Conduct Rule 2110, Standards of Commercial Honor and Principles of Trade; NASD Conduct Rule 2120, Use of Manipulative, Deceptive or other Fraudulent Devices.
26. MICHAUD, *supra* note 5, at 36.
27. William J. Coaker, II, *The Volatility of Correlation,* 19 JOURNAL OF FINANCIAL PLANNING 57-69 (2006); Rachel Campbell, Kees Koedijk and Paul Kofman, *Increased Correlation in Bear Markets*, 58 FINANCIAL ANALYSTS JOURNAL 87 (2002); Eric Jacquier and Alan J. Marcus, *Asset Allocation Models and Market Volatility*, 57 FINANCIAL ANALYSTS JOURNAL 16 (2001).
28. William F. Sharpe, *Adaptive Asset Allocation*, 66 FINANCIAL ANALYSTS JOURNAL, 45 (2010); SHARPE, INVESTORS AND MARKETS, *supra* note 22, at 206-209.

The value of dynamic asset allocation is further supported by studies showing that avoiding the "worst" days of the market has a much greater impact on overall portfolio return than missing the "best" days of the market. According to one recent study, missing the "best" 10, 20 and 100 days on the market, defined as the Dow Jones Industrial Average ("DJIA"), during the period 1990-2006 would have reduced an investor's terminal wealth by 38%, 56.8% and 93.8% respectively. Conversely, avoiding the worst 10, 20 and 100 days on the DJIA over the same period would have improved an investor's terminal wealth by 70.1%, 140.6% and 1,619.1% respectively.[29] The study found similar results for the period 1900-2006.

The concept of static asset allocation also contradicts the Rule's standards for prudent fiduciary investing, which state that

> "Asset allocation decisions are a fundamental aspect of an investment strategy….These decisions are subject to adjustment from time to time as changes occur in the portfolio, in economic conditions or expectations, or in the needs or investment objectives of the trust. This is consistent with the trustee's duty to monitor investments and to make portfolio adjustments if and as appropriate."[30]

Nevertheless, the financial services industry has denounced dynamic asset allocation as "market timing" and has promoted the "buy-and-hold" approach to investing. This "buy-and-hold" mentality is apparently based on an erroneous interpretation of the famous BHB study.[31]

The BHB study studied 91 pension plans and analyzed the impact of the plans' allocation among three asset classes - stocks, bond and cash. The BHB study concluded that, on average, asset allocation accounted for approximately 93.6% of the variability of the plans' returns.[32] Considering that historically stocks have been more volatile than bonds and bonds more volatile than cash, these findings are not surprising.

The BHB study focused on the *variability* of returns, not the returns themselves. The financial services industry has repeatedly misrepresented the findings of the BHB study to insinuate that the BHB study proves that asset allocation accounts for 93.6% of an investor's returns. Financial advisers then use these misrepresentations to promote a "buy-and-hold

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29. Javier Estrada, *Black Swans, Market Timing and the Dow,* 16 APPLIED ECONOMICS LETTERS 1117 (2009) *available at* http://web.iese.edu/jestrada/PDF/ Research/Refereed/ BSMTDow.pdf.

30. RESTATEMENT (THIRD) OF TRUSTS, § 80 cmt. d(2).

31. Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower, *Determinants of Portfolio Performance,* 42 FINANCIAL ANALYSTS JOURNAL 39 (1986).

32. *Id.*

approach," since active asset allocation would theoretically add only a minor benefit. Ironically, these same advisers often then turn around and recommend actively managed investments.

The findings of the BHB study have been the subject of numerous studies, with various results significantly reducing the purported impact of asset allocation. A recent study suggests that market movement actually has the greatest on the variability of portfolio returns, with asset allocation and active management playing an equal, but much lesser, role.[33]

CONCLUSION

Current practices in the financial services industry, particularly in the financial planning and investment advisory industries, are prime areas for litigation by the plaintiffs' securities bar. The situation is so bad that Nobel Laureate Dr, William Sharpe has described the situation as "financial planning in fantasyland."[34]

This paper has discussed various issues with current diversification practices within the financial services industry. In many cases financial advisers are improperly using MPT and/or the Rule in the creation of asset allocation recommendations, resulting in questionable financial advice and unnecessary financial losses for investors. While financial advisers and their counsel often attempt to use portions of MPT and the Rule in defending securities cases, the plaintiffs' securities bar can actually use the core tenets of MPT and the Rule to prove clients' claims.

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33. James X. Xiong, Roger G. Ibbotson, Thomas M. Idzorek, Peng Chen, *The Equal Importance of Asset Allocation and Active Management*, 66 FINANCIAL ANALYSTS JOURNAL 22 (2010).

34. William F. Sharpe, *Financial Planning in Fantasyland*, http://www.stanford.edu/~wfsharpe/art/fantasy/fantasy.htm.

Notes & Observations

THE MADOFF DISTRACTION

Frederick W. Rosenberg, J.D.[1]

I. VICTIMS ALL

Today, Wall Street is breathing sighs of relief in part because the $50 billion Madoff distraction, the media darling of financial disasters, has moved the spotlight away from ordinary investors - who've collectively seen trillions in savings turn to vapor - to fixate on losses suffered by a relatively few wealthy investors swindled in an affinity fraud.[2]

Since the mid 1990s, public investors - those ordinary working people and retirees whose life savings have been sucked into the financial maelstrom - have been systematically victimized by what can only be characterized as a Ponzi market that finally went nuclear in 2008, devastating the lives and hopes of millions. The responsibility for this investor catastrophe rests squarely on the financial services industry, its sales representatives, managers and quasi-professionals who have consistently misled investors about their professed ability to control portfolio losses in any meaningful manner. Worse, they have negligently if not recklessly kept investors in the dark about the overwhelming problems associated with systemic risk.

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1. Frederick Rosenberg obtained his JD from George Washington University in 1971 with an emphasis on business planning. He founded an NASD member firm in 1981 in Washington DC and was a Series 24 principal and Series 4 registered options principal. Today he has over 30 years business and legal experience as claimant's counsel, chief financial officer, private equity underwriter, foreclosed commercial real estate asset manager, and bank risk auditor. He has qualified as an expert in federal and state courts and in NASD arbitrations, has written chapters for PLI's arbitration course books and articles for the Piaba Bar Journal, and has been a speaker at the Piaba Annual Meeting and a faculty member of the Practicing Law Institute program on securities arbitration.
2. NY Times reported on March 12th, 2009, that in the last quarter of 2008 Americans had lost $5.1 Trillion and $11 Trillion over all for 2008 (and that leaves out 2009). Vikas Bajaj, *Household Wealth Falls By Trillions*, N.Y. TIMES, March 12, 2009, http://www.nytimes.com/ 2009/03/13/business/economy/13wealth.html.

SYSTEMIC RISK

Under normal market conditions, negative events generally occur randomly and most often are offset by non-correlated events moving in a positive direction. This is the rationale for diversification. But, when negative events begin to occur in concert, they become correlated and their combined negative effect is amplified across the entire economy.

Systemic risk - the risk of a catastrophic collapse of the financial system - by definition is non-diversifiable. In a systemic meltdown, the interconnection and interdependence of large financial companies through complex financial dealings such as credit default swaps, overnight lending, underwriting, and loan participations, means that the failure of just one can set off a chain reaction of failures that jeopardize the entire financial system, exactly what happened in 2008. "Too Big to Fail!" became the bailout mantra, as insolvent of companies like AIG and Citicorp could not go down without all of their counterparties toppling like dominoes. In short, the sources of systemic risk are the financial companies and counterparties themselves. That is exactly the problem.

The collapse in housing prices in 2006 and 2007 led to a collapse in mortgage backed securities, which when marked-to-market caused insolvencies and capital impairments that triggered a credit crunch. Financial derivatives used to hedge the risks of assets of dubious if not unknowable value contributed to gross instability if not outright failure of premiere commercial, banking, insurance and investment companies and their counter-parties. Without credit, retail sales foundered in all sectors. Unemployment ballooned with the uncertainty brought about by frozen credit markets and declining retail sales that further stressed the economy.

For investors, the economic collapse in 2007 and 2008 cascaded across all investment sectors and asset classes, leaving them scratching their heads upon reviewing their monthly statements. Years of savings evaporated amid conflicted recommendations to ride out the crisis. We've all heard the financial clichés:

- Diversify
- You can't time the market so ride out the storm
- Allocate your portfolio in various sectors
- Be a long term investor.

But, over the past decade and two market crashes, this advice has proven disastrous to many. Still, the vast majority of investors, brokers and investment advisers appear blind to that fact.

Advice to public investors to *stay the course and diversify* proved catastrophic in 2008. Such advice negligently ignored the economic turmoil driving the markets every day in favor of strategies based upon the historical analyses of financial markets that resemble contemporary markets in name only. Given that most investors are incapable of efficient hedging against catastrophe, the only advice to protect one's investments during a systemic crisis is to tactically rebalance and ride out the storm in cash, savings bonds or other instruments with strong credit backing and little market risk.

Over the past decade and with increasing frequency in recent years economists, research universities and government entities like the Treasury Department, the Federal Reserve and White House have been holding conferences and delivering papers about Systemic Risk, how to control it and how to regulate the systems to maintain efficiency in the economy. A word search for "systemic risk" on Google will illustrate the depth and pervasiveness of those concerns. Yet, despite deep concerns, the retail brokerage and financial services industry simply ignored systemic risk to persist with portfolio strategies based not upon what was actually driving the markets, but solely upon an individual investor's investment profile and a near religious adherence to the portfolio theories popularized in recent years.

The growth of the financial services industry began in earnest during the 1990s and was rooted in the demise of pension plans (defined benefit plans) and the rise of self-directed 401Ks (defined contribution plans). For the first time in modern history, ordinary and unsophisticated individuals found themselves in control of 100% of their retirement assets without any safety net or guidance, making them targets for the burgeoning financial services salesmen eager to promote equities as the vehicle for building wealth. Trillions of dollars flowed into mutual funds, brokerages and investment managers, whose principal investment recommendations for a diversified portfolio over-concentrated in high risk equities were rationalized by questionable conclusions drawn primarily from mathematical analyses of the past markets from past eras.

Unfortunately, over the past 15 years, too many financial services professionals, brokers, financial planners and investment advisers grew fat selling and allegedly managing investments without any concrete understanding of the risks they promised to control. Worse, they uniformly claimed credit for the appreciation occurring during rising markets while disclaiming liability for their failures when the markets reversed. Furthermore, the income, bonuses and wealth of these self-professed experts are actually correlated directly with their success in preventing ordinary investors from exiting high risk markets. Welcome to the Hotel California![3]

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3. "You can check out anytime you want, but you can never leave." EAGLES, *Hotel California*, *on* HOTEL CALIFORNIA (Asylum Records, 1976).

Why did the very brokers who promoted market investments to excess during the boom of the 1990s fail during the bust of the 2000s to recommend a retreat to safer harbors? Amazingly, not a single brokerage or advisory firm of consequence ever sent out a general warning advising investors to substantially reduce market exposure as the economy imploded. In fact, most brokerages still maintain their model portfolio allocations to this very day.

The facts are crystal clear: public investors were simply kept in the dark by those whose profits, fees and commissions derived explicitly from keeping them fully invested even as disaster consumed their savings. Ironically, even after a decade of unmitigated failures, many of these self-styled professionals are still in denial about their ability to control portfolio risk through their "set it and forget it" strategies and mathematical projections. Many advisers today are even claiming victim status at the hands of Wall Street's financial alchemists whose alphabet soup of concoctions by every measurement make the Madoff scam seem amateurish if not picayune.

SUSPENSION OF DISBELIEF

The real tragedy in the events of 2008 lies not with the affluent, powerful and high profile victims of the Madoff scam (i.e., those whose tragic fall can best be explained by Coleridge's aesthetic theory of "the suspension of disbelief," the willingness to accept the impossible as true). Rather, the tragedy of 2008 lies with the millions of unsophisticated and trusting public investors left without recourse while our Government - whose job it is to protect its citizens - allocates their tax dollars to bail out the greed-driven institutions that orchestrated the economic collapse in the first place.

While the how and why of the Madoff scam are slowly coming to light, there is a clear explanation why financial service companies ignored systemic risk. A general recommendation to reduce exposure to market risk, and equities in particular, was likely to pull the house down upon themselves. With trillions of dollars under the management of seriously conflicted companies and individuals generating enormous fees, any recommendation to exit the markets would have emptied their trough. In short, public investors were trapped if not actually deceived into holding onto their investments over months of market declines under the rationale of diversification and the questionable logic of using historical analyses as a basis for forecasting future market performance without regard to the existing economic realities.

On the institutional and investment banking side of the industry, the repeal of Glass Steagall, along with reduced regulation, the relaxation of capital requirements in 2004, and extraordinary fee generation, stimulated a gluttonous appetite for financial instruments of incomprehensible risk like Collateralized Mortgage Obligations, Credit Default Swaps, Auction Rate Securities, Derivatives and a host of arcane concoctions that generated enormous profits from the leakage off the financial trash heap, an alchemy of disaster.

Paralleling the Madoff catastrophe, during the last decade, new money poured into financial service companies from investors unwary of how their savings became the essential feedstock that Wall Street required to perpetuate its excesses. Diversification and portfolio strategies recommended to public investors at a time when blood cascaded down Wall Street proved no barrier against loss at all and were flat out wrong. It is no coincidence that public investors were cajoled by sales-trained registered representatives into standing pat amidst the worst systemic collapse in history.

Those in control, who understood systemic risk, failed to disabuse their representatives of the erroneous conclusion that there were no market conditions too risky for public investors so long as the portfolio was balanced and their life expectancy exceeded 15 years. The Madoff scandal may be good press and great story telling, but it pales in importance and magnitude to the catastrophe that befell innocent investors negligently - if not recklessly - kept in the dark about the risk in their portfolios while being advised to adopt strategies that all but assured disaster under existing market conditions.

