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Technical Editing Assistance: Creighton Hayes, J.D. Candidate, U.S.C. School of Law

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In this Issue

LETTER FROM THE EDITOR

Timothy A. Canning

In this issue of the *PIABA Bar Journal*, we are pleased to present three of the best student-written articles that were submitted to the James E. Beckley Writing Competition for 2010, sponsored by PIABA. Two other articles that also ranked highly in the Competition will be published in the next issue of the *PIABA Bar Journal*. The student articles have been subject to very minor, technical editing; what you read in here is exactly what the students wrote.

The three articles in this issue received the following awards:

First Place Winner: Art Gharibian, from Southwestern University, for his article, *Extending Fiduciary Duties To Broker-Dealers*.

Second Place Winner: Michael Geeraerts, from St Johns University, for the article, *Hackers Who Steal And Trade On Inside Information Finally Fear The Securities And Exchange Commission And Section 10(B).*

Third Place Winner: Aaron Stendell, from SMU, for his article *Structured Products Regulation in the Wake of the Financial Collapse.*

The purposes of the Competition are to promote greater interest in and understanding of the fields of securities arbitration and securities law and to encourage excellent legal writing skills in law students. As you are about to see, this year's submissions reflect that purpose very well.

The Competition is named after James E. Beckley, who was a passionate securities arbitration activist and an accomplished scholar. Mr. Beckley was well known for defending and promoting the rights of public investors. Along with his advocacy skills, he was as a prolific and outstanding writer. Mr. Beckley served on the Securities Industry Conference on Arbitration, an organization created at the request of the Securities and Exchange Commission to maintain and update the Uniform Code of Arbitration for securities arbitration, and to serve as a sounding board on issues of fairness in arbitration. At the time of his death in 1999, Mr. Beckley was the President of PIABA.

This competition and award has been established to honor his legacy.

PIABA will once again be sponsoring the James E. Beckley Writing Competition for 2011; submissions will be due October 3, 2011. Please check the PIABA website for more details on deadlines and requirements.

I hope you will enjoy the articles in this special issue of the *PIABA Bar Journal*. And congratulations to all the student authors who worked so hard on their articles.

Tim Canning
Editor-in-Chief
PIABA Bar Journal

EXTENDING FIDUCIARY DUTIES TO BROKER-DEALERS: YES, WE CAN & YES, WE SHOULD

Artin Gharibian[*]

I. INTRODUCTION

With three simple words – Yes We Can – President Barack Obama won the hearts and minds of millions of Americans and became the 44th President of the United States of America. President Obama, then-senator, spoke those words almost three years ago during a time when America's economy was in no apparent danger. A time when the Dow Jones Industrial Average had reached record highs, soaring above 14,000 points.

Since then, however, America's economy has been hard hit by the global financial crisis. A crisis in which Americans witnessed the Federal Government bail out financial institutions like Citigroup and Bank of America, only to witness others collapse, such as financial giants Lehman Brothers and Bear Stearns. In the midst of the financial turmoil, investor confidence plummeted, the financial markets crumbled, and politicians scrambled to find a solution.

As these events unfolded, many investors were left holding risky investments, most of which were represented as safe and secure. As a result, arbitration claims filed with the Financial Industry Regulatory Authority (FINRA) sky-rocketed. In defending these cases, broker-dealers took a hard-line approach, labeling the global financial crisis as the "perfect storm" and a "once-in-a-century credit tsunami." Wall Street – ironically – blamed the very financial markets and credit rating agencies it was responsible for maintaining.

But as much as these events propelled America's economy towards a recession, they also cleared the path towards much needed financial reform. During the summer of 2009, President Obama proposed sweeping overhaul of the United States financial regulatory system, calling it "a transformation on a scale not seen since the reforms that followed the Great Depression."

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*Art Gharibian graduated from Southwestern Law School in December, 2010. He was a full time judicial extern to the honorable Stephen J. Hillman, Chief Magistrate Judge, United States District Court, Central District of California, and was also Chair of the Moot Court Honors Program. His article was the first place winner for PIABA's 2010 James E. Beckley Securities Arbitration and Law Writing Competition. Mr. Gharibian may be reached at agharibian@swlaw.edu.

One year later, on July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which among other measures, includes provisions for creating a uniform fiduciary standard for professionals who provide personalized investment advice to customers.

Currently, the fate of a uniform fiduciary standard rests in the hands of the U.S. Securities and Exchange Commission (SEC). Specifically, section 913 of the Dodd-Frank Act gives the SEC the authority to write rules that would create a uniform fiduciary standard for broker-dealers. The SEC, however, can only create these rules after it studies the effectiveness of existing standards of care for broker-dealers and investment advisers. As it stands now, investors who turn to financial professionals often do not realize that there is significant difference between the standards of care of brokers and investment advisers.

Accordingly, this Comment will argue that a uniform fiduciary standard will protect investors by increasing their chances of succeeding in cases under Rule 10b-5 of the Securities Exchange Act of 1934. Part II will provide a brief overview of the different standards of care of broker-dealers and investment advisers. Part III will conclude by examining the proposed uniform fiduciary standard's impact on securities litigation and arbitration in connection with the "Prospectus Defense," which is a common defense used by brokerage firms in Rule 10b-5 cases.

II. BROKER-DEALERS VS. INVESTMENT ADVISERS: A BRIEF OVERVIEW

In 2005, the SEC recognized the importance of creating a uniform fiduciary standard for professionals providing investment advice to customers, calling for a study to address whether brokers who provide financial advice should be subjected to fiduciary obligations normally imposed on advisers.[1] Four years later, the financial crisis paved the way for the Obama Administration to propose major financial reform "to increase fairness for investors."[2] One such way of increasing fairness was to "establish a fiduciary duty for broker-dealers offering investment advice and

1. *See Certain Broker-Dealers Deemed Not to Be Investment Advisers*, Exchange Act Release No. 34-51523, 70 Fed. Reg. 20424 (Apr. 19, 2005) (proposing study that would address whether "broker-dealers who provide investment advice but who are excepted from the Investment Advisers Act [should] nonetheless be subject to the fiduciary obligations imposed by that Act on investment advisers").

2. *See* U.S. DEPT. OF TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, 71 (2009).

harmonize the regulation of investment advisers and broker-dealers."[3]

As the Obama Administration recognized, investors who turn to financial professionals for investment advice are often either unaware of or confused about the differences between broker-dealers and investment advisers.[4] Indeed, in a 2008 report, the authors concluded that many survey participants "did not understand key distinctions between investment advisers and broker-dealers — their duties, the titles they use, the firms for which they work, or the services they offer."[5] Specifically, although broker-dealers and investment advisers often provide the same financial services, they are regulated under different frameworks.