The correlated disasters suffered in every sector of the economy in 2008, the blind arrogance of bonus driven investment bankers and executives, the credit rating agencies paid to bless risky instruments, and the laissez-faire oversight by ideologically disinterested regulators led to a predictable catastrophe of historic proportion. It doesn't take an Agatha Christie to figure out the complicity if not conspiracy of every entity responsible for this "Murder on the Systemic Express." More than one suspect had a motive.

II. PUBLIC INVESTOR CLAIMS

Arbitrators will be faced in coming years with claims from public investors arising out of the turmoil experienced between the end of 2007 and the present. Many arbitrators, victims too of their own brokers' misguided advice, are more likely to be empathetic to those claims. In evaluating such cases, arbitrators - if they are to identify causation - will need to look beyond mere structural and suitability arguments to focus on the duties and disclosure of those selling their market expertise. I've enumerated below several identifiable areas that should rightly be considered.

1. Broker Training

From 2000 to the present and particularly in recent years, the issue and impact of systemic risk has dominated the economic and financial press. For financial advisors counseling investors about risk, a failure to identify, understand and explain systemic risk and its consequences likely amounts to recklessness in most cases. In short, the one risk that a customer does not assume is that his broker doesn't know what he's talking about.

2. Portfolio Theories and Indexes

Portfolio theorists and indexers generally ignore current market conditions under assumptions that over the long term markets are rational and that a portfolio constructed around historical performance measurements will average out, (regress to the mean).

In contrast, most active managers rely on market fundamentals to value assets and control the timing of purchases and sales. Typically, actively managed funds also impose guidelines that limit exposure to sector concentration regardless of the makeup of the index they're benchmarked to. This often means that active managers will likely underperform the index, especially during bubbles such as technology in 2000 and more recently, in the financial sector. In short, return is only one consideration when selecting a benchmark; the other considerations are weighting and volatility. Balancing risk and return generally leads to lower but more stable performance when measured by long term returns.

All portfolio theories and indexing strategies necessarily require human intervention to contain catastrophic short term losses. If there are no market conditions under which a broker will advise tactical rebalancing, then the client needs to be advised that he or she will be on their own during market declines. Brokers *absolutely need to disclose and explain* to investors whether or not they actually have a methodology or strategy for controlling portfolio declines beyond merely advising investors to stay the course, especially during periods of systemic turmoil when risk is amplified.

3. Risk Creep

Furthermore, portfolios and indexes are rarely static. Arbitrators, therefore, must also consider Risk Creep - the fact that that indexes and portfolios actually wander across a wide spectrum of volatilities as measured by standard deviation. Market cap weighted indexes like the SP500 and the portfolios benchmarked to them, often become over-concentrated in the hottest sectors and underweighted in conservative sectors with predictable effect on risk and volatility.

For example, when tech grew to 35% of the SP500 in 2000, up from 15%, the standard deviation of the index blew past 21, a level equal to the normal Russell 2000. During much of 2008, the 30-day trailing standard deviation of the S&P500 (which normally ranges between a standard deviation of 10 and 20), actually ranged between 35 to 75 for much of the year, mirroring the VIX, the volatility index that blew past 80 at one point, exceeding by 3 times the normal risk of small cap index. Consequently, in 2008, a broker's advice to stay the course in portfolios benchmarked to the S&P500 meant that investors were unknowingly saddled with two to four times the expected risk, far in excess of what was authorized and approved in their New Account Forms.

Arguably, brokers who recommend portfolio strategies and diversification must actually monitor the risk characteristics of the portfolios they recommend to provide full and complete disclosure. Given the probability of a systemic meltdown and the excessive volatility arising from the uncertainty of 2008, investors should generally have been advised to adopt safe-harbor strategies that substantially reduced market exposure by moving to cash and investment grade bonds.

4. The Point of Non-Recovery

The risk to most investors is not that their portfolio declines to zero, but rather that it rapidly declines in value to the point where its sustainability and capacity to achieve the customer's objectives is a practical impossibility over all relevant periods. A portfolio may be sustainable under normal market conditions with a 15% decline but be unsustainable following a 30% decline and having a strategy that controls losses between those points is essential. Consequently, it is critical for portfolio investors to know both the point of non-recovery and the point of sustainability so that protective measures can be implemented and understood by the client.

It is simply negligent to advise investors to stay the course when the conditions of recovery require a lifetime of 1999 repeats. The asymmetry in this equation is also obvious. Portfolios that can go up 400% may suffer losses over time, but once a portfolio declines 40%-60% its ability to recover under normal markets becomes problematic.

5. Beware Market Timing

Market Timing is a trading strategy that attempts to beat the market over the long term through in-and-out trading. But Tactical Rebalancing, such as shifting one's portfolio to lower risk sectors and cash in times of turmoil clearly is not Market Timing. Rather, it is a preferred and acceptable defensive measure to control risk albeit with potentially lower upside.

The Towneley Study[4] logically concludes that market timing is a practical impossibility over the long term. Tables A and B of the Towneley Study[5] confirm that missing all the best months over a protracted period (decades) reduces returns substantially. However, the study also shows that missing the worst months increases returns proportionately more and remarkably, the study also demonstrates that missing both the best and worst months produces returns that actually exceed "staying the course" over the long term. Furthermore, Table A illustrates that the consequence of missing the single best month is only a 44 basis point reduction in return, while missing the three best months, if that were the outcome, only reduced long term returns by only 1.24%, from 10.04% to 8.8%. This is still an excellent return.

Towneley's numbers suggest that getting out of the market entirely during periods of extreme turmoil may be preferable to the alternative of a 20% to 60% decline in current portfolio value. Unfortunately, the investor, who should be made aware of all these facts, is typically given only half-truth warnings against missing all the best months over a lifetime, a most unlikely probability.

4. H. Nejat Seyhun, *Stock Market Extremes and Portfolio Performance 1926-2004,* Towneley Capital Management, Inc. (2005), http://www.towneley.com/pdf/MT%20Study %2004.pdf.

5. Seyhun, *supra* note 4, at 11.

6. The Bear Stearns Market: Do as I say, not as I do!

In August 2008, one month before the Lehman Brothers failure and AIG bailouts, the Counterparty Risk Management Policy Group III (CRMPGIII) issued a report to the Treasury Secretary on systemic risk, stemming from the Bear Stearns failure in April 2008. The Management Group,[6] consisting of many of the top risk managers of the major financial industry leaders and brokerages, commenced its report with the following paragraph:

> Dear Secretary Paulson and Governor Draghi:
>
> On behalf of CRMPG III we are pleased to convey to you our Report entitled "Containing Systemic Risk: The Road to Reform." As the title of the Report suggests, the Policy Group considers the financial crisis of 2007 and 2008 to be the most severe we have experienced in the postwar period. While this turn of events had multiple causes and contributing factors, the root cause of financial market excesses on both the upside and the downside of the cycle is collective human behavior – unbridled optimism on the upside and fear – bordering on panic – on the downside. As history tells us in unmistakable terms, it is virtually impossible to anticipate when optimism gives rise to fear or fear gives rise to optimism. The last twelve months have been no exception to this sobering reality.[7]

CRMPG III is important reading because it fully reveals that *by April 2008 at the latest,* the financial services industry at its highest levels well understood the potential disastrous consequences of a systemic collapse. CRMPG II, which was issued three years earlier, warned mightily about the consequences of uncontrolled growth in CDO's and other gimmicky financial instruments.

The April 2008 Bear Stearns failure quantified for the counterparties the magnitude of the risks they had first identified as early as 2005. Left with vast exposure to the collateral markets, the major financial institutions began a mad dash to exit their web of financial entanglements. Meanwhile, as these financial giants strove desperately to exit their positions, not one offered an

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6. CRMPG III members at the time the report was released are listed at http://www.crmpolicygroup.org/docs/CRMPG-III-Exhibit-I.pdf and http://www.crmpolicygroup.org/docs/CRMPG-III-Exhibit-II.pdf.

7. Transmittal letter from CRMPG III to Henry M. Paulson, Jr. and Mario Draghi (August 6, 2008), http://www.crmpolicygroup.org/docs/CRMPG-III-Transmittal-Letter.pdf.

instruction, warning, or advisory to their retail brokers and customers of the potential impact of "the worst financial crisis in post war America."

III. CONCLUSION – FOR NOW

There was a broad chasm between those institutions heading for the doors and their customers whom they advised to be patient in the misplaced assertion that long term market recovery is adequate reason to accept short term catastrophe under actual market conditions. If there is one thing we need to take away from this disaster it is that there is no formula, equation or portfolio allocation theory that does not require the exercise of good judgment to avoid riding the wave over the falls.

Arbitrators must also seriously consider the question: "Is there ever a time when the market is simply too risky for small investors?" Historical volatility failed to predict 2008's black swan[8] meltdown while portfolio theories based on rational markets have succumbed to reality. Sure, we will all benefit from a rising market in the next decade, but without the leverage and exotic financial instruments, the market recovery may take a very long time, certainly longer than the recovery from the 2001 collapse that took five years to reach breakeven under the previous regime.

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8. "Black Swans" represent unanticipated catastrophic events and are the subject of Dr. Nassim's writings which argue that black swans occur with greater frequency and severity than predicted by bell curve simulations using standard deviation alone as a proxy for risk. See NASSIM NICHOLAS TALEB, THE BLACK SWAN -THE IMPACT OF THE HIGHLY IMPROBABLE (2007); and NASSIM NICHOLAS TALEB, FOOLED BY RANDOMNESS: THE HIDDEN ROLE OF CHANCE IN LIFE AND IN THE MARKETS (2008).

DISREGARDING THE MANIFEST DISREGARD OF THE LAW STANDARD UNDER THE FEDERAL ARBITRATION ACT

David Gaba and J.L. Spray[1]

It has always been difficult to overturn an award in a securities arbitration under the Federal Arbitration Act (FAA), no matter how poorly decided. Thanks to a 2008 United States Supreme Court case, it may now be harder than ever.

THE FEDERAL ARBITRATION ACT

Arbitration is ordinarily a matter of contract and has been a form of dispute resolution in the United States since the eighteenth century.[2] However, the judiciary at one time evinced a longstanding refusal to enforce arbitration agreements.[3]

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J. L. Spray is a partner with Mattson Ricketts Davies Stewart and Calkins head quartered in Lincoln, Nebraska with a broad based practice in the Midwest concentrating in commercial litigation with an emphasis on investor litigation. Mr. Spray also has handled dozens of cases against insurance carriers asserting policy holder rights, and prosecuting bad faith claims. He was appointed by the Governor to serve on the Nebraska Equal Opportunity Commission in 2005, and prior to that served 6 years on the Nebraska Accountability and Disclosure Commission overseeing campaign finance, lobbying, and ethics in state government. Mr. Spray also served seven years as a member of the Supreme Court's Advisory Committee providing ethics opinions for Nebraska lawyers. He is a 1983 graduate of the University of Nebraska and a 1986 graduate of the University of Nebraska College of Law.

2. Air Line Pilots Ass'n v. Miller, 523 U.S. 866, 876 (1998); Delta Mine Holding Co. v. AFC Coal Props*.,* 280 F.3d 815, 820 (8th Cir. 2001).

3. *See* Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 219-20 (1985).

In enacting the FAA, Congress declared a national policy in favor of arbitration.[4] The law's purpose was to reverse judicial hostility toward arbitration agreements and place such agreements on the same footing as other contracts.[5] On this "same footing," the FAA does not compel arbitration of any dispute at any time; rather, it confers only the right to obtain an order directing arbitration to proceed in the manner provided for in the agreement.[6]

As a result, current federal policy strongly favors arbitration.[7] "The Supreme Court has repeatedly counseled that the FAA leaves no room for judicial hostility to arbitration proceedings and that courts should not presume, absent concrete proof to the contrary, that arbitration systems will be unfair or biased." [8]

The FAA rests on Congress' broad authority to enact substantive law under the Commerce Clause.[9] The United States Supreme Court has broadly construed the FAA's phrase "a contract evidencing a transaction involving commerce."[10] Thus, in most jurisdictions the FAA will preempt any state arbitration acts if the issue involves interstate commerce.[11] Under this framework, federal law establishes the enforceability of arbitration agreements while state law governs their interpretation and formation.[12]

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4. Southland Corp. v. Keating, 465 U.S. 1, 10 (1984).
5. Green Tree Fin. Corp. v. Randolph, 531 U.S. 79, 89 (2000). *See also* Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 270 (1995); Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 4 (1991) (observing that the purpose of the FAA "was to reverse the longstanding judicial hostility to arbitration agreements . . . and to place arbitration agreements upon the same footing as other contracts.").
6. Volt Info. Scis., Inc. v. Bd. of Trustees, 489 U.S. 468, 474-75 (1989).
7. *See Gilmer,* 500 U.S. at 26.
8. Penn v. Ryan's Family Steak Houses, Inc., 269 F.3d 753, 758 (7th Cir. 2001).
9. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 405 (1967)
10. *Id.* (citing *Allied-Bruce Terminix Cos.,* 513 U.S. at 277).
11. *See* Good Samaritan Coffee Co. v. LaRue Distrib., Inc., 275 Neb. 674, 678, 748 N.W. 2d 367, 371 (2008). *See also* 9 U.S.C. § 1.
12. Employers Ins. of Wausau v. Bright Metal Specialties, Inc., 251 F.3d 1316, 1322 (11th Cir. 2001).