Investment advisers, who are regulated under the Investment Advisers Act of 1940,[6] are held to a fiduciary duty standard of care, which requires them to act in the best interests of their clients and make full and fair disclosure to clients with respect to conflicts of interest.[7] Although the Advisers Act does not expressly impose a fiduciary duty upon investment advisers, the United States Supreme Court, in *SEC v. Capital Gains Research Bureau*, *Inc*.,[8] evaluated the history of the Advisers Act and found that Congress intended for the Act to be interpreted broadly.[9] The Supreme Court

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3. *Id*.

4. *Id*.

5. *See* Angela Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers*, 112, 117 (2008), *available at* http://www.sec.gov/news/press/ 2008/2008-1_randiabdreport.pdf.

6. The Advisers Act describes an investment adviser at "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." 15 U.S.C. § 80b-2(a)(11) (2010).

7. *See Information for Newly-Registered Investment Advisers* (Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations) (stating that investment advisors "have a fundamental obligation to act in the best interests of [their] clients and to provide investment advice in [their] clients' best interests. [They] owe [their] clients a duty of undivided loyalty and utmost good faith. [They] should not engage in any activity in conflict with the interest of any client…" *available at* http://www.sec.gov/divisions/investment/advoverview.htm.

8. 375 U.S. 180 (1963).

9. *Id*. at 195.

then held that Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers by operation of law.[10] Years later, the Supreme Court, in *Transamerica Mortgage Advisors*, *Inc. v. Lewis*,[11] reaffirmed that the Advisers Act established "federal fiduciary standards" for investment advisers.[12]

Conversely, broker-dealers, who are regulated under the Securities Exchange Act of 1934,[13] are not held to a fiduciary standard of care in most states, but rather, a "suitability" standard of care and "know your customer"[14] requirement. The Financial Industry Regulatory Authority (FINRA),[15] formerly known as the National Association of Securities Dealers (NASD),[16] imposes upon broker-dealers suitability and due diligence obligations when recommending investments to customers.[17] Specifically, Rule 2310(a) outlines the "suitability" obligation, providing that in recommending securities to customers, 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."[18] With respect to due

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10. *See id*. at 195-96.

11. 444 U.S. 11 (1979).

12. *Id*. at 17-18.

13. The Exchange Act defines a broker to include "any person engaged in the business of effecting transactions in securities for the account of others," while a dealer is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. §§ 78c (a)(4), (a)(5) (2010).

14. *See* NYSE Rule 405, DILIGENCE AS TO ACCOUNTS.

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

16. In July 2007, the NASD officially changed its name to FINRA and its internet domain from www.nasd.com to www.finra.org. *See* FINRA's News Release, *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA*, *available at* http://www.finra.org/Newsroom/NewsReleases/2007/p036329 (last visited Aug. 27, 2010).

17. *See* FINRA Rule 2310, RECOMMENDATIONS TO CUSTOMERS (SUITABILITY).

18. *Id*.

diligence, subsection (b) of the rule places an affirmative duty on the broker before a recommended order can be executed to "make reasonable efforts to obtain information concerning the customer's financial status; the customer's tax status; the customer's investment objectives; and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[19]

III. THE UNIFORM FIDUCIARY STANDARD'S IMPACT ON THE PROSPECTUS DEFENSE IN RULE 10b-5 CASES

The line of demarcation between broker-dealers and investment advisers has not protected investors from fraudulent and deceptive acts. Instead, many investors have been lured into a false sense of security by placing their trust and confidence in their brokers, only to later find out that their brokers did not owe them a fiduciary duty. Consequently, the absence of a fiduciary relationship has left investors vulnerable to securities fraud, which has been one of the main factors that led to the financial crisis.

A particular area where this is apparent is where investors rely on their brokers' advice only to later find out that their reliance was unjustifiable, barring them from recovering any damages. In securities litigation and arbitration cases, the concept of "justifiable reliance" has become a reoccurring theme through what has commonly become known as the "Prospectus Defense."[20] To defeat the prospectus defense, investors must "justify" their reliance on their broker's oral representations that contradicted risk disclosures in written materials, such as a prospectus.[21]

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19. *Id*.

20. The scope of this Comment is limited to material misrepresentations since material omissions do not require positive proof of reliance. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972) (explaining that when deceit arises from nondisclosure in a Rule 10b-5 cases, positive proof of reliance is not a prerequisite to recovery).

21. Section 2(10) of the 1933 Securities Act broadly defines "prospectus" to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . . ." 15 U.S.C. § 77b(a)(10) (2010); *see also* Gustafson v. Alloyd Co., Inc., 513 U.S. 561, 574-75 (1995).

According to the SEC, delivery of a prospectus does not absolve a broker of liability for misleading oral statements.[22] As an independent United States governmental agency, the SEC is responsible for enforcing federal securities laws and regulating the securities industry.[23] Within this enforcement context, the SEC has held that, "a registered representative may be found in violation of the NASD's rules and federal securities laws for failure to fully disclose risks to customers even though such risks may have been discussed in a prospectus delivered to the customers."[24] In fact, the SEC – in its commitment to protecting investors – has long held that "those who sell securities by means of representations inconsistent with [information in prospectuses] do so at their peril."[25]

As the largest self-regulatory organization for all securities firms in the United States, FINRA also adheres to this principle. FINRA regulates firms by adopting and enforcing rules and regulations.[26] In publishing *Regulatory Notices*, FINRA provides brokerage firms with timely information on a variety of issues, such as recently approved rules and amendments, proposed rules on which FINRA solicits comment, and legal interpretations and guidance relating to existing rules.[27] A review of these notices reveals that FINRA has taken the position that risk disclosures in a prospectus do not insulate brokers from responsibility for making oral representations that contradict written risk disclosures.[28]

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

23. http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 27, 2010).

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

25. *See Ross*, 41 S.E.C. at 510.

26. http://www.finra.org/AboutFINRA/index.htm (last visited Aug. 27, 2010).