STATUTORY GROUNDS FOR VACATION OR MODIFICATION UNDER THE FAA

Historically, courts have had only a limited role when asked to review an arbitrator's decision.[13] In fact, the scope of judicial review of an arbitration award is among the narrowest known in the law.[14] Due to the voluntary, contractual nature of arbitration, the grounds for challenging an award are quite limited.[15] If an unsatisfied party wishes to challenge the arbitrator's decision, "[t]he burden is on the party seeking to vacate an arbitration award . . . to show that one of the limited statutory grounds exist for setting aside the arbitration result."[16]

A disappointed party seeking to vacate or modify an award governed by the FAA must look to 9 U.S.C. §§ 9-11.[17] The FAA provides that:

> In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration –
> (1) where the award was procured by corruption, fraud, or undue means;
> (2) where there was evident partiality or corruption in the arbitrators, or either of them;
> (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or
> (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.[18]

The FAA further provides for modification of an arbitration award in the following circumstances:

> (a) Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award.

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13. United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 36 (1987).
14. Maine Cent. R.R. Co. v. Bd. of Maint. of Way Employees, 873 F.2d 425, 428 (1st Cir. 1989).
15. IDS Life Ins. Co. v. Royal Alliance Assocs., 266 F.3d 645, 649 (7th Cir. 2001).
16. Youngs v. Am. Nutrition, Inc., 537 F.3d 1135, 1141 (10th Cir. 2008).
17. Grain v. Barnes, 551 F.3d 374, 378 (6th Cir. 2008).
18. 9 U.S.C. § 10(a).

> (b) Where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted.
>
> (c) Where the award is imperfect in matter of form not affecting the merits of the controversy. [19]

Conversely, confirmation of an award can be denied only if the award is vacated, modified, or corrected pursuant to the FAA.[20]

MANIFEST DISREGARD OF THE LAW

In addition to the statutory grounds under the FAA, courts have historically set aside arbitration awards when they believed that the award was in "manifest disregard of the law." The manifest disregard doctrine was first introduced in dicta found in the United States Supreme Court's decision in *Wilko v. Swan.*[21] In *Wilko,* the Supreme Court wrote that "the interpretations of the law by the arbitrators *in contrast to manifest disregard* are not subject, in the federal courts, to judicial review for error in interpretation."[22].

The implications of the Supreme Court's use of this phrase have been examined by numerous courts since *Wilko*. As the Third Circuit Court of Appeals has explained: "[T]he judicially created manifest disregard . . . standard . . . allows a district court to vacate an arbitration award that evidences manifest disregard of the law."[23]

The federal circuits split over how they characterized manifest disregard as a basis for vacating an award: some circuits considered it a *nonstatutory,* judicially-created ground for vacation of an arbitration award. [24] Other circuits have deemed it to be an application of the *statutory* ground that permits an award to be vacated where the arbitrators have exceeded their powers.

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19. 9 U.S.C. § 11.
20. Taylor v. Nelson, 788 F.2d 220, 225 (4th Cir. 1986).
21. 346 U.S. 427 (1953); see Kanuth v. Prescott, Ball & Turben, Inc., 949 F.2d 1175, 1178 (D.C. Cir. 1991).
22. 346 U.S. at 436-37 (emphasis added).
23. Dluhos v. Strasberg*,* 321 F.3d 365, 369 (3d Cir. 2003).
24. Dominion Video Satellite, Inc. v. Echostar Satellite, L.L.C., 430 F.3d 1269, 1275 (10th Cir. 2005). *See also* Val-U Constr. Co. v. Rosebud Sioux Tribe*,* 146 F. 3d 573, 578 (8th Cir. 1998) ("Beyond the grounds for vacation provided in the FAA, an award will only be set aside where it ... evidences a manifest disregard for the law.").

Under both characterizations, however, the reach of the manifest disregard doctrine as grounds for vacating has been severely limited.[25] Great judicial deference is given to arbitration awards.[26] On appeal, district courts were found to have very little authority to upset an arbitrator's award.[27]

Manifest disregard required "more than error or misunderstanding with respect to the law."[28] Rather, an error of law must have been obvious and capable of ready and instant perception by the average person qualified to serve as an arbitrator.[29] As the Eighth Circuit put it: "An arbitration decision evidences a manifest disregard for the law where the arbitrators clearly identify the applicable, governing law and then proceed to ignore it." [30] In other words, it must have been clear from the record that the arbitrator recognized the applicable law but intentionally disregarded it.[31]

To be successful, the party seeking vacation bore the burden of proving that the arbitration award evinced manifest disregard of the law.[32] As previously mentioned, arbitration awards were accorded "an extraordinary level of deference." [33]In support of this propensity to uphold the arbitration award, courts reasoned that:

> A policy favoring arbitration would mean little . . . if arbitration were merely the prologue to prolonged litigation. If such were the case, one would hardly achieve the twin goals of arbitration, namely, settling disputes efficiently and

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25. Gov't of India v. Cargill, Inc., 867 F.2d 130, 133 (2d Cir. 1989). *See also* Hoffman v. Cargill, Inc., 236 F.3d 458, 461 (8th Cir. 2001) ("The extra statutory grounds are extremely narrow.").
26. Winfrey v. Simmons Food, Inc., 495 F.3d 549, 551 (8th Cir. 2007); UMass Mem. Med. Ctr., Inc. v. United Food & Commer. Workers Union, 527 F.3d 1, 6 (1st Cir. 2008).
27. United Transp. Union Local 1589 v. Suburban Transit Corp., 51 F.3d 376,379 (3d Cir. 1995).
28. Am. Laser Vision, P.A. v. Laser Vision Inst., L.L.C., 487 F.3d 255, 259 (5th Cir. 2007). *See also* Collins v. D.R. Horton, Inc., 505 F.3d 874, 879 (9th Cir. 2007).
29. Prestige Ford v. Ford Dealer Computer Servs., Inc., 324 F.3d 391, 395-96 (5th Cir. 2003).
30. Gas Aggregation Servs., Inc. v. Howard Avista Energy, L.L.C., 319 F.3d 1060, 1069 (8th Cir. 2003). *See also* Schoch v. InfoUSA, Inc., 341 F.3d 785, 788 (8th Cir. 2003); Mo. River Servs., Inc. v. Omaha Tribe of Neb., 267 F.3d 848, 854 (8th Cir. 2001); Fahnestock & Co., Inc. v. Waltman, 935 F.2d 512, 516 (2d Cir. 1991).
31. Kashner Davidson Securities Corp. v. Mscisz, 531 F.3d 68, 74 (1st Cir. 2008).
32. Greenberg v. Bear, Stearns & Co., 220 F.3d 22, 28 (2d Cir. 2000).
33. Boise Cascade Corp. v. Paper Allied-Indus. Chem. & Energy Workers, Local 70159, 309 F.3d 1075, 1080 (8th Cir. 2002).

> avoiding long and expensive litigation.[34]

To successfully invoke the manifest disregard standard, an appellant had to establish at least three elements. As the Second Circuit Court of Appeals explained:

> First, we must consider whether the law that was allegedly ignored was clear, and in fact explicitly applicable to the matter before the arbitrators. An arbitrator obviously cannot be said to disregard a law that is unclear or not clearly applicable. Thus, misapplication of an ambiguous law does not constitute manifest disregard. Second, once it is determined that the law is clear and plainly applicable, we must find that the law was in fact improperly applied, leading to an erroneous outcome. We will . . . not vacate an arbitration award for an erroneous application of the law if a proper application of the law would have yielded the same result. In the same vein, where an arbitration award contains more than one plausible reading, manifest disregard cannot be found if at least one of the readings yields a legally correct justification for the outcome. Even where explanation for an award is deficient or non-existent, we will confirm it if a justifiable ground for the decision can be inferred from the facts of the case. Third . . . we look to the subjective element, that is, the knowledge actually possessed by the arbitrators. In order to intentionally disregard the law, the arbitrator must have known of its existence, and its applicability to the problem before him . . . Absent this, we will infer knowledge and intentionality on the part of the arbitrator only if we find an error that is so obvious that it would be instantly perceived as such by the average person qualified to serve as an arbitrator.[35]

In short, manifest disregard was an extremely narrow ground for vacation that was rarely used.[36]

34. Remmey v. Paine Webber, Inc., 32 F.3d 143, 146 (4th Cir. 1994).

35. Duferco Int'l Steel Trading v. Klaveness Shipping AIS, 333 F.3d 383, 389-90 (2d Cir. 2003) (internal citations omitted).

36. *See Hoffman,* 236 F.3d at 461. *See also* AmeriCredit Fin. Servs. v. Oxford Mgmt. Servs*.,* 2008 Dist. LEXIS 76720, at *13 (E.D.N.Y. 2008).

HALL STREET ASSOCIATES, L.L.C. V. MATTEL, INC.

The judicially-created doctrine of manifest disregard has been placed into question following the United States Supreme Court's decision in *Hall Street Associates, L.L.C. v. Mattel, Inc*.[37] In *Hall Street,* the Supreme Court was presented with the issue of whether parties could, by contract, supplement the statutory grounds for vacation and modification found in the FAA.[38] The Court held in that context that the statutory grounds for vacation and modification under the FAA were exclusive.[39]

In doing so, the Court reflected on the manifest disregard doctrine and the vagueness of *Wilko*'s use of the phrase.[40]. The Court explained that while, on the one hand, the phrase might have named a new ground for review, on the other hand, it might simply be referring collectively to the statutory grounds for vacation found in 9 U.S.C. § 10.[41] The Court stated:

> Instead of fighting the text, it makes more sense to see the three provisions, §§ 9-11, as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. Any other reading opens the door to the full-bore legal and evidentiary appeals that can render informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process.[42]

Moreover, the Court also determined that "the text compels a reading of the §§ 10 and 11 categories as exclusive." [43]

As a result of the *Hall Street* decision*,* the fate of the manifest disregard doctrine is not entirely clear. Post-*Hall Street,* lower courts are beginning to grapple with the continuing role, if any, to be played by the doctrine of manifest disregard. While the *Hall Street* Court clearly stated that 9 U.S.C. § 10 provided the "exclusive" grounds for vacation, the Court's passive reflection on the split among circuits also evinces an intent to avoid ruling on a question not directly before Court. However, a review of lower court decisions addressing the question leads to the conclusion that "manifest disregard" no longer exists as an *independent* judicially-created ground for vacating an arbitration award under the FAA, but it survives in those circuits

37. 552 U.S. 576 (2008).
38. *Id.* at 578.
39. *Id.*
40. *Id.* at 584-85.
41. *Id.*
42. *Id.* at 588.
43. *Id.* at 586.

where it is seen as merely an application of the *statutory* ground of "exceeding the arbitrator's powers."

In *Citigroup Global Markets, Inc. v. Bacon,* the Fifth Circuit Court of Appeals determined that "manifest disregard of the law" no longer exists as an independent ground for vacation.[44] The court noted that the *Hall Street* decision repeatedly stated that the FAA's statutory grounds were exclusive.[45]. Further, the circuit found that the *Hall Street* Court's determination was consistent with a national policy that favored arbitration with limited review.[46] Based on *Hall Street,* the court explained:

> The question before us now is whether, under the FAA, manifest disregard of the law remains valid, as an independent ground for vacatur, after *Hall Street.* The answer seems clear. *Hall Street* unequivocally held that the statutory grounds are the exclusive means for vacatur under the FAA. Our case law defines manifest disregard of the law as a nonstatutory ground for vacatur. Thus, to the extent that manifest disregard of the law constitutes a nonstatutory ground for vacatur, it is no longer a basis for vacating awards under the FAA.[47]

But the Court in *Citigroup* proceeded to discuss how the 2nd, 7th and 9th Circuits treated "manifest disregard" as falling within the *statutory* ground of "exceeding an arbitrator's powers," and remanded the case to the District Court with instructions to determine "whether the grounds asserted for vacating the award might support vacatur under any of the statutory grounds."

The First Circuit Court of Appeals has acknowledged, at least in dicta, that manifest disregard is no longer a valid ground for vacating an award *under the FAA* (the case before it was not controlled by the FAA).[48] The First Circuit said:

> We acknowledge the Supreme Court's recent holding in *Hall Street Assocs., L.L.* C. v. *Mattel, Inc ...* that manifest disregard of the law is not a valid ground for vacating or modifying an arbitration award in cases brought under the Federal Arbitration Act.[49]

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44. 2009 U.S. App. LEXIS 4543, at *24-25 (5th Cir. 2009).
45. *Id.* at *10.
46. *Id.*
47. *Id.* at 17 (internal citations omitted).
48. Ramos-Santiago v. United Parcel Serv., 524 F.3d 120, 124 n.3 (lst Cir. 2008).
49. *Id.* (internal citations omitted).

Additionally, without discussing the manifest disregard doctrine, the United States Court of Appeals for the Eighth Circuit cited *Hall Street* for the proposition that "[a]n arbitration award may be vacated only for the reasons enumerated in the FAA." [50]

Finally, even those courts that have determined that the doctrine survived *Hall Street* have noted that manifest disregard is no longer an independent, non-statutory ground for vacation. In *Comedy Club, Inc. v. Improv West Assocs.,* the Ninth Circuit Court of Appeals concluded that *Hall Street* did not undermine the manifest disregard doctrine as understood by that circuit.[51] The court noted:

> We have already determined that the manifest disregard ground for vacatur is shorthand for a statutory ground under the FAA, specifically 9 U.S.C. § 10(a)(4), which states the court may vacate 'where the arbitrators exceeded their powers.' [52]

The court determined their reading was not irreconcilable with *Hall Street* and concluded that manifest disregard remained a "valid ground for vacation because it is a part of § 10 (a)(4)."[53]

This same reasoning was applied by the Second Circuit Court of Appeals. In *Stolt-Nielsen SA v. Animal Feeds Int'l Corp.,* the Second Circuit explained that *Hall Street* was "undeniably inconsistent" with treating the manifest disregard standard as an independent, non-statutory ground for vacation.[54] However, the court did not think that *Hall Street* abrogated manifest disregard altogether.[55] Rather, the court agreed with a view expressed by the Seventh Circuit:

> It is tempting to think that courts are engaged in judicial review of arbitration awards under the Federal Arbitration Act, but they are not. When the parties agree to arbitrate their disputes they opt out of the court system, and when one of them challenges the resulting arbitration award he perforce

50. Crawford Group, Inc. v. Holekamp, 543 F.3d 971, 976 (8th Cir. 2008). *See also* Prime Therapeutics L.L.C. v. Omnicare, Inc*.,* 555 F. Supp. 2d 993, 999 (D. Minn. 2008) (noting that the Eighth Circuit treated manifest disregard as an extra-statutory ground for vacation, then refusing to address the manifest disregard argument because its ability to vacate was limited to the exclusive grounds under 9 U.S.C. § 10).

51. 553 F.3d 1277, 1283 (9th Cir. 2009).

52. *Id.* at 1290 (citation omitted).

53. *Id.*

54. 548 F.3d 85, 94 (2d Cir. 2008).

55. *Id.* at 95.

> does so not on the ground that the arbitrators made a mistake but that they violated the agreement to arbitrate, as by corruption, evident partiality, exceeding their powers, etc. – conduct to which the parties did not consent when they included an arbitration clause in their contract. That is why in the typical arbitration . . . the issue for the court is not whether the contract interpretation is incorrect or even wacky but whether the arbitrators had failed to interpret the contract at all, for only then were they exceeding the authority granted to them by the contract's arbitration clause. [56]

The court agreed with those courts that recognized manifest disregard as a "judicial gloss" on the FAA's specific grounds for vacation.[57]

CONCLUSION

From these cases, it seems evident that manifest disregard of the law no longer exists as an extra-statutory ground for vacating an arbitration award. *Hall Street* made it clear that 9 U.S.C. §§ 9-11 provide the exclusive means for vacating or modifying an arbitration award under the FAA. However, the idea that an arbitrator cannot manifestly disregard the law in making a judgment may be inherent from the language of the statute, and manifest disregard survives in many jurisdictions as an application of the statutory grounds found in 9 U.S.C. § 10 – which allows for vacation when the arbitrator has clearly exceeded the limits of his or her power.

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56. *Id.* at 95 (quoting Wise v. Wachovia Sec., L.L.C., 450 F.3d 265, 269 (7th Cir. 2006)).

57. *Id.* at 94. *See also* Mastec N. Am., Inc. v. MSE Power Sys., Inc*.,* 581 F. Supp. 2d 321, 325 (N.D.N.Y. 2008) ("[T]his Court will view manifest disregard of law as judicial interpretation of the Section 10 requirements, rather than as a separate standard of review").

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

East Tennessee Neurology, P.C. Profit Sharing Plan v. Morgan Keegan & Company, Inc.
FINRA Case No. 08-04070

Claimant's representative was a wealthy doctor who had experience in the market, only owned closed end funds and who had purchased millions of dollars in speculative real estate. Claimant's claims pertained purchases of RMK Multi-Sector Funds and RMK Advantage Funds, as well as others.

During the pre-hearing phase, there were discovery issues that were brought to the Panel's attention. Ultimately, the Panel sanctioned Morgan Keegan for e-mail harvesting.

Claimants alleged the following claims: (1) breach of fiduciary duty; (2) violation of NASD and FINRA Rules; (3) breach of contract; (4) negligence; (5) fraud; (6) violation of Tennessee Consumer Protection Act of 1977; and (7) failure to supervise. In their Statement of Claim, Claimants sought compensatory damages of $601,195, punitive damages, interest, costs, treble damages under the Tennessee Consumer Protection Act.

Respondents denied the claims and raised various affirmative defenses.

Award: The Panel found Respondent liable for breach of fiduciary duty, fraud, and violation of the Tennessee Consumer Protection Act of 1977, and ordered Respondent to pay Claimants $301,195 in compensatory damages, plus interest in an amount of $15,060, attorneys' fees of $115,689 pursuant to TCA Section 47-18-109, and Claimant's costs and expenses of $52,413.

Claimants' Counsel: Brian N. Smiley, Esq., Smiley Bishop & Porter, LLP, Atlanta, Georgia.

Respondent's Counsel: John Bolus, Esq., Maynard Cooper & Gale, P.C., Birmingham, Alabama.

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

Respondent's Expert: Steve Scales, Secure Financial Services, Inc.; Shel Ekdahl, Bates Private Capital.

Arbitrators: Elton Charland (Chairperson), Kenneth Jackson (Public), and Joshua Wallach (Non-public).

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This case is significant because the award represented approximately 100% of net out of pocket losses, or approximately 75% of losses under a well-managed portfolio theory, as well as more than $165,000 in attorneys' fees and costs (which represented more than 55% of the amount of damages awarded).

According to Claimant's counsel, the Chairperson in this case had previously ruled in favor of Morgan Keegan in two previous cases, including one case in which the Claimant had been ordered to pay Morgan Keegan's attorneys' fees.

The award is also notable because the Panel specifically found violations of the Tennessee Deceptive and Unfair Trade Practices Act and awarded damages and attorneys' fees under the Tennessee Consumer Protection Act.

Marcia Baker v. Global Trading Group and William Savary
FINRA Case No. 09-04019

Plaintiff was unemployed and living off her investments as a retired journalist. Claimant opened an account with Respondents in 2003. Prior to that, she had invested only in mutual funds and municipal bonds and had never used margin. Respondents were aware of her risk averse nature and assured Claimant in writing that their objective was to meet her income needs without exposing Claimant's principal to "undue risk." Claimant's stated investment objective was income with a risk tolerance of "safety." Claimant's first account was not approved for options trading and Claimant did not grant discretionary authority over this account.

However, Respondents encouraged Claimant to open a second "trading" account. A letter from Respondents stated that the second account's main objective will be "Speculation," rather than "safety and income." In contrast to the first account, there was an option agreement for the second account.Ultimately, Respondents churned the first account. Respondents also traded in stocks and options in the account. The annual turnover ratio the first year exceeded 7.5 and the annual cost of equity was 9.2 percent. As a result, in order to cover the costs of trading, Claimant's account was required to generate a return that significantly exceeded the reasonable expected return for a conservative, income account. While Claimant lost a considerable amount of money in the account, Respondents profited by charging approximately $74,000 charged in commissions, interest, and fees. Perhaps most alarming, Respondents recommended and transacted a large number of options and short sales in her account, including extremely dangerous naked put options. In total, the investments purchased, and strategies pursued, with Claimant's life savings, were at least ten times more risky than the S&P 500 Index – the account was coded as conservative. Respondents' unsuitable recommendations were compounded by unauthorized trading, including buying options in an account for which Claimant never executing an option agreement.

Respondents also purchased and sold securities to Claimant while she was a resident of Washington. However, Respondent Savary was not, and never has been, licensed in the state. According to Claimant's counsel, Respondent Savary had a long history of violating laws and regulations and his CRD shows at least nine prior lawsuits, eight prior judgments, a prior NASD investigation and Letter of Caution, numerous customer complaints, an arbitration award to three customers, two firings from other brokerage firms for investment violations, a bankruptcy, and two tax liens.

In total, Claimant's accounts suffered losses of more than $273,000. Claimant asserted the following causes of action: (1) violation of the Washington State Securities Act and state securities regulations; (2) violation of FINRA rules; (3) breach of contract; (4) breach of fiduciary duties; (5) common law fraud; (6) negligent misrepresentation; (7) conversion and unjust enrichment; (8) violation of the Washington Consumer Protection Act; and (9) negligence.

Respondents denied the claims and raised various affirmative defenses.

Award: The Panel found Respondents jointly and severally liable and ordered Respondents to pay Claimants $200,000 plus pre- and post-judgment interest at a rate of 8% ($26,419.59 in pre-judgment interest), plus attorneys' fees in the amount of $84,257, pursuant to RCW §19.86, *et seq.*

Claimants' Counsel: Al Van Kampen, Esq., Law Offices of Rohde & Van Kampen PLLC, Seattle, Washington.

Respondent's Counsel: David Choi, Esq., Burkhart Wexler & Hirschberg LLP, Garden City, New York (Withdrew); Respondents appeared at the hearing *pro se*.

Claimant's Expert: Bob Grosnoff, Grosnoff Litigation Consultants LLC, Coronado, California

Respondent's Expert: None

Arbitrators: Kim Stephens (Public Chairperson), Thomas Dreiling (Public), Courtland Shafer (Non-Public)

This case is significant because the arbitration panel awarded nearly $85,000 in attorneys' fees. In total, the award of attorneys' fees and damages award reflected more than 100% of Claimant's total losses.

Craig Kneisly as the Successor Trustee of the Alf Co., Inc., Retirement Trusts and has Trustee of the Marietta Kneisly Trust v. Morgan Keegan & Co., Inc.

FINRA Case No. 09-01592

Respondent's broker had a long-term relationship of trust with Claimants and Claimants' family. He had helped them establish the family trusts and he directed all of the investments. The broker persuaded Robert Kneisly to make a $50,000 investment in a private placement known as the DVS Group. Claimants thought it was a Morgan Keegan sponsored investment. However, the broker was actually a principal in the DVS Group, and this fact was not disclosed. Over a two year period, the broker converted additional funds from the Claimant's accounts by using forged or photocopied Letters of Authorization. By the time the broker was finished, he had taken $315,000 of Claimants' money for this investment. In total, the broker had convinced seven of his Morgan Keegan clients to invest in DVS. When Morgan Keegan learned of the wrongdoing, it immediately terminated the broker and alerted the clients - but did not offer to refund the money.

Morgan Keegan blamed the victim and raised a "you should have caught us" defense. Through testimony of the Branch Office Manager, Claimants were able to establish multiple violations of Respondent's internal policies and procedures - including one that required Morgan Keegan to send a confirming letter to the client any time there was a wire or check deducted from the account. The BOM was unable to identify any such letters having been sent to Claimants. There were also numerous e-mails from Morgan Keegan's e-mail system that discussed the DVS Group. In total, the words "DVS Group" appeared more than 30 times in the internal records of Morgan Keegan. Each of these was connected with clients of the broker. Despite this, no one from management raised any concerns. Morgan Keegan's expert testified that there was no deviation from the standard of care.

Claimants' alleged various claims related to unauthorized investments in the DVS Group in their accounts. After the claim was filed, the original Claimant, Robert Kneisly, passed away. Claimants prevailed against a motion to bar testimony or evidence regarding statements by Robert Kneisly under the Tennessee Dead Man's Statute and federal and state rules of evidence.

Claimants asserted the following causes of action: (1) unauthorized trading; (2) breach of contract and promissory estoppel; (3) violation of Mississippi Securities Act Section 75- 71-101 et seq. of the Code of Mississippi (4) intentional and negligent misrepresentations of material fact; (5) breach of fiduciary duty; (6) breach of the duty of good faith and fair dealing; (7) negligence; (8) gross negligence; and, (9) respondeat superior.

Award: The panel ordered Respondent to pay Claimants compensatory damages of $315,000, plus pre-judgment interest of $94,812, post-judgment at 8% per annum, and attorneys' fees of $143,434 pursuant to Mississippi Code of 1972 § 75-71-717.

Claimants' Counsel: Robert A. Kantas, Esq. and Ronald H. Thrash, Esq., Shepherd, Smith, Edwards & Kantas, LLP, Houston, Texas.

Respondent's Counsel: Clinton J. Simpson, Esq., Elizabeth Moccaldi, Esq., and Richard Chotard, Esq., Baker, Donaldson, Bearman, Caldwell & Berkowitz, P.C., Memphis, Tennessee.

Claimant's Expert: Michael Clements, Wall Street Consulting Group, Inc. (Initially, Claimants had retained Lou Straney to be their expert; however, due to a conflict with one of the arbitrators, he was asked to resign prior to the arbitration hearing.)

Respondent's Expert: John West, West Consulting

Arbitrators: David H. White, J.D. (Public Chairperson); Ronald Futterman (Public); Stephanie Malevich (Non-Public)

This case is significant because the panel awarded 100% of the compensatory damages of $315,000, plus more than $94,000 in pre-judgment interest and more than $140,000 in attorneys' fees. Claimants' counsel argued for statutory damages from the outset. Ultimately, the panel granted their request.

Gerald J. Kazma Revocable Trust and Amzak Capital Management, LLC v. Citigroup Global Capital Markets, Inc. f/k/a Citicorp Investment Services and Citigroup Alternative Investments, LLC
FINRA Case No. 09-02697

Claimants were wealthy retirees with investment experience. Respondents sold Claimants $4 million in shares of the ASTA Three Series 2006-1 and ASTA Five Series 2007-1A funds. Claimants had a 12-year relationship with Citibank and their private banker. This private banker told them that the investments were safe. Respondents induced Claimants and other high-net-worth investors to invest a substantial amount of money in what was represented as relatively conservative investments that could generate attractive returns. Risk was categorized as "low" and the funds were marketed as "moderately conservative." Respondents represented that the funds utilized a "disciplined and experienced" approach to trading and a "rigorous risk management" strategy. In fact, Claimants alleged that the funds were speculative equity-type investment vehicles - defective products - that Respondents designed, negligently tested, and then grossly misrepresented to its sales force and best clients to sell and improve

Respondent's own balance sheets. Ultimately, the municipal bonds in the fund dropped in price and the funds' hedging strategies failed. This resulted in substantial losses to the funds' shareholders. Early in 2008, Claimants were informed that they had lost the full value of their investment.

Claimants asserted the following causes of action: (1) breach of fiduciary duty; (2) common law fraud; (3) negligent misrepresentation; (4) negligent management; (5) negligent supervision; and (6) breach of contract.