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

28. *See* NASD Notice to Members 94-16, *NASD Reminds Members Of Mutual Fund Sales Practice Obligations* (Mar. 1994); *see also* NASD Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds*, at 49 (Feb. 2003); NASD Notice to Members 03-71, *NASD Reminds Members of Obligations When Selling Non-Conventional Investments*, at 765 (Nov. 2003); NASD Notice to

Despite the SEC's and FINRA's position that delivery of a prospectus should not absolve broker-dealers of liability for oral misrepresentations, the prospectus defense often comes into play in Rule 10b-5 cases. Specifically, if investors bring a claim under Rule 10b-5 of the Securities Exchange Act of 1934,[29] the prospectus defense may apply because Rule 10b-5 requires justifiable reliance as an element.[30] In determining justifiable reliance, courts use an eight-factor balancing test,[31] which was first employed by the Tenth Circuit in *Zobrist v. Coal-X Inc.*[32] Under this balancing test, courts examine the following factors: (1) the plaintiff's sophistication and expertise in financial and security matters; (2) whether a long standing business or personal relationships exist between the plaintiff and the defendant; (3) the plaintiff's access to relevant information; (4) *whether the defendant owed a fiduciary relationship to the plaintiff*; (5) whether the defendant concealed

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

29. Rule 10b-5 provides that "it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2010).

30. Rule 10b-5's language does not support a reliance requirement; however, since Rule 10b-5 is an implied cause of action, courts defined its elements and incorporated the reliance element from common law deceit. *See* Dunn v. Borta, 369 F.3d 421, 430 (4th Cir. 2004) ("Such federal claims have no statutorily-defined elements; rather, they were judicially created. And because the causes of action under section 10(b) and Rule 10b-5 are implied, the responsibility of defining those claims rests with the courts."); *see also* Basic v. Levinson, 485 U.S. 224, 243 (1988) (noting that reliance is an element of a Rule 10b-5 cause of action).

31. *See*, *e.g.*, Kennedy v. Josephthal & Co., 814 F.2d 798, 804-05 (1st Cir. 1987); Brown v. E.F. Hutton Group, Inc., 991 F.2d. 1020, 1032 (2d Cir. 1993); Myers v. Finkle, 950 F.2d 165, 168 (4th Cir. 1991); Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991); Davidson v. Wilson, 973 F.2d 1391, 1400 (8th Cir. 1992); Atari Corp. v. Ernst & Whinney, 981 F.2d 1025, 1029 (9th Cir. 1992); Zobrist v. Coal-X Inc, 708 F.2d 1511, 1516 (10th Cir. 1983); Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989).

32. 708 F.2d 1511 (10th Cir. 1983).

the fraud; (6) the plaintiff's opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.[33]

However, if the SEC adopts a uniform fiduciary standard, courts will have to modify the balancing test in Rule 10b-5 cases involving oral misrepresentations. Under this modified version, courts will no longer need to determine whether a fiduciary relationship exists (*i.e*., Factor No. 4), because a fiduciary relationship will always exist between investors and broker-dealers. The potential impact under this model is significant. While the existence of a fiduciary relationship is not a controlling factor in a court's justifiable reliance analysis,[34] the existence of a fiduciary relationship appears to increase an investor's chances of defeating the prospectus defense in 10b-5 cases. Indeed, a review of case law examining whether investors were justified in relying on their brokers' oral misrepresentations is telling. In cases in which a *fiduciary duty did not exist*, courts have often found that the investor's reliance was *unjustifiable*.[35] In contrast, in cases in which a *fiduciary duty existed*, courts have often found that the investor's reliance was *justifiable*.[36] Therefore, the existence of a uniform fiduciary standard will provide investors with strong evidence to succeed in 10b-5 cases by overcoming the justifiable reliance element.

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

34. *See* cases cited *supra* note 31.

35. *See, e.g., Kennedy*, 814 F.2d at 805; *Zobrist*, 708 F.2d at 518-19; *Brown*, 991 F.2d at 1032-33; *Davidson*, 973 F.2d at 1400-1401; Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1030 (4th Cir. 1997).

36. *See, e.g., Myers*, 950 F.2d at 168-69; *Bruschi*, 876 F.2d at 1530; Carr v. Cigna Sec., Inc., 95 F.3d 544, 548 (7th Cir. 1996); Holdsworth v. Strong, 545 F.2d at 696-97 (10th Cir. 1976); *Molecular Tech. Corp*., 925 F.2d at 918.

The notion that the existence of a fiduciary relationship will enable investors to satisfy the justifiable reliance element in 10b-5 cases stems from the fact that a breach of fiduciary duty cause of action *does not* require reliance as an element.[37] According to both the Restatement (First) and Restatement (Second), "a fiduciary relation exists between two persons when one of them is under a duty to act for or to give *advice* for the benefit of another upon matters within the scope of the relation."[38] Under this standard, providing advice is an integral part of a fiduciary duty relationship. In fact, advice has taken over as the primary service performed by broker-dealers.[39] For years now, broker-dealer registered representatives have been labeling themselves as financial advisers, financial consultants, financial representatives, and investment specialists.[40] Since reliance on advice is a key component to a fiduciary relationship, investors should be entitled to rely on their brokers as fiduciaries, and therefore, not have to justify their reliance. For example, in discussing a fiduciary obligation, one commentator has explained:

> This missing element of reliance is perhaps one of the more interesting and often misunderstood aspects of the fiduciary obligation. Although many cases discuss the question of whether a borrower actually relied on the lender, and, if so, whether such reliance was reasonable under the circumstances, the *fiduciary relation does not require reliance, reasonable or otherwise.* One scholar expressed this point quite clearly when he wrote, "*the law entitles the entrustor to rely on the fiduciary's trustworthiness. The entrustor is therefore not required to show that he actually relied on the fiduciary* and the fiduciary has the burden of justifying self-dealing transactions."[41]

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

38. RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) (emphasis added).

39. *See* Letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Jonathan G. Katz, Secretary, SEC, Sept. 24, 2004, *available at* http://www.consumerfed.org/pdfs/broker-dealer_rule_comment_ltr_09202004.pdf.

40. *See* Hung, et al., *supra* note 5, at 74.

41. Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719, 731 (1994) (quoting

Further support for such a proposition is inherent in the nature of a fiduciary obligation with respect to trust and honesty. The Third Circuit, in *Straub v. Vaisman & Co.*,[42] perhaps explained it best, stating:

> A sophisticated investor is *not barred by reliance upon the honesty* of those with whom he deals in the absence of knowledge that the trust is misplaced. Integrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts.[43]

With this principle in mind, the court rejected the defendant's argument that the investor's lack of due diligence rendered his reliance unreasonable.[44] The court explained that the broker "abused this trust [between him and the investor] to promote a transaction which otherwise would have been received with caution" by exploiting the business relationship in which the broker knew the investor was not likely going to investigate the merits of the recommendations.[45]

Since integrity is the mainstay of commerce, the presence or absence of some type of fiduciary relationship, whether it be imposed by law or as a matter of fact based on a long standing relationship of trust and confidence, should justify an investor's failure to investigate misrepresentations. For example, in *Zobrist*, the court charged the investor with constructive knowledge of the written risk disclosures found in the Private Placement Memorandum, and therefore, held that the investor's reliance on the

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Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 824-25 (1983)) (emphasis added); *see also* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (explaining that "a fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior").

42. 540 F.2d 591 (3d Cir. 1976).

43. *Id*. at 598 (emphasis added); *see also* Professional Serv. Indus. v. Kimbrell, 834 F. Supp. 1289, 1301-03 (D. Kan. 1993) (finding reliance unjustifiable in the absence of a long-standing business relationship and fiduciary duty. "The absence of such a relationship would give PSI less reason to trust the Kimbrells, and thus weighs in Kimbrell's favor."); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 631 (1996) (explaining that "[o]nce a broker successfully cultivates trust, willing reliance by the sophisticated investor . . . is quite likely and, for that reason alone, worthy of some protection").

44. *Straub*, 540 F.2d at 598.

45. *Id*.

defendants' oral misrepresentations was unjustified.[46] While weighing the factors, the court appeared to be mainly concerned with the fact that the defendants did not conceal their fraud from the investor since "they provided him with information and warnings which exposed the representations as false."[47] Under those circumstances, the court found that the investor acted recklessly "by intentionally closing his eyes to and failing to investigate the contradiction between the misrepresentations and the information in the memorandum."[48] In short, the apparent lack of due diligence by the investor trumped the intentional misrepresentations by the defendants.[49]

Although the investor's apparent failure to investigate the misrepresentations in the face of contradictory written risk disclosures appeared to be the court's primary concern in *Zobrist*, the absence of a fiduciary relationship and the lack of evidence of any long standing business or personal relationship also contributed to the court's finding.[50] Specifically, the court stated that while it was true the investor – who was a sophisticated businessman – had previously participated in investments with the broker, there was no evidence of any long standing business or personal relationship that would have justified the investor's reliance on the broker's oral misrepresentations.[51]

Therefore, if a uniform fiduciary standard existed at the time *Zobrist* was decided, the outcome should have been different. The existence of such a standard likely would have, at the very least, filled the void of a long standing business or personal relationship, which would have in turn, justified the investor's reliance on the misrepresentations. For instance, in limiting its holding, the court stated that "[w]e do not say that such reliance might not be justified under *different factual circumstances*."[52] The existence

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46. 708 F.2d 1511, 518 (10th Cir. 1983).

47. *Id*.

48. *Id*. at 1518-19.

49. *See id*.

50. *Id.*

51. *Id.*

52. *Zobrist*, 708 F.2d at 1518 (emphasis added); *see also* Carr v. Cigna Sec., Inc., 95 F.3d 544, 548 (7th Cir. 1996) (limiting its holding like *Zobrist*, stating, "[w]e do not say that a written disclaimer provides a safe harbor in every fiduciary case. Not all principals of fiduciaries are competent adults; not all disclaimers are clear; and the relationship may involve such a degree of trust invited by and reasonably reposed in the fiduciary as to dispel any duty of self-protection by the principal.)" Therefore,

of a fiduciary relationship would have undeniably created a different circumstance, providing the investor a compelling reason, and thus, justification for accepting his broker's contradictions.

A different factual circumstance, however, was not necessary in finding that the investor's reliance was justified. According to Judge Holloway's dissenting opinion in *Zobrist*, he would have found in the investor's favor under the current factual circumstances of the case without the existence of a fiduciary relationship. Therefore, the existence of a fiduciary relationship should have been *more* than enough to find the investor's reliance justifiable. Specifically, in rejecting the investor's apparent recklessness, Holloway opined that "the federal policy of deterring intentional misconduct in securities dealings outweighs the policy of deterring negligent behavior by investors."[53] Holloway further explained that "[t]he majority's resolution of this issue defeats the main purpose of the securities law to protect from fraud and misrepresentation, unsoundly striking the balance in favor of the wrongdoers by penalizing a plaintiff for his neglect or recklessness in not discovering the defendants' intentional wrongs."[54] Therefore, "[t]he defendants are instead exonerated by a theory of constructive knowledge imputed to the plaintiff of the defendants' exculpatory boilerplate. Fashioning such a rule favoring those found guilty of knowing misconduct frustrates the important policy of the securities law and the [10b-5] Rule."[55] As a result, Holloway would have ruled in the investor's favor irrespective of whether a fiduciary relationship existed.

The Tenth Circuit's holding in *Holdsworth v. Strong*[56] further supports the proposition that a fiduciary relationship would have altered the outcome in *Zobrist.* In this case, on the basis of misrepresentations by a close business and personal friend, the plaintiff sold his stock in the corporation without first examining the corporate books and records.[57] Under those circumstances, the court found that the plaintiff's reliance was justifiable

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Carr further supports the proposition that the existence of a fiduciary relationship or a long standing relationship will provide an investor with evidence to succeed in a 10b-5 claim despite the receipt of a prospectus that contradicted oral representations.

53. *Zobrist*, 708 F.2d at 1522 (Holloway, J., dissenting).

54. *Id*.

55. *Id.* at 1520; *see also* Luksch v. Latham, 675 F. Supp. 1198, 1203 n.7 (N.D. Cal. 1987) (noting the force of Judge Holloway's dissent).

56. 545 F.2d 687 (10th Cir. 1976).

57. *Id*. at 689.

despite his sophistication and failure to investigate because the defendant had carefully cultivated the plaintiff's trust and confidence over a long period of time, and then used that trust to encourage the sale.[58]

With this in mind, the investor in *Zobrist* – despite his sophistication and apparent recklessness in failing to investigate the misrepresentations – should have been able to meet the justifiable reliance element if a uniform fiduciary duty existed at the time his case was decided. Specifically, like the investor in *Zobrist*, the investor in *Holdsworth* was sophisticated and failed to investigate the misrepresentations.[59] However, the court – unlike *Zobris*t – found that the investor's reliance was justified.[60] The key to reaching this conclusion was, of course, due to the existence of a long standing personal relationship.