Award: The Panel found Respondents jointly and severally liable and ordered them to pay Claimants approximately $1.817 million.

Claimants' Counsel: Robert Wayne Pearce, Esq., Robert Wayne Pearce, P.A., Boca Raton, Florida.

Respondent's Counsel: Jason M. Fedo, Esq., Greenberg Traurig, P.A., West Palm Beach, Florida.

Claimant's Expert: Joseph R. Prendergast, Securities Litigation & Consulting Group

Respondent's Expert: Nat Singer, Swap Financial Group, LLLC

Arbitrators: Myron E. Levenson (Public Chairperson); Joseph Benalt (Public); Donald R. McGahan (Non-Public)

This award is significant because it represents recovery of two-thirds (2/3) of Claimants' losses in Citigroup's ASTA Three and ASTA Five funds. Claimants focused their claims on Respondents' negligent management of the ASTA funds and negligent supervision of the fund manager, Reaz Islam. Claimants had obtained millions of pages of documents produced by Respondents during the investigation by the SEC. These documents proved to be invaluable and allowed Claimants to focus on the negligent supervision of the fund's manager, rather than point-of-sale representations.

WHERE WE STAND

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

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

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

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

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

The following PIABA Comment Letter regarding *Release No. 34-62584/SR-FINRA-2010-035- Proposed Rule Change Amendmetns to the Discovery Guide and Rules 12506 and 12508 of the Code of Arbitration Procedure for Customer Disputes* was submitted to the Securities and Exchange Commission by Scott R. Shewan on August 24, 2010.

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

RE: SR-FINRA-2010-035 (Rule Proposal Regarding Discovery Guide in FINRA Arbitrations)

Dear Ms. Murphy:

Thank you for the opportunity to comment upon the above-referenced proposal to amend FINRA's Discovery Guide ("Guide"). The Discovery Guide has significant impact on the conduct of parties and arbitrators in FINRA arbitration proceedings.

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is a national bar association of approximately 450 attorneys devoted to the representation of public investors in arbitration proceedings. As such, we are keenly interested in the discovery procedures and their impact on the fairness of FINRA arbitrations.

INTRODUCTORY COMMENTS

PIABA commends FINRA's exhaustive efforts to refine the Guide. We believe that on balance, the proposed revisions to the Guide represent a meaningful improvement to the existing Guide. Accordingly, PIABA urges the Commission to adopt the proposed rule change. The proposed revisions to the Guide would tend toward a leveling of the playing field for public investors during the discovery process. The proposed Guide also clarifies some outstanding ambiguities commonly faced during discovery proceedings. PIABA believes the proposed Guide will better protect investors' rights during the arbitration process, potentially discourage abusive tactics, and instill greater public confidence in the FINRA arbitration system.

That said, we continue to find certain aspects of the proposed Guide to be troubling. For example, disparate and unnecessary burdens are still imposed upon customers with regard to documents that are presumptively discoverable in all cases. However, we note that such concerns pertain primarily to provisions carried forward from the existing Discovery Guide, and not to the new provisions of the proposed Guide. PIABA concludes the improvements in the proposed Guide outweigh the negatives. Public investors will be best served if the proposed revisions to the existing Guide take effect promptly.

We further note that the Guide has essentially remained unchanged since its adoption in 1999. During the intervening years, there have been significant changes in the securities industry, and we have seen several industry-wide scandals relating to various products and practices. We think, and we believe FINRA also feels, that too much time has gone by since the original Guide was adopted without regular scrutiny and amendment. As a result, the rewriting of the Guide has turned out to be a herculean task. In future, we hope that FINRA will regularly review the Guide with a view to its constant improvement, especially as new product cases arise and present different discovery challenges. With that in mind, this letter will provide suggestions for FINRA's consideration in the future, as well as our comments on the current proposed rule change.

FINRA'S INTRODUCTORY COMMENTS TO THE GUIDE

PIABA is pleased with the proposed Guide's introductory comments. The introduction clarifies existing principles as taught to arbitrators in FINRA training. PIABA also suggests that FINRA include provisions that direct and remind arbitrators to uphold their duty to enforce the discovery obligations of the parties.

1. Confidentiality

PIABA approves of the Guide's introductory discussion of Confidentiality Agreements. The proposed discussion will assist the arbitrators in particular by: 1) clarifying that the party seeking confidential treatment of documents has the burden of establishing legitimate reasons for such exceptional treatment; and 2) illustrating some factors for arbitrators to consider when deciding whether that burden has been met. While these non-exhaustive factors have been set forth and discussed in FINRA's Neutral

Corner publication[1], inclusion of these points within the Guide's introduction will clarify for arbitrators and parties that a confidential designation is not automatic. Rather, it is appropriate only under limited circumstances.

2. Affirmations

PIABA supports FINRA's proposed clarification to a portion of the existing provisions, so as to provide, among other things, that the party who claims it does not have documents requested by the other party must produce affirmations that no responsive documents are within the party's "possession, custody or control". Currently, such affirmations call for the party to represent that no such documents "exist." By essentially narrowing the breadth of what the party need affirm, the affirmations provide a more practicable tool for discovery. Parties who may not be able to affirm that documents do not exist may be able to more accurately affirm that the documents are not within its possession, custody or control.

3. Arbitrator Enforcement of Discovery Obligations

PIABA encourages FINRA to add language concerning arbitrators' duty to enforce discovery obligations. We also propose that in its arbitrator training, and in its written materials provided to arbitrators, FINRA emphasize the arbitrators' ability to sanction parties who ignore or subvert the discovery process. Too often, our members experience situations where brokerage firms, particularly the major firms, submit wholesale objections to the current Discovery Guide, followed by production of monthly statements, confirmations, and little else.

Arbitrators need to be reminded that they have the authority to enforce orders, strike pleadings and preclude admission of evidence at hearing when a party has stonewalled production during the process.[2] In other words, the arbitrators need to be instructed, indeed encouraged, to give "teeth" to discovery enforcement provisions. If parties and arbitrators better understand that discovery obligations cannot be manipulated under the guise that arbitrations are "informal proceedings," or in favor of those associated with a powerful brokerage firm that necessarily appears in numerous arbitrations, the discovery process will be better served.

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1. *See*, *Arbitrators and Orders of Confidentiality*, **The Neutral Corner**, April 2004, available at http://www.finra.org/ArbitrationMediation/Neutrals/Education/NeutralCorner/P010040.
2. Rules 12511(b), 12514(c), Code of Arbitration Procedure.

4. Electronically Stored Information.

The introductory comments to the proposed Guide make it clear that information which is stored electronically falls within the definition of a "document." This is a welcome addition, and should foreclose any argument to the contrary.

5. No Obligation to Create Documents

The proposed introductory language clarifies that no party has an obligation to create documents to satisfy a discovery request. In the past, firms have sought to have the arbitrators require customer claimants to prepare a financial statement when one was not already in existence. PIABA welcomes this clarification.

SPECIFIC COMMENTS ON DOCUMENT LISTS

PIABA offers the following comments to the lists set forth in the proposed Guide.

LIST 1-Documents the Firm/Associated Persons Shall Produce in All Customer Cases

1) (a) The account record information for the customers, including the customers' name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, and the account's investment objectives.

(b) All documents concerning the customers' risk tolerance.

(c) All agreements with the customers, including, but not limited to, account opening documents and/or forms; cash, margin, option, and discretionary authorization agreements; trading authorizations; and powers of attorney.

> PIABA strongly supports all parts of this Item. These documents are essential. They should reflect basic information that member firms must obtain from their customers both when opening an account, and thereafter when updating account profiles. The firms must retain these documents in good order pursuant to industry regulation. Production of the documents should therefore not impose any undue burden.

We note with approval FINRA's use of language that tracks SEC Rule 17a-4, to clearly include 'account record' information as part of the presumptive production in all cases. This clarifies the records to be produced and should enable customers to obtain the official records duly kept by the firm pursuant to applicable regulations. In addition, specification of 'account record' information will require firms to provide those documents reflecting whether a principal of the firm approved the record. PIABA suggests that this item should include codes used by the firm so the customer can identify relevant information such as 1) objectives and 2) risk tolerance, and similar information which might be presented by use of codes.

2) All correspondence sent to the customers or received by the firm/associated persons specifically relating to the accounts or transactions at issue including, but not limited to, documents relating to asset allocation, diversification, trading strategies, and market conditions; and all advertising materials sent to customers of the firm that refer to the securities and/or account types that are at issue. (Unless separately requested, the firm/associated persons need not produce confirmation slips and monthly statements.)

PIABA supports this Item which clarifies some ambiguities within the current List 1, Item 2, to expressly require production of documents relating to asset allocation, trading strategies and other historical facts relative to a customer's account or the transactions at issue. Under existing practice, customers too often find that they must waste time battling firms for highly relevant information. The proposed item 2 should help alleviate those wasteful exercises and allow parties to proceed with discovery and resolution of the dispute.

PIABA also supports this Item's expansion to include various advertising materials relating to the accounts or transactions at issue, and which the firm sent to the customer.

PIABA does not oppose elimination of confirmation slips and monthly statements from scope of the proposed item. While this means that firms do not have to automatically produce these records, it is clear in cases where the documents are needed, an arbitration panel should order their production should a firm/associated person fail to honor the customer's supplemental request.

3) All documents evidencing any investment or trading strategies utilized or recommended in the customers' accounts, including, but not limited to, options programs, and any supervisory review of such strategies.

> This Item is new, and a welcome addition to the [proposed] Discovery Guide. Trading strategies used or recommended, for example, must be produced for the customer's accounts, as well the records of any supervisory review of these records. Early production of these records, if they exist, will promote arbitration's goal of expedient yet full and fair resolution of claims.

4) For claims alleging unauthorized trading, all documents the firm/associated persons relied upon to establish that the customers authorized the transactions at issue and all documents relating to customer authorization of the transactions at issue.

> PIABA supports this Item and is pleased that it slightly expands upon the existing provision in List 11, Item 3. The proposed Item would properly require firms/associated persons to produce those documents relating to the authorization of a disputed trade.

5) (a) All materials the firm and/or associated persons prepared or used and/or provided to the customers relating to the transactions or products at issue, including research reports, sales materials, performance or risk data, prospectuses, and other offering documents, including documents intended or identified as being "for internal use only."

(b) All worksheets or notes indicating that the associated persons reviewed or read such documents.

> PIABA supports this proposed Item. Materials the firm/associated persons used, prepared or showed to customers relating to the very transactions/accounts at issue are highly relevant. We are pleased to see that FINRA also proposes to retain the language calling for 'internal use only' documents. As most representatives, and the regulators, are aware, this latter category of documents is often what the broker uses in whole or in part to promote an investment.
>
> The Guide should also specifically make presumptively discoverable all information and all materials that the brokerage firm and/or associated person obtained from the customer prior to placing the first

trade or transaction, and every subsequent trade or transaction, in the customer's account. And more specifically, the Guide should make presumptively discoverable every document and all information obtained by the firm and/or associated person which provided the basis upon which the firm and/or associated person made a recommendation, sold an investment product, or provided any other financial planning or financial advice. While the firms/associated persons may not in fact have documents showing a basis for recommendations throughout the account life, to the extent they do, such documents should be presumptively discoverable.

6) All notes the firm/associated persons made, including, but not limited to, entries in any diary or calendar, relating to the customers and/or the customers' accounts or transactions at issue.

PIABA supports this Item, which appears on current List 1, Item 6. The slight expansion to include notes and other documents relating more broadly to the customer, [and not just his accounts or transactions at issue], may provide important evidence in the case, with minimal additional burden. Certainly the firms/associated persons will or should review all their records regarding the customer. The customer in turn ought to be afforded the same opportunity to review these materials.

7) (a) All notes or memoranda evidencing supervisory, compliance, or managerial review of the customers' accounts or trades therein for the period at issue.

(b) All correspondence between the customers and firm/associated persons relating to the customers' accounts or transactions at issue bearing indications of managerial, compliance, or supervisory review of such correspondence

This Item properly identifies relevant documentation without imposing undue burden. However, the Guide might clarify, or refer to the introductory comments, specifying that electronic and/or digital forms of these writings are to be produced. This Item should clarify that it encompasses summaries of such communications and reviews.

8) All recordings, telephone logs, and notes of telephone calls or conversations about the transactions at issue that occurred between the associated persons and the customers (and any person purporting to act on behalf of the customers), and/or between the firm and the associated persons.

This Item calls for essential documents presumptively relevant to all cases. PIABA believes this does not impose any undue burden and supports the proposal.

Indeed, this Item is similar to proposed List 2, Item 8, which requires the same, and a bit more, from customers in all cases. In the customer counterpart, for example, customers must also produce these records as they relate to 'accounts' at issue, not just to 'transactions' as is here proposed for firms and associated persons. FINRA explains that this item is limited for firms to those records relative to 'transactions' because otherwise a broad search for telephone records /notes relative to 'an account' could impose undue expense/effort upon firms that would not be able to set temporal parameters around the search relative to 'accounts' and telephone notes, for example.

PIABA does not oppose the narrowing of this Item for purposes of determining what is presumptively discoverable. However, PIABA submits that qualifying language ought be included to explain to parties and the arbitrators that such documents would be subject to production if 1) the customer provides details sufficient to narrow the search, or 2) facts of the case suggest that these logs/notes are likely relevant to a claim.

Discussed below at List 2, Item 8, are the customer's production obligations concerning telephone records/logs/notes of conversations. There appears to be some ambiguity in that proposed Item as discussed below.

9) All writings reflecting communications between the associated persons assigned to the customers' accounts at issue during the time period at issue and members of the firm's compliance department relating to the securities/products at issue and/or the customers' accounts.

PIABA supports inclusion of this new Item. Documents reflecting communications between the associated person and the firm's compliance department concerning the customer's account at issue, or products at issue, are certainly relevant if they exist. Any such records bear on supervision issues, at a minimum. We submit the language should also encompass other supervisory departments for the same reasons. In many instances, the associated person may communicate not initially with compliance, but with others in a supervisory chain, such as a regional director, or with a registration department official. The Item is appropriate, and the purpose can be better fulfilled by expansion to include all supervisory departments or personnel.

10) All Forms RE-3, U-4, and U-5 and Disclosure Reporting Pages, including all amendments, for the associated persons assigned to the customers' accounts at issue during the time period at issue, redacted to delete associated persons' social security numbers, all customer complaints identified in such forms, and all customer complaints filed against the associated persons that were generated not earlier than three years prior to the first transactions at issue through filing of the Statement of Claim, redacted to prevent the disclosure of non-public personal information of the complaining customer.

PIABA supports this Item. It should be clarified to state that oral complaints are included, as they are encompassed within certain DRP reports.

11) All sections for all of the firm's manuals and all updates thereto relating to the claims alleged in the Statement of Claim for all years in which the Statement of Claim alleges that the conduct occurred, including separate or supplemental manuals governing the duties and responsibilities of the associated persons and supervisors, all bulletins (or similar notices) the firm issued for all years in which the Statement of Claim alleges that the conduct occurred, and the entire table of contents and index to each such manual or bulletin. In responding to this request, the firm must provide a list of all of its manuals and bulletins which may contain directives related to the conduct or product at issue in the claim.

PIABA supports this Item as essential to preparing a customer's case. PIABA applauds FINRA for dealing with this consistently difficult discovery issue. Historically, obtaining a firm's manual(s) has been a herculean task not for the faint of heart. In addition, many arbitrators have given great credence to the firms' insistence that the manuals contain trade secrets, for example. In other instances, we have witnessed gamesmanship by firms who fail to produce a manual unless requested by the exact name of that manual. While ultimately manuals that are produced often do not contain trade secrets or other highly confidential material, the manuals are crucial to establishing what the firm did or did not have in place for proper execution of its compliance obligations.

FINRA's current proposal will significantly reduce such wasteful discovery battles, and will promote the investor's ability to concentrate on the task at hand --- developing his case for final hearing. PIABA also notes with approval the proposal's requirement that firms produce in all cases a list of all the firms' manuals and bulletins.

12) All analyses and reconciliations of the customers' accounts prepared during the time period at issue, including, without limitation, those relating to reviews of the customers' accounts or transactions at issue.

This provision is substantially identical to List 1, Item 10 of the current Discovery Guide. PIABA supports the expansion of the provision, which now includes both accounts *and* transactions at issue. PIABA also approves the inclusion of analyses 'prepared' during the time at issue, including those relating to reviews of customers' accounts/transactions at issue.

13) (a) All exception reports, supervisory activity reviews, concentration reports, active account runs and similar documents produced to review for activity in the customers' accounts related to the allegations in the Statement of Claim or in which the transactions at issue are referenced or listed.

(b) For claims alleging failure to supervise, all exception reports, supervisory activity reviews, concentration reports, active account runs, and similar documents produced to review for activity in customer accounts handled by associated persons and related to the allegations in the Statement of Claim that were generated not earlier than one year before or not later than one year after the transactions at issue.

PIABA supports both sections of this Item. Generally, inclusion of these critical documents will streamline the case process and enable customers, and respondents, to assess important facts customers are entitled to discover. We offer suggestions for future improvement as well.

Paragraph (a) is similar to List 1, Item 11 of the current Discovery Guide. It now includes the language "related to the allegations in the Statement of Claim" or "in which the transactions at issue are referenced or listed". This section is reasonable, though there should be a mechanism for a customer to learn exactly how the firm defined 'related to' when conducting its search. The proposed language is highly subjective and prone to abuse. This item might best include a provision for a customer to verify the nature and parameters of the firm's search, and to ask that the panel review, perhaps *in camera,* a record evidencing the firm's search. Alternatively, or in addition, this Item could mention that customers can require the firm to produce the affidavit that these documents do not exist, somewhat in a similar vein to the provision for affidavits available when a party asserts the documents are not within its possession, custody or control.

Paragraph (b) apparently only applies to claims for failure to supervise, and therefore reasonably requires the production of those reports 'related to' the allegations in the Statement of Claim, among other parameters. We believe these documents should be presumptively discoverable in all cases regardless of whether or not failure to supervise is explicitly alleged. Some customers file arbitrations *pro se* and do not know to allege failure of supervision even when it exists. Other customers might unfortunately be represented by inexperienced counsel. Public customers should not be penalized for failure to denominate a claim properly. Finally, we believe the time frame should extend to three years prior to the transactions at issue.

14) Those portions of internal audit reports for the branch in which the customers maintained accounts that: (a) focused on associated persons or the accounts or transactions at issue; and (b) were generated not earlier than one year before or not later than one year after the transactions at issue, and discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the Statement of Claim.

We are pleased that this Item has been moved from List 5, Item 3 of the current Discovery Guide and made presumptively discoverable in all cases, and not just those alleging failure to supervise. In addition, we are pleased that it has been expanded to include the customers' accounts, and not solely the transactions at issue.

15) Records of disciplinary action taken against associated persons by any regulator or employer for all sales practice violations or conduct similar to the conduct alleged in the Statement of Claim.

> PIABA is pleased that this Item, already included in List 1, Item 12 of the current Discovery Guide, remains in the proposed Guide. We note with approval that the language has been expanded to include the word 'violations'. This helps to make the provision more inclusive and less ambiguous than if it called for documents merely that 'relate to' conduct alleged in the Statement of Claim. As we have mentioned in connection with other Items, we are concerned about the use of the phrase 'conduct similar to,' as it leaves some room for interpretation as to what constitutes similar conduct, and may be subject to abuse.

16) All investigations, charges, or findings by any regulator (state, federal or self regulatory organization) and the firm/associated persons' responses to such investigations, charges, or findings for the associated persons' alleged improper behavior similar to that alleged in the Statement of Claim.

> PIABA supports this new Item. Again, however, the provision should not limit production to investigations, charges or findings that relate to behavior 'similar' to that alleged in the Statement of Claim, allowing the firm and/or associated person to interpret what constitutes similar behavior. If there are a number of investigations, charges or finding against an associated person, this is relevant. Alternatively, the firms/associated persons should be required to maintain a log of all such investigatory documents, for possible review if the 'similarity' assessment is called into question.

17) Those portions of examination reports or similar reports following an examination or an inspection conducted by any regulator (state, federal or a self-regulatory organization) that focused on the associated persons' or the customers' accounts or transactions at issue or that discussed alleged improper behavior in the branch against other individuals similar to the conduct alleged in the Statement of Claim, for the period one year before the transactions at issue through the filing of the Statement of Claim.

> PIABA is pleased that this Item has been retained. Presently, it appears in List 5, Item 3 of the current Discovery Guide, but is now made presumptively discoverable in all cases, and not just those alleging

failure to supervise. In addition, we are pleased that the provision has been expanded to include customers' accounts in addition to the transactions at issue. As with the prior Item, we believe this provision should not be limited to behavior 'similar' to the conduct alleged in the Statement of Claim, as this provision is fraught with potential for abuse. Moreover, all reports should be produced that reference the associated person or the customers' accounts or the transactions at issue, and not simply those that "focused on" these items. We submit the time frame should be expanded to three years consistent with time frames proposed for other items. Examinations are not conducted annually in many instances, and by limiting the time frame to one year, important documentation could be missed when, for instance, the last examination was 2 years prior to the transaction at issue and yet contained otherwise relevant information.

18) All documents related to the case at issue that respondent received by subpoena under Rule 12512 or by document request directed to third parties at any time during the case.

We support the inclusion of this new Item. This should remain a continuing obligation throughout the discovery process.

19) For all transactions at issue in the Statement of Claim, documentation showing the compensation, gross and net, to the associated persons for such transactions. In the event accounts at issue are the subject of fee arrangements that are not based on remuneration per trade, a record showing compensation earned by period on the accounts.

PIABA supports this new Item. We are pleased with the addition of this new Item as presumptively discoverable in all cases. It appears that this Item replaces commission runs which are in the current Discovery Guide as Item 1 on both Lists 3 and 5. The new Item should present the commission information in a more accessible, simple way for the customer's understanding. It would be beneficial if the firms and associated persons were also required to produce documents showing the associated person's overall gross compensation. Compensation relating only to the transactions at issue tells only part of the story. The percentage of such compensation to the associated person's gross compensation can be strong evidence in a case.

20) (a) For claims related to solicited trading activity, a record of all compensation, monetary and non-monetary, including, but not limited to, monthly commission runs for the associated persons, listing the securities traded, dates traded, whether the trades were solicited or unsolicited, and the gross and net commission from each trade. The firm shall provide this information for a period of time beginning three months before and ending three months after the trades at issue in the customer's accounts.

(b) The firm may redact names and other non-public personal information concerning customers who are not parties to this claim, but should provide sufficient information to identify: (1) the non-party customers' accounts, including the last four digits of the nonparty customers' account numbers; (2) the associated persons' own and related accounts, including the last four digits of the associated persons' account numbers; and (3) the type of account (IRA, 401(k), etc.).

> PIABA supports both sections of this Item. This Item is the missing part of the picture which is not included in item 19 above. We also submit it should be presumptively discoverable in all cases, and not only those relating to solicited trading activity. It is not uncommon in FINRA arbitrations for there to be a dispute as to whether an order ticket is properly marked "unsolicited." This Item is similar to Item 2 on both Lists 3 and 5 of the current Discovery Guide. The time frame has been changed from two months proceeding through two months following the transaction at issue or twelve months, whichever is longer, to three months before to three months after the trades at issue. We support the lengthening of the time frame from two months to three months; however, for claims relating to shorter periods of time, we suggest that the item include the minimum time period of twelve months which has been removed.

21) (a) A record of all agreements pertaining to the relationship between the associated persons and the firm, summarizing the associated persons' compensation arrangement or plan with the firm, including:
- **Commission and concession schedules;**
- **Bonus or incentive plans including those relating to deferred compensation; and**
- **Schedules showing compensation received or to be received based upon volume, type of product, nature of trade *(agency v. principal),* etc.**

(b) To the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation was determined.

> We are pleased with the inclusion of this Item as presumptively discoverable in all cases. The Item is similar to List 13, Item 2 of the current Discovery Guide; however, it has been changed to now require production of records of agreements rather than the documents themselves. A fair reading of Item 22 may be that the industry parties must supply the records described therein, with the agreements themselves constituting part of those records. However, to avoid future disputes, we suggest that this Item plainly state that 'records' shall include the actual agreements as well.

22) If the Statement of Claim includes allegations regarding an insurance product that includes a death benefit, the firm and/or associated persons must provide all information concerning the customers' insurance holdings and the recommendations, if any, to the customers regarding insurance products.

> We support the inclusion of this new Item.

<u>LIST 2</u> -Documents the Customers Shall Produce in All Customer Cases

1) All customer and customer owned business (including partnership, corporate) federal income tax returns the customers filed, limited to pages 1 and 2 of Form 1040, Schedules A, B, D, and E, and the IRS worksheets related to these schedules, or the equivalent for any other type of return, redacted to delete the customers' social security numbers, for the three years prior to the first transactions at issue in the Statement of Claim through the date the Statement of Claim was filed. The customers may redact information relating to medical and dental expenses and the names of charities on Schedule A unless the information is related to the allegations in the Statement of Claim. The income tax returns must be identical to those that were filed with the Internal Revenue Service.

> PIABA continues to be deeply troubled by this provision, which is a holdover from the prior Guide, and similar provisions requiring the customer to provide private financial information in all cases. To begin with, the customer's financial status has no relevance to many kinds of cases filed in FINRA arbitrations, such as claims asserting churning, unauthorized trading, breach of contract, fraud or violation of state Blue Sky acts. Indeed, theses documents are not always relevant to suitability cases. The danger is that it will lead arbitration panels to believe, incorrectly, that a customer's wealth will permit a post hoc determination of suitability, rather than focusing on what the firm knew or should have known at the time the investment recommendation is made. There is no basis in law for permitting such an after-the-fact analysis.
>
> Personal tax information is highly sensitive and private. In some states, such as California, tax returns are privileged from disclosure in litigation proceedings except where tax issues are specifically involved. Under this Item, the firm/associated person is permitted to conduct a fishing expedition into a customer's financial condition, whether or not such financial condition has any bearing on the issues presented by a case. PIABA encourages FINRA and the Commission to reconsider permitting firms to engage in this intrusive discovery, which has been likened to a "financial colonoscopy." Customers should not be required to waive their financial privacy rights as a condition to filing a claim in arbitration, except in those cases where the customer's financial condition is at issue.

2) Financial statements, including statements within a loan application, or similar statements of the customers' assets, liabilities, and/or net worth for the period covering the three years prior to the first transactions at issue in the Statement of Claim through the date the Statement of Claim was filed. Customers are not required to create financial statements in order to comply with this item.

PIABA believes this Item, like tax returns, should not be part of a presumptively discoverable checklist. PIABA does note with approval that this Item properly states that a customer has no obligation to create such documents, in keeping with the overarching instructions to this Guide. However, we nevertheless are concerned that the presumptive discoverability of this item will have a chilling effect on pro se customers, and confuse members of the panel with the erroneous notion that a customer's financial statements are relevant in all cases. They are not.

Perhaps the drafters of this proposed item intended that it serve to "provide a better understanding of the claimant's financial status …" as FINRA described in its discussion of Item 1 immediately above. However, FINRA does not state any reason why item 2 should be presumptively discoverable in all cases.
PIABA submits that financial statements should not and need not be required in all cases. PIABA suggests that this item be removed from the proposed Guide. Alternatively, qualifying language as used in the Guide's Introduction when discussing firms with different business models, could be adopted with respect to Items 1 and 2 of the proposed List 2.