A further review of circuit decisions in this context further reveals that the absence or presence of some form of a fiduciary relationship is often determinative on whether an investor's reliance is justifiable. While applying the eight-factor balancing test from *Zobrist*, the First Circuit, in *Kennedy v. Josephthal & Co*.,[61] found that the investors unjustifiably relied on their broker's oral misrepresentations.[62] In reaching this conclusion, the court found that although the investors had previously dealt with a particular broker from the brokerage firm, the investors did not deal with that same broker with respect to the investment at issue.[63] Under those circumstances, the court stated that the existence of a fiduciary duty was suspect since "[t]here was no record of trust between appellants [the investors] and Sinclair [broker]."[64] The court's reference to the investors' prior dealings with a specific broker from the brokerage firm implies that if the investors had dealt with that same broker with respect to the investment at issue, there might have been the trust necessary to find the investors' reliance justifiable.

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58. *Id.* at 696-97.

59. *Id*.

60. *See id.*

61. 814 F.2d 798 (1st Cir. 1987).

62. *Id*. at 805.

63. *Id.*

64. *Id*.

The Second and Eight Circuits have also found reliance unjustifiable in the absence of a fiduciary relationship. In the Second Circuit case of *Brown v. E.F. Hutton Group*, *Inc*.,[65] none of the investors alleged the existence of a fiduciary relationship or of a longstanding business or personal relationship with the brokerage firm or its brokers.[66] The court, after weighing additional factors, ultimately concluded that the investors' reliance was unjustifiable as a matter of law.[67] Likewise, the Eighth Circuit, in *Davidson v. Wilson*,[68] did not find a fiduciary or longstanding relationship of trust between the investors and broker.[69] Although both cases, like many others, discussed other *Zobrist* factors in ultimately finding investors' reliance unjustifiable, the common missing factor in these cases was some sort of fiduciary relationship.[70]

Conversely, in cases in which courts found an investor's reliance justifiable, a fiduciary relationship was present. In *Myers v. Finkle*,[71] the Fourth Circuit held that summary judgment was inappropriate since there were genuine issues of material of fact as to whether there was a long standing personal and business relationship between the investors and defendants.[72] Specifically, the investors had claimed that they were "social friends" with the defendants, and had worked with them for years prior to the transaction at issue.[73] And in *Bruschi v. Brown*,[74] the Eleventh Circuit stated

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65. 991 F.2d. 1020 (2d Cir. 1993).

66. *Id*. at 1032.

67. *Id*. at 1033.

68. 973 F.2d 1391 (8th Cir. 1992).

69. *Id*. at 1400-01.

70. *See also* Banca Cremi, S.A. v. Alex. Brown & Sons, 132 F.3d 1017, 1030 (4th Cir. 1997) (finding reliance unjustifiable. Defendants "were not the agents of the Bank, but rather interacted with the Bank at arm's length in principal-to-principal dealings, and no common law fiduciary duty was ever created."); Foremost Guar. Corp. v. Meritor Sav. Bank, 910 F.2d 118, 125 (4th Cir. 1990) (finding reliance unjustifiable. "There [was] no evidence of a long standing relationship between the insurers and EPIC" and "there was no fiduciary relationship between EMI and the insurers. As a result, any dealings between EMI and the insurers should have been conducted as an arm's-length transaction").

71. 950 F.2d 165 (4th Cir. 1991).

72. *Id*. at 169.

73. *Id*. at 168.

that "[the broker] was [the investor's] investment advisor and was more knowledgeable as to the economic and tax risks of the investment" and "as [the investor's] offeree representative [the broker] undertook a fiduciary obligation to act in [the investors] best interests."[75] The common denominator in these cases was the *presence* of some sort of fiduciary relationship, not the *absence* of a fiduciary relationship like in cases in which an investor's reliance was unjustifiable.[76]

Accordingly, although courts claim that no one factor from the eight-factor balancing test is determinative on whether an investor's reliance is justifiable, a closer examination reveals a different story. The presence or absence of some type of fiduciary relationship, whether it be imposed by law or as a matter of fact based on a long standing relationship of trust and confidence, is a key factor, and perhaps the most determinative factor, in cases involving Rule 10b-5 claims. This appears to be the case even in circumstances involving sophisticated investors who received a prospectus that contradicted their broker's oral representations. Indeed, common sense dictates that investors should be entitled to rely on their fiduciary's trustworthiness, and therefore, not be required to prove that their reliance was justified.[77]

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74. 876 F.2d 1526 (11th Cir. 1989).

75. *Id*. at 1530.

76. *See also* Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991) (finding that a reasonable juror could conclude that plaintiffs did not act recklessly in relying on alleged misrepresentations reliance. None of the plaintiffs personally knew or had a fiduciary relationship with the defendants).

77. The author of this Comment is currently working on a sequel to this Comment entitled: *Unjustifying the Justifiable Reliance Element in Rule 10b-5 Cases* in which it is argued that since the presence of a fiduciary relationship often results in courts finding that investors were justified in relying on their brokers' oral misrepresentations, justifiable reliance in 10b-5 cases should be presumed or not required at all. In fact, justifiable reliance should not be required irrespective of whether the SEC adopts a uniform fiduciary standard. Indeed, the Supreme Court, in Basic v. Levinson, 485 U.S. 224, 243 (1988), has stated that "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." However, the Court also recognized that "[t]here is . . . more than one way to demonstrate the causal connection." *Id*. Moreover, since a Rule 10b-5 cause of action is implied, courts defined its elements and incorporated the reliance element from common law deceit. *See* Dunn v. Borta, 369 F.3d 421, 430 (4th Cir. 2004); RESTATEMENT (SECOND) OF TORTS § 525 (1977). The Supreme Court, however, has stated that "[a]ctions under Rule 10b-5 are distinct from common-law deceit and

IV. CONCLUSION

The financial crisis has left many investors holding risky investments that were marketed as safe and secure in which broker-dealers did not have their customers' best interests in mind. Consequently, securities fraud cases filed through FINRA increased during this time. In defending these cases, broker-dealers often utilize the "Prospectus Defense," seeking to avoid accountability for their fraudulent and deceptive acts. A uniform fiduciary standard, however, will alleviate these problems. Since most investors primary reason for seeking and retaining financial professionals, such as brokers and investment advisers, is to receive and rely on financial advice, a uniform fiduciary standard will ensure that all financial professionals providing investment advice act in the best interests of their customers. In addition, since investors should be entitled to rely on their financial professionals as fiduciaries, a uniform fiduciary standard will give investors the evidence they need to overcome the justifiable reliance element in Rule 10b-5 cases. After all, when brokers provide investment advice and seek to gain investor trust, it only makes sense to hold them to the same fiduciary standard as investment advisers.