PIABA does not suggest that former 'claim specific' lists are appropriate. Rather, for Items 1 and 2 of List 2, language can be tailored for certain claims as has already been done for certain categories of documents within List 1.

3) All documents the customers received from the firm/associated persons and from any entities in which the customers invested through the firm/associated persons, including account opening documents and/or forms, prospectuses, research reports, annual and periodic reports, and correspondence. Unless contending non receipt of periodic account statements and/or confirmations sent in the ordinary course of business, the customers may satisfy the production requirements for these items by stipulating to the receipt of all such periodic account statements and confirmations, but must produce those periodic account statements and confirmations that have handwritten notations or that are not identical to those the firm sent.

PIABA has no objections to this Item.

4) All account statements for each securities firm where the customers have maintained an account for the three years prior to the first transactions at issue in the Statement of Claim through the date the Statement of Claim was filed. In the alternative, the customers shall provide a written authorization allowing the respondent firm/associated persons to obtain the account statements directly from each securities firm. If the customers elect to provide written authorization to the firm/associated persons to obtain the account statements, the customers must also provide all account statements in the customers' possession, custody, or control containing handwritten notes or that are not identical to those the firm sent.

> PIABA does not object to production of these documents or the alternative production of authorization for the firm to seek the documents directly. However, the time frame is excessive. Contrast the time frames in List 1 applicable to production of an associated person's commission reports. The information is limited both as to the nature of claims (solicited trading only) but also to a shorter time running from three months before, to three months after the trades at issue. There is less reason – in all cases – to require that a customer produce account statements at another firm beginning three years prior to the trading in question. The disparate treatment should be resolved in any event, with the shorter time frames being less burdensome for both firms and customers.

5) All documents, including agreements and forms, relating to accounts at the respondent firm or transactions with the respondent firm.

> PIABA does not oppose this Item.

6) All account analyses and reconciliations prepared by or for the customers relating to the accounts at the respondent firm or transactions with the respondent firm during the time period at issue.

> PIABA does not oppose this Item.

7) All notes, including entries in diaries or calendars, relating to accounts at the respondent firm or transactions at issue with the respondent firm.

> PIABA does not oppose this Item.

8) (a) All recordings and notes or logs of telephone calls or conversations about the customers' accounts or transactions at issue that occurred between the associated persons and the customers (and any person purporting to act on behalf of the customers).

> PIABA does not oppose this Item. We note, however, that recording of telephone calls can be unlawful in many states. If privileges attach to production of such documents (under the Fifth Amendment, for example), we trust that a customer should be allowed to assert such privilege.

(b) All telephone records evidencing telephone contact between the customers and the firm/associated persons.

> PIABA does not oppose this Item with one important clarification. In its Notice of Filing, and discussion therein concerning this item, FINRA states that for "claims alleging unauthorized trading, claimants are required to produce telephone records" evidencing phone contact with the associated person. However, the actual text of the rule does not reflect that language limiting presumptive production to unauthorized trading cases. PIABA believes this is an oversight, or error, in the final printing of List 2, Item 8 (b). We believe subsection (a) correctly states the proposal and is in accordance with FINRA's discussion. However, a careful reading of 8(b) indicates an error. Assuming that the FINRA discussion on page 54-55 of its filing is

correct, and the text of the final Item 8(b) mistakenly omits the 'unauthorized trading' limitations, PIABA would have no objection to this subsection. The language of List 2, Item 8(b) needs to be reviewed, compared to the discussion in Notice, and clarified.

PIABA would oppose a presumptive requirement to pay for and produce all telephone records in all cases. We note there is no such requirement of the associated person/firm and, again, believe there is an error in the text of Item 8(b).

9) All correspondence the customers (or any person acting on behalf of the customers) sent or received relating to the accounts or transactions at issue.

PIABA does not object to this request insofar as it calls for presumptive production of such correspondence between claimants and firms/associated persons. Nor does PIABA object to production of such non-privileged correspondence with third parties and that relates to financial matters. However, the item as proposed is overly broad and could impose undue burden in some situations.

10) Previously prepared written statements by persons with knowledge of the facts and circumstances related to the accounts or transactions at issue, including those by accountants, tax advisors, financial planners, associated persons, and any other third party.

PIABA does not object to this Item, noting that in accordance with the Rule Proposal and applicable state law, it does not call for privileged material.

11) (a) All Complaints/Statements of Claim and answers filed in all civil actions involving securities matters and securities arbitration proceedings in which the customers have been a party, and all final decisions or awards or non-confidential settlements entered in these matters through the date the Statement of Claim was filed.

This sub-part appears in the current Discovery Guide, and is reasonable for at least discovery purposes. PIABA does not object to this Item.

(b) If a person is a party to a confidential settlement agreement that by its terms does not preclude identification of the existence of the settlement agreement, the party shall identify the documents comprising the confidential settlement agreement. Although not presumptively discoverable, a confidential settlement agreement may be obtained with an order from the panel.

> Settlement agreements in securities matters typically have confidentiality clauses, usually at the insistence of brokerage firms. And, as this item appears to contemplate, some such agreements preclude the client from even acknowledging the existence of the settlement agreement. Many of these agreements have strict consequences for a client who breaches the confidentiality clauses, and any requirement to produce these agreements would trigger those consequences. This can create a dilemma where a customer is supposed to keep a prior settlement agreement confidential, but then is ordered to produce the agreement by a panel. In any event, this item does not appear to require a claimant to disclose an agreement whose very existence is subject to confidentiality. Assuming this reading of the item is correct, PIABA does not object to the Item standing alone.
>
> However, we note a seeming lack of corresponding obligations requiring firms/associated persons to produce settlement agreements. If the obligation is imposed on the claimant, the firm/associated person should likewise be obligated to produce these agreements, at least as pertains to the associated person or the transactions, or to the branch that might be implicated in such a settlement agreement. If the matter is a "product" case, then the firm should have to produce settlement agreements related to the investment at issue. This could easily be made part of proposed List 1, Item 10.

12) Documents showing the customers' ownership in or control over any business entity, including general and limited partnerships and closely held corporations. If the customers are Trustees, provide documents showing the accounts over which the customers have trading authority.

> We observe that this Item does not reference a time frame. A plain reading of the Item suggests the documents sought pertain to the customer's present holdings. This needs to be clarified. PIABA does not object to producing general information described in this Item, assuming the time frame is limited reasonably. In addition, to be relevant for presumptive discovery, the business related documents

should be limited to a listing of the business ownership/control, at least for purposes of initial presumptive production in all cases.

PIABA does not object to the section of this Item concerning Trustees, to the extent that a listing of accounts over which a customer has trading authority is sufficient, with personal information of non-parties redacted. However, provision should be made for professional trustees who may have dozens of trusts under their control. In such a case, this information should not be discoverable.

13) All documents the customers received, including documents found through the customers' own efforts, relating to the investments at issue in the Statement of Claim.

This Item is reasonable and PIABA does not object to the concept.

14) For claims alleging unauthorized trading, all documents the customers relied upon to show that the customers did not know about or consent to the transactions at issue.

This Item is reasonable. PIABA does not object.

15) All materials the customers received or obtained from any source relating to the transactions or products at issue, and all materials the customer received from any source relating to other investment opportunities, including research reports, sales literature, performance or risk data, prospectuses, and other offering documents, including documents intended or identified as being "for internal use only," and worksheets or notes.

This Item has two main parts. PIABA notes that the first phrase seems duplicative of Item No. 13, and is unnecessary. As to the remainder of the Item, PIABA respectfully submits that this request is confusing, overbroad both in time and scope of all materials, apparently without regard as to whether the customer bought the security, or even considered the security or investment opportunity. The ambiguities and overbreadth render this Item unduly burdensome. If this Item would require a customer to produce documents concerning an investment the customer considered (which is not entirely clear from the language) and which the customer decided not to invest in, the document would not be relevant for all cases. Such materials about investments, which the customer may not have even considered, would instead be relevant in few cases at most.

16) The customers' resumes.

PIABA does not object, and notes that the proposal does not require creation of a resume to satisfy this Item.

17) Documents showing the customers' complete educational and employment background or, in the alternative, a description of the customers' educational and employment background if not set forth in resumes produced under item 16.

PIABA does not object to this Item.

18) All documents related to the case at issue that the customers received by subpoena under Rule 12512 or by document request directed to third parties at any time during the case.

PIABA has no objection. This Item calls for production of material relevant at least for discovery purposes. As with other third party documents, PIABA notes that the Guide and applicable laws protect against production of privileged documents. PIABA also notes as a practical matter that parties might not receive subpoenaed documents until after the Discovery Guide deadline. The Guide should reference that production of these documents be within thirty days of the customer's receipt of the same.

19) To the extent that an insurance product that provides a death benefit is included in the Statement of Claim, the customers shall provide all insurance information received from an insurance sales agent or securities broker relating to such insurance.

PIABA does not object to this Item.

ESSENTIAL IMPROVEMENTS NEEDED TO PROTECT PUBLIC INVESTORS

The current Discovery Guide has perpetuated an improper and false understanding of the law in securities cases, whether they sound in negligence, fraud, equity or contract, and which find their way into FINRA arbitration. In essence, the current Discovery Guide propagates the myth that FINRA arbitrations are all about placing the customer on trial. To the extent that the proposed Guide lists extensive financial disclosure *presumptively* discoverable by all customers *in all cases*, that myth is perpetuated. Not only does such production unduly burden many investors, the Guide's pronouncement on this point almost certainly conveys to some arbitrators hearing an attendant discovery objection the belief that such documents are essential for all cases.

The industry often defends cases which are not otherwise defensible by attempting to prove that the customer was wealthy enough to have taken the risks involved, even if the wealthy customer was, in fact, extremely risk-averse, or had been deceived as to salient facts. The SEC has repeatedly rejected this concept. No one deserves to be lied to, especially when paying for investment services in an industry that touts professionalism and integrity. If a customer nearing retirement is lied to about liquidity of an investment, for example, it is irrelevant that the customer had some risky stocks at another firm eight years earlier.[1] If a customer gives an order which is not timely executed, it should not matter whether the customer was a pauper or a king. Yet by instructing arbitrators – in every customer case – that a broad reach into the customer's private financial information is presumptively justified - in every case - FINRA gives arbitrators the strong, yet erroneous, message that the customer's wealth, or lack thereof, is the critical issue in every case.[2]

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1. It is well-established that wealth of the customer (however accumulated) and sophistication are not bases for recommending risky investments, nor are they defenses to claims of unsuitability. See *Arthur Joseph Lewis*, 50 S.E.C. 747, 749 (1991) ("the fact that a customer ... may be wealthy does not provide a basis for recommending risky investments."); *David Joseph Dambro*, 51 S.E.C. 513, 517 (1993) ("Suitability is determined by the appropriateness of the investment for the investor, not simply by whether the salesman believes that the investor can afford to lose the money."); see also *Krull v.SEC*, 248 F.3d 907 (9th Cir. 2001) (giving deference to the SEC's interpretation of "unsuitability" under the NASD's Rules of Fair Practice) (citing *Alderman v. SEC*, 104 F.3d 285, 288 (9th Cir. 1997)).
2. Hellie could not ignore his instructions on the basis of [the customer's] prior transactions. . . . If, as Hellie claims, he was uncertain as to what [the customer] meant by "medium risk," he was not free to guess at its meaning by following [the customer's] prior course of trading. *In re Hellie*, 50 S.E.C. 611, 613-14 (1991)

Even in a suitability case, wholesale mining for financial records, in every such case, is both intrusive and unwarranted. If a 55 year old man bought a municipal bond fund 5 years ago upon his advisor's recommendation, the information he put on a car an application 8 years ago is of little consequence. Even if the customer no longer has the loan application, firms, using their tremendous credit check and other investigatory resources, will relentlessly seek subpoenas for even remote, trivial nuggets, and sometimes unfortunately will do so to harass and wear down the customer who dared to bring a claim.

In addition, the firms should have sufficient information in their possession about the suitability of recommendations to the customer. The test after all has not been what should the broker have learned, but rather has centered on what the customer disclosed, and what the broker knew about the security and the customer before making recommendations. By allowing broad, tangentially relevant discovery, the brokers are empowered to conduct essentially an improper *ex post facto* suitability profile for the customer who has had the temerity to file an arbitration claim. This is hardly consistent with investor protection goals.

For other cases such as unauthorized trading, bad executions, forgery, material omission and more, as noted above, there is virtually no credible reason to burden every such customer with expansive tax and financial disclosures in order to bring those claims.

The more principled approach at this time would be for FINRA to simply remove hugely broad financial fishing expeditions from the presumptively discoverable lists that are now proposed. At a minimum, FINRA can include limiting language, as FINRA has done for the industry in the Guide's introductory comments. The proposed Guide states:"not all firms have the same business operations model and certain items on the Lists may not be relevant in a particular case when the firm's business model …is taken into consideration". There is no compelling reason why some limiting instruction cannot also be provided to protect customers from intrusive, burdensome disclosure of potentially irrelevant private information in every single case, when at a minimum preliminary limiting language can be included in the Discovery Guide.

(footnotes and citations omitted); see also *DBCC v. Wayne Vaughn,* 1998 NASD Discip. LEXIS 47 (October 22, 1998) ("A customer's prior transactions, however, are not relevant in a suitability determination...").

CONCLUSION

The Discovery Guide is, and even with the proposed improvements will continue to be, deeply flawed. We understand that this is a natural outgrowth of the collaborative process which takes place as a precursor to the Guide's adoption and revision. Despite this historical approach to the Guide, we urge FINRA and the SEC to take a more proactive approach to ensure the primacy of investor protection, consistent with the stated mission of the Commission and the SROs.