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misrepresentation claims." *See Basic*, 485 U.S. at 244 n.22 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-745 (1975)). In addition, section 12(a)(2) of the Securities Act of 1933 does not require reliance as an element to recover damages. *See* Haralson v. E.F. Hutton Group, Inc., 919 F.2d 1014, 1032-33 n.10 (5th Cir. 1990) ("We do not suggest that a purchaser has any duty to find out the truth under section 12(a)(2) . . . indeed, a purchaser who is actually ignorant that a seller's representation is inaccurate or incomplete may recover even though the full truth is apparent from materials in her possession. The concept of a plaintiff's constructive knowledge has no place in section 12(a)(2) actions."); *see also* Wright v. Nat'l Warranty Co., 953 F.2d 256, 262 (6th Cir. 1992) ("Unlike a Rule 10b-5 claim, however, reliance on alleged misrepresentations or omissions is not an element of a section 12(a)(2) cause of action. Because of this, a purchaser's investment sophistication is immaterial to a section 12(a)(2) claim. A purchaser has no duty to investigate a seller's possible fraud and need not verify a statement's accuracy."). Likewise, most states' blue-sky statutes (state securities acts) also do not require investors to prove reliance. *See* Bowden v. Robinson, 136 Cal. Rptr. 871, 877-78 (Ct. App. 1977) (stating that California's blue sky act "conspicuously avoids the requirement of actual reliance. The legislature is again expressing its intention to afford the victims of securities fraud with a remedy without the formidable task of proving common law fraud [which requires reliance])."

HACKERS WHO STEAL AND TRADE ON INSIDE INFORMATION FINALLY FEAR THE SECURITIES AND EXCHANGE COMMISSION AND SECTION 10(b)

*Michael Geeraerts**

> Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-á-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.[1]

INTRODUCTION

ABC, Inc. ("ABC") is scheduled to report their quarterly earnings after the stock market close. The earnings are negative and are likely to cause ABC's stock price to decline. ABC hires a well respected investor relations firm to release the earnings to the public after the stock market close. Just prior to the earnings release, a computer hacker[2] "breaks into" the investor relations firm's computer system and steals the earnings information. The hacker now knows the earnings are negative and that ABC's stock price will probably decline once the earnings are publicized. Therefore, the hacker

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* Michael Geeraerts is a CPA in his third year at St. John's University School of Law. Mr. Geeraerts will graduate in June 2011 and will start with a tax firm in Fall 2011. His article was the second place winner for PIABA's 2010 James E. Beckley Securities Arbitration and Law Writing Competition. Mr. Geeraerts may be reached at mgeeraerts@gmail.com.

1. United States v. O'Hagan, 521 U.S. 642, 658–59 (1997) (citations omitted).

2. The term "hacker" is defined as a person who obtains "unauthorized access to and subsequent use of other people's computer systems." PAUL A. TAYLOR, HACKERS: CRIME IN THE DIGITAL SUBLIME xi (1999). *Cf.* Beryl A. Howell, *Real-World Problems of Virtual Crime*, *in* CYBERCRIME 87, 89 (Jack M. Balkin, James Grimmelmann, Eddan Katz, Nimrod Kozlovski, Shlomit Wagman, & Tal Zarsky eds., 2007) (stating that hacking is not a defined term).

purchases put options[3] in ABC stock that will increase in value if ABC's stock declines. The earnings are released and, as expected, ABC's stock plummets, resulting in the hacker realizing a substantial profit.[4]

The Securities and Exchange Commission's ("SEC") power to regulate the securities markets from the wrongful conduct just described stems from section 10(b) of the Securities Exchange Act of 1934. Section 10(b) prohibits manipulation[5] or deception[6] when trading securities.[7] In pertinent part, it states:

> It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or *deceptive* device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . .[8]

Pursuant to § 10(b), the SEC has promulgated Rule 10b-5, which makes it "unlawful for any person. . . [t]o employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security."[9] Rule 10b-5, created by the SEC based on Congress's § 10(b) delegation of rulemaking authority to the SEC, is limited by § 10(b)'s "deceptive" requirement.[10]

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3. A put option gives the owner the right to sell a fixed number of shares at a fixed price before the option contract's expiration date. *See* Deutschman v. Beneficial Corp., 841 F.2d 502, 504 (3d Cir. 1988). The value of the option contract itself is related to the underlying stock price. *See id.*

4. This scenario is based on SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009).

5. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977) ("[Manipulation] generally refers to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.") (citations omitted).

6. *See infra* Parts I and II (analyzing the deceptive requirement under § 10(b)).

7. *See* 15 U.S.C. § 78j (2006).

8. § 78j(b) (emphasis added).

9. 17 C.F.R. § 240.10b-5(a) (Supp. II 2007).

10. United States v. O'Hagan, 521 U.S. 642, 651 (1997) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976)); SEC v. Cuban, No. 3:08-CV-2050-D, 2009 WL 2096166, at *11 (N.D. Tex. July 17, 2009) ("The SEC's rulemaking authority under § 10(b) is bounded by the statute's proscription of conduct that is manipulative or deceptive.").

The essence of § 10(b) is to assure orderly and fair securities markets,[11] especially after the 1929 stock market crash.[12] The recent stock market downfall and economic turmoil has made the need for fair markets even more crucial.[13] Congress understood that the markets would evolve, intending that § 10(b) and the SEC's power would be amenable to economic and technological changes.[14] Computers and the internet, however, have challenged the SEC's regulatory power.[15]

Hackers, like the one in the introduction, would traditionally escape § 10(b) liability.[16] This is due to the judicial interpretation that "deceptive" under § 10(b) requires a breach of a fiduciary[17] duty. Generally, hackers do

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11. *See* H.R. REP. NO. 94-229, at 91–92 (1975) (Conf. Rep.) ("The basic goals . . . [are] to assure that dealing in securities is fair and without undue preferences or advantage among investors, . . . and to provide, to the maximum degree practicable, markets that are open and orderly.").

12. *See* SEC v. Zandford, 535 U.S. 813, 819 (2002) ("Among Congress' objectives in passing the Act was 'to insure honest securities markets and thereby promote investor confidence' after the market crash of 1929." (quoting *O'Hagan*, 521 U.S. at 658)).