Despite its continued shortcomings, PIABA views the proposed revisions to the Guide as a long overdue step in the direction of leveling the playing field in arbitrations. We support the rule's passage, and we urge FINRA and the Commission to continue to improve the Guide.

I thank the Commission for its consideration and attention to PIABA's comments. If you wish to discuss any aspect of this letter further, please do not hesitate to contact me.

Respectfully,
Scott R. Shewan
President

The following PIABA Comment Letter regarding *Release No. 34-62134/SR-FINRA-2010-022- Proposed Rule Change Amending the Codes of Arbitration Procedure to Increase the No. of Arbitrators on Lists Generated by the Neutral List Selection System* was submitted to the Securities and Exchange Commission by Scott R. Shewan on June 14, 2010.

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

Re: SR-FINRA-2010-022; Changes to List Selection

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I thank the Commission for the opportunity to comment on the above-referenced proposed changes to the list selection procedures contained in §§ 12403 and 12404 of the FINRA Customer Code of Arbitration Procedure and §§ 13403 and 13404 of the Industry Code of Arbitration Procedure. PIABA applauds FINRA's rule change and supports the proposal.

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 relating to arbitration, particularly those that impact the selection and appointment of arbitrators.

The Proposed Change Should Be Approved Because It Will Likely Decrease The Incidence of Appointment of "Extended List" Arbitrators

PIABA believes that because the proposed rule change would increase the number of arbitrators available for selection from eight to ten, while retaining the number of available strikes at four per party, the rule change is likely to decrease the incidence of appointments of arbitrators that the parties have not approved via administrative, so-called "extended list" appointments. This is so because under the proposed change even if the parties each exercise their maximum of four peremptory strikes in a given case, and if there is no duplication of peremptory strikes, there will in all instances be at least two arbitrators remaining on each list after the exercise of peremptory strikes. Further, in most instances there will in all likelihood be more than two arbitrators remaining after the exercise of the parties' peremptory strikes.

Under the current rules, it is not unusual for only one or two, or even zero, arbitrators to remain eligible for service in a given case after the exercise of peremptory strikes by the parties. If no remaining arbitrator is eligible to serve, FINRA then appoints an arbitrator without input from the parties. As a result of the proposed change, the number of cases in which no arbitrator remaining after the exercise of peremptory strikes is willing or able to serve will almost certainly be reduced. As such, under the proposed rule, it is more likely that all three arbitrators ultimately appointed to the panel will have been reviewed and vetted by the parties and will, at a minimum, not have been one of the four most objectionable arbitrators in the view of any party.

In PIABA's view, this rule change is important because it will reduce the number of instances in which an arbitrator is appointed with no input from or approval by the parties. Instances in which so-called "extended list" appointments result in appointment of an arbitrator who has, for example, repeatedly ruled against public customers, leave the public customer with limited recourse in seeking recusal or removal of the arbitrator and give rise to the perception that the FINRA arbitration process is not fair to public customers. Further, such appointments can obviously have an outcome-determinative effect that may be unjust in a given case. Put simply, it is fairer and more consistent with Anglo-American traditions that the trier of fact be selected with the full and informed input of the parties to the extent practicable.

Conclusion

For the above reasons, PIABA respectfully requests that FINRA approve the proposed changes to the Code of Arbitration Procedure as soon as possible. If this rule change does not completely eliminate the problem of off-list appointments, we have ideas for additional changes, which we will share with you at your request. Thank you for your consideration.

Respectfully,
Scott R. Shewan
President

The following PIABA Comment Letter regarding *Release No. 34-61938/SR-FINRA-2010-014- Proposed Rule Change Relating to FINRA Rule 9554 to Eliminate Explicitly the Inability-to-Pay Defense in the Expedited Proceedings Context* was submitted to the Securities and Exchange Commission by Scott R. Shewan on May 17, 2010.

Ms. Florence Harmon
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2010-014 Rule Proposal Regarding Inability-to-Pay Defense

Dear Ms. Harmon:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I thank you for the opportunity to comment on the above-referenced Rule Proposal to amend FINRA Rule 9554 regarding the 'Inability-to-Pay Defense'. 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 protect public investors, particularly those that impact the fairness of the arbitration process.

PIABA supports the proposed rule change which would eliminate the defense of 'inability to pay' an arbitration award in the context of expedited suspension proceedings by FINRA against that non-compliant member firm/associated person. The rule change will implement a substantial and positive step toward ensuring that more investors are paid when they win at arbitration. A natural consequence will also be enhanced confidence in the arbitration process overall.

Summary of Proposal

Under the current rules, when an award is found in favor of a customer claimant, a member firm or associated person has 30 days to pay the award or face discipline. The current framework allows for FINRA to suspend the firm or associated person for a failure to pay the award, but it also allows for certain defenses to a suspension, including an inability-to-pay defense.

Unpaid arbitration awards have long been a problem within the securities industry. According to a GAO study done in 2003, about 55% of the $100.2 million (totaling $55 million) awarded by NASD arbitration panels to investors went unpaid.[1] A similar report done in 2000 found that 80% of the $161 million awarded to securities customer claimants in 1998 went unpaid as well. While the incidence of unpaid awards has declined somewhat in recent times, even one such incident is unnecessary and unjust. Accordingly, we applaud FINRA in its proposal to extinguish this defense.

The amended rule will benefit certain customers, most obviously those who obtain an arbitration award against firms/associated persons reluctant or unable to pay with ease. In these instances, it is more likely is that firms or associated persons will find the means to honor the award or to make suitable arrangements with the customer. As stated in the SEC's release, the elimination of this defense should prompt reasonable settlement discussions between the parties when prudent, as well as to the payment of awards as required by FINRA rules.

Bankruptcy Defense Should Be Re-Considered

While PIABA believes that this proposed rule is a step in the right direction, it still gives the firm or associated person ways to avoid paying an award. The proposed rule allows a firm or associated person to avoid paying an award under four circumstances, including when a member or associated person files a petition for bankruptcy.

FINRA notes that a bankruptcy court may have the best ability to adjudicate a financial condition defense, and PIABA does not dispute this per se. However, this loophole for a firm or associated person to avoid paying an award and yet remain in this highly regulated industry without interruption, deserves closer scrutiny. This exception provides an escape hatch for the firm or associated person and potentially leaves a wronged investor with an unpaid award. As such, the bankruptcy defense is contradictory to the spirit of the proposed rule and should also be eliminated or restricted in its wholesale use. While the purpose of the proposed rule change includes protection of investors and the public interest, the bankruptcy defense works against that purpose. Simply put, if the firm fails to pay an award because of an inability to pay (whether through bankruptcy or not), that firm should not be allowed to remain active in an industry which is so heavily dependent

1. *Follow-up Report on Matters Related to the Securities Arbitration*, U.S. General Accounting Office, GAO 03-162R, pg. 9 (Apr. 11, 2003).

upon investor trust, until the bankrupt compensates the victorious investor or enters into a reasonable settlement regarding restitution.

In sum, PIABA supports the proposed rule change and urges the Commission to approve the same. We also submit that FINRA should eliminate or restrict the bankruptcy defense still available in expedited proceedings. Please do not hesitate to contact the undersigned if you have any questions regarding the comments herein.

Respectfully,
Scott R. Shewan
President

The following PIABA Comment Letter regarding *Release No. 34-61927/SR-FINRA-2010-012- Proposed Rule Change to Amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure)* was submitted to the Securities and Exchange Commission by Scott R. Shewan on May 11, 2010.

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

RE: **File No. SR-FINRA-2010-012**
Proposed Rule Change to Amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure)

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I thank the Commission for this opportunity to comment on the above-referenced rule change proposal that would amend FINRA Rule 8312 to expand the information released through BrokerCheck, and to provide for BrokerCheck dispute process. 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 protect public investors, particularly those that impact the scope of information available to the public.

PIABA supports the current rule proposal in its endeavor to expand BrokerCheck. Any proposal to increase the ease with which investors may gain information about those with whom they are doing business is a positive one. However, there is still room for the rule to go further.

As stated in its release, FINRA established BrokerCheck in 1988 to provide the public with information on the professional background, business practices, and conduct of FINRA members and their associated persons. In 2000, BrokerCheck was expanded to include formerly registered persons whose registration had terminated within two years. This past year, FINRA expanded BrokerCheck again to make certain information about formerly registered persons who have been the subject of a final regulatory action permanently available. FINRA has recognized the expanding role BrokerCheck now plays in the context of investor protection. Accordingly, FINRA proposes to: (1) expand the BrokerCheck disclosure period for formerly registered persons from two years to ten years; (2) permanently make publicly available certain information about former associated persons if any of the following applies: (i) the person was convicted of or pled *nolo contendere* to a crime; (ii) the person was the subject of a civil injunction in connection with investment-related activity or a civil court finding of involvement in a violation of any investment-related statute or regulation; or (iii) the person was named as a respondent or defendant in an investment-related, consumer-initiated arbitration or civil litigation which alleged that the person was involved in a sales practice violation and which resulted in an arbitration award or civil judgment against the person; and (3) make publicly available all historic customer complaints that were archived after the implementation of Web CRD.

Expansion of BrokerCheck Information Concerning Formerly Registered Persons

PIABA supports each of these amendments. BrokerCheck is no longer used solely to check on presently registered persons with whom investors are doing business. Moreover, FINRA recognizes that certain information should remain permanently available, regardless of when the formerly registered person left the industry. FINRA's main argument for making the information available centers around the potential that registered persons may move into other investment related industries, or otherwise remain in positions of trust with potential investors. This argument is well founded. We have witnessed time and again situations where a broker with numerous complaints leaves the securities industry, only to have the broker resurface and cause harm to unsuspecting consumers in yet another investment business. This scenario becomes more likely if the broker's record becomes unavailable to the public after two years. Accordingly, we urge the Commission to approve the proposal.

However, FINRA does not make a compelling argument as to why certain information should remain available permanently and why certain information should be removed after ten years. FINRA argues that the information proposed to be included permanently constitutes a final disposition; and that much of the information is available publicly through other means. While this may be true, it is not a compelling reason to exclude the remainder of the information from BrokerCheck after ten years. FINRA clearly recognizes that information about formerly registered persons remains relevant to the investing public. FINRA has instituted procedures whereby formerly registered persons may make comments on information appearing on BrokerCheck; therefore, the fact that the information FINRA proposes to remove after ten years does not constitute a final disposition is not a compelling concern. All of the information contained within BrokerCheck should remain available permanently. PIABA does fully support the expansion of the rule to eliminate the conditions on the reporting of historic customer complaints.

Uniformity of Available Information

PIABA does believe there is still room for further expansion of BrokerCheck. According to FINRA, "The CRD system is an online registration and licensing system for the U.S. securities industry, state and federal regulators, and self-regulatory organizations (SROs). The CRD system contains broker/dealer information filed on Forms BD and BDW and information on associated persons filed on Forms U4 and U5. The CRD system also contains information filed by regulators via Form U6. The CRD system contains administrative information (e.g., personal, organizational, employment history, registration, and other information) and disclosure information (e.g., criminal matters, regulatory disciplinary actions, civil judicial actions, and information relating to customer disputes) filed on these forms. FINRA operates the CRD system pursuant to policies developed jointly with the North American Securities Administrators Association (NASAA). FINRA works with the SEC, NASAA, other members of the regulatory community, and member firms to establish policies and procedures reasonably designed to ensure that information submitted to and maintained on the CRD system is accurate and complete."[1]

FINRA makes certain information contained in the CRD system available to the public through BrokerCheck. The public may either go to FINRA or to their state securities regulator to get information about firms or registered persons. If a member of the public contacts a state regulator for information about a registered (or formerly registered) person, the state may either use BrokerCheck itself, or provide the individual with a different CRD report. For example, if an individual contacts the Florida Office of Financial Regulation, the agency will provide the individual with a CRD report for any registered person who, at any point, was registered with Florida. The report that Florida generates is more expansive than the report that BrokerCheck generates. The CRD report contains more expansive information about registrations with previous employers, including the reason for termination,

1. See, Notice to Members 04-16, "NASD Adopts Rule 2130 Regarding Expungement of Customer Dispute Information From The Central Registration Depository"

any termination comment, as well as which registrations the individual held while employed with the firm. The report also details the position the individual had with each firm and whether the employment was investment related. The CRD report provides all exam information, including whether or not the individual has failed any exams. BrokerCheck simply tells the public which exams the individual has passed. The CRD report also indicates whether or not the individual has satisfied the continuing education requirements. To the extent the CRD provides access to historical or archived customer complaints, the current rule proposal has not addressed the discrepancy.

In sum, the information about registered (or formerly registered) persons is not uniform. In certain states, the public has access to a much broader spectrum of information. Because FINRA is the gatekeeper for this information, it should endeavor to ensure that the investing public has equal access to the information available. Investors in Florida should not be more protected than investors in New York.

BrokerCheck Dispute Process

With regard to the formalization of a process by which individuals may dispute information contained within BrokerCheck, PIABA supports the proposal. To the extent the process is already occurring, it should be codified. However, the process should not in any way apply to the reporting of customer complaints, the dispute of which should be covered by FINRA Rule 2080. PIABA recognizes the need for a formalized mechanism whereby FINRA may fulfill its obligation to ensure the accuracy of the CRD system, and by extension, BrokerCheck.

Conclusion

As FINRA recognizes, there are many different ways a financial professional may interact with an investor. To limit information available to the public because an individual has not worked in a registered capacity within the past ten years is somewhat arbitrary. If the person has a checkered past, the need to protect the public is that much greater. Therefore, PIABA urges FINRA to consider expanding the information permanently available to include all of the information otherwise available on BrokerCheck, and to consider expanding BrokerCheck to align it with the information made available by certain of the states.

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,
Scott R. Shewan
President

Notes & Observations