13. The SEC has recently filed another high profile insider trading case involving a $2 billion investment advisor. *See* Complaint, SEC v. Galleon Management, LP (S.D.N.Y. filed Oct. 16, 2009) (No. 09-CV-8811).

14. *See* H.R. REP. NO. 94-229, at 92 (1975) (Conf. Rep.) ("This bill is an important step in assuring that the securities markets and the regulation of the securities industry remain strong and capable of fostering these fundamental goals *under changing economic and technological conditions*.") (emphasis added).

15. *See* Robert A. Prentice, *The Internet and its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 265–67 (1999).

16. There is a lack of cases dealing with whether hacking is deceptive under § 10(b); two securities fraud cases that did concern hacking resulted in no opinions which to rely on. *See* SEC v. Blue Bottle Ltd., No. 07-CV-1380, 2007 WL 580798 (S.D.N.Y. Feb. 26, 2007) (default judgment); SEC v. Lohmus Haavel & Visemann, No. 05-CV-9259, 2005 WL 3309748 (S.D.N.Y. Nov. 8, 2005) (settled).

17. "[O]ne who owes to another the duties of good faith, trust, confidence, and candor." BLACK'S LAW DICTIONARY 658 (8th ed. 2004). *See also* 17 C.F.R. § 240.10b5-2 (Supp. II 2007) (stating when a fiduciary duty arises). However, a fiduciary duty between two parties must be agreed to by both parties either expressly or implicitly. *See* United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (en banc) (citing Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980)); SEC v. Cuban, No. 3:08-CV-2050-D, 2009 WL 2096166, at *10 (N.D. Tex. July 17, 2009). Further, a "relationship of trust and confidence" similar to a

not owe a fiduciary duty to the victim of the hack or the counterparty to the securities transaction.[18] Thus, § 10(b) liability has never applied to a hacker who is a corporate outsider owing no fiduciary duty.[19]

The fiduciary duty requirement has left a gap in the SEC's power to regulate the markets.[20] The gap has been further widened because many courts have extended the fiduciary duty requirement to affirmative misrepresentation cases instead of limiting it to nondisclosure cases. For example, the Fifth Circuit in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.* concluded that all § 10(b) cases require a breach of a fiduciary duty for conduct to be deceptive.[21] The court claimed that the ordinary definition of "deceptive" was irrelevant because the Supreme Court defined "deceptive" to require a breach of a fiduciary duty in all § 10(b) cases.[22] The Fifth Circuit criticized other courts by stating that "[i]t is by losing sight of the limits that [§ 10(b)] places on [Rule 10b-5], and by ascribing, natural, dictionary definitions to the words of the rule, that the. . . courts have gone awry."[23]

The Fifth Circuit and other likeminded courts misapplied the Supreme Court precedent that defined "deceptive" because the Supreme Court's holdings were limited to nondisclosure.[24] Holding traders liable under § 10(b) and Rule 10b-5 for affirmative, deceptive acts is not a new concept as the Supreme Court has never held that affirmative fraud, unlike nondisclosure, required a breach of a fiduciary duty.[25] Hackers commit

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fiduciary duty will suffice. *Chestman*, 947 F.2d at 569; United States v. Kim, 184 F. Supp. 2d 1006, 1010–11 (N.D. Cal. 2002).

18. Deception and fiduciary duty under § 10(b) are discussed in detail *infra* Parts I and II.

19. *See* SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009) ("For, as the SEC even acknowledges, in the 74 years since Congress passed the Exchange Act, no federal court has *ever* held that the theft of material non-public information by a corporate outsider and subsequent trading on that information violates § 10(b).") (emphasis in original).

20. *See id.*

21. *See* 482 F.3d 372, 384, 387–89 (5th Cir. 2007).

22. *See id.*

23. *Id.* at 387.

24. *See infra* Part I.

25. *See infra* Part II.

affirmative fraud when they breach a computer's security measures to obtain confidential financial information.[26] Therefore, this Note argues that hackers should be held liable under § 10(b) and Rule 10b-5 for trading on stolen, nonpublic information.

Part I of this Note briefly discusses three important Supreme Court cases—all nondisclosure cases—that deal with the deception requirement of § 10(b). Part II demonstrates that § 10(b) precedent dealing with affirmative misrepresentation does not require a breach of a fiduciary duty for conduct to be deceptive. Part III analyzes *SEC v. Dorozhko*,[27] the case the opening hacker scenario is based on. The Southern District of New York kept up with the prevailing belief that a § 10(b) violation may only be found if a hacker owed a fiduciary duty.[28] The Second Circuit, however, did not analyze hacking under one of the insider trading theories—briefly discussed in Part I.A—but as an affirmative misrepresentation that does not require the breach of a fiduciary duty.[29] Part IV argues that hacking is deceptive regardless of the hacking method used, which is contrary to the Second Circuit's view in *Dorozhko* that hacking would only be deceptive if the hacker falsely identified himself. Part V discusses the policy reasons for holding hackers liable under § 10(b) and argues that the SEC is well equipped to regulate hackers. This Note concludes that the Second Circuit's decision in *Dorozhko* finally grants the SEC the appropriate power to regulate fraudulent hackers who trade in the securities markets.

I. SUPREME COURT PRECEDENT CONSTRUING A FIDUCIARY DUTY REQUIREMENT IS LIMITED TO NONDISCLOSURE CASES

The majority of courts and commentators hold the view that the SEC "cannot establish a violation of § 10(b) absent a breach of a fiduciary duty to disclose" in *any* case.[30] The fiduciary duty requirement, however, was a

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26. *See infra* Part IV.

27. 574 F.3d 42 (2d Cir. 2009).

28. SEC v. Dorozhko, 606 F. Supp. 2d 321, 330–36 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009).

29. *Dorozhko*, 574 F.3d at 51.

30. *Dorozhko*, 606 F. Supp. 2d at 338; Carolyn Silane, *Electronic Data Theft: A Legal Loophole for Illegally-Obtained Information—A Comparative Analysis of U.S. and E.U. Insider Trading Law*, 5 SETON HALL CIR. REV. 333, 339 (2009).

judicial creation because neither the legislative history nor the text of § 10(b) defined "deceptive."[31] The Supreme Court has stated that there can be *no deception without some breach of a fiduciary duty* in cases dealing with *nondisclosure* of material,[32] nonpublic financial information.[33] The leading case on nondisclosure is *Chiarella v. United States*, where an employee of a printer deduced the concealed names of corporations that were the target of takeover bids.[34] Chiarella purchased target companies' stock and, once the takeovers were announced, he sold the shares at a profit.[35] The Court stated that the "case concern[ed] the legal effect of [Chiarella's] silence,"[36] and "the element required to make silence fraudulent—*a duty to disclose*—is absent in this case."[37] To get to this rule, the Court applied the common law of nondisclosure and misrepresentation.[38] "At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to consummation of a transaction commits fraud only when he is under a duty to do so."[39] Therefore, it is common law that serves as the basis for the Supreme Court's § 10(b) fiduciary duty requirement because a breach of a fiduciary duty has generally been required for nondisclosure to be actionable under common law.

In contrast to *Chiarella*, a breach of a fiduciary duty was found in *United States v. O'Hagan*.[40] O'Hagan, a partner at a law firm that was representing a corporation in a tender offer, bought the corporation's stock before the tender offer announcement.[41] As a partner, O'Hagan owed his law firm and

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31. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980).

32. Materiality is based on reasonableness determined on a case-by-case basis. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 239–40 (1988).

33. *See Chiarella*, 445 U.S. at 235; United States v. O'Hagan, 521 U.S. 642, 660–61 (1997).

34. *Chiarella*, 445 U.S. at 224.

35. *Id.*

36. *Id.* at 226.

37. *Id.* at 232 (emphasis added).

38. *Id.* at 227–28.

39. *Id.*

40. 521 U.S. 642 (1997).

41. *Id.* at 647. O'Hagan did not work on the tender offer. *Id.*

clients a fiduciary duty.[42] Therefore, O'Hagan was deceptive by *not disclosing* to the firm and client his intent to trade on the confidential information.[43] Nevertheless, O'Hagan would *not* have violated the "disclose or abstain from trading"[44] principle had he told the law firm and client that he was going to purchase securities based on the unpublicized information.[45]

The fiduciary duty requirement was again reiterated in *SEC v. Zandford*.[46] The Court stated that disclosing the intent to breach a fiduciary duty absolved any deception in connection with trading securities.[47] Zandford was a securities broker who persuaded an elderly client to open a discretionary account and granted Zandford a general power of attorney to trade without approval.[48] Thereafter, Zandford sold securities in the client's account and transferred the sales proceeds to Zanford's personal account.[49] The Court found that Zandford owed the client a fiduciary duty,[50] but stated that if Zandford informed the client of his intent to steal the client's money, the breach of the fiduciary duty would not be deceptive.[51] These three cases, among others,[52] led to the *belief* that deception under § 10(b) required a fiduciary duty under all circumstances even though those cases dealt only with nondisclosure.[53] Therefore, illegal insider trading under § 10(b) has

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42. *See id.* at 660.

43. *Id.*

44. Chiarella v. United States, 445 U.S. 222, 227 (1980).

45. *O'Hagan*, 521 U.S. at 655.

46. 535 U.S. 813 (2002).

47. *Id.* at 825 n.4.

48. *Id.* at 815.

49. *Id.*

50. *Id.* at 823.

51. *Id.* at 825 n.4.

52. *See, e.g.*, Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 384, 387–89 (5th Cir. 2007); SEC v. Cherif, 933 F.3d 403, 412 (7th Cir. 1991).

53. *See, e.g.*, Silane, *supra* note 30, at 339 ("Supreme Court precedent makes it abundantly clear that a breach of a fiduciary duty, or some derivation thereof, must occur for conduct to be deemed 'deceptive.' ").

only been found if there has been a breach of a fiduciary duty. The next section outlines the insider trading theories the SEC usually argues in Rule 10b-5 cases.

A. *THE FOUR INSIDER TRADING THEORIES*

Insider trading liability has generally been found on one of four theories: (1) traditional; (2) tipper-tippee; (3) temporary insider; or (4) misappropriation.[54] First, under the traditional theory, a corporate insider is liable under § 10(b) and Rule 10b-5 for trading on material, nonpublic information.[55] Liability is premised on the breach of a fiduciary duty a corporate insider, such as a chief executive officer, owes to shareholders.[56]

The second theory, tipper-tippee liability, is derivative of the traditional theory and occurs when a corporate insider informs a corporate outsider of material, nonpublic information that the outsider trades on.[57] The tippee[58] is liable "only when an 'insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.' "[59]

Under the third theory, also derivative of the traditional theory, temporary insiders, such as lawyers, accountants, underwriters, and consultants are granted access to inside information in order to perform some service.[60] "This theory clothes an outsider with temporary insider status when the outsider obtains access to confidential information solely for corporate purposes in the context of a special confidential relationship. The

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54. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 564–67 (2d Cir. 1991) (en banc); SEC v. Dorozhko, 606 F. Supp. 2d 321, 331–33 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009); SEC v. Kornman, 391 F. Supp. 2d 477, 483–84 (N.D. Tex. 2005).

55. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

56. *See id. See also supra* note 17 (discussing fiduciary duty).

57. *See, e.g.*, *Chestman*, 947 F.2d at 565.

58. A tippee is a corporate outsider who receives information from a corporate insider. *See* Dirks v. SEC, 436 U.S. 646, 656 (1983).

59. *Chestman*, 947 F.2d at 565 (quoting *Dirks*, 463 U.S. at 655).

60. *See id.*

temporary insider thereby acquires a correlative fiduciary duty to the corporation's shareholders."[61]

Lastly, the misappropriation theory holds a *corporate outsider* liable when he "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[62] All four insider trading theories *rest on some breach of a fiduciary duty*, as Justice Ginsburg stated in *O'Hagan*:

> The classical[, tipper-tippee, and temporary insider theories] target[] a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.[63]

Under the prevailing insider trading theories, the misappropriation theory is the most fitting for an internet hacker who is a corporate outsider.[64] The problem, however, is that a hacker generally owes no fiduciary duty to the source of the information—the victim of the hack.[65] Therefore, the affirmative fraud theory must be used to bring a hacker's conduct under § 10(b).

II. CASE LAW ON AFFIRMATIVE SECURITIES FRAUD

Courts have made clear that § 10(b) should be flexibly and liberally construed,[66] avoiding strict categories that allow people who do not fall into

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61. *Id.* (internal quotations omitted).

62. United States v. O'Hagan, 521 U.S. 642, 652 (1997). The SEC has provided examples of when a duty exists for the misappropriation theory: (1) agreeing to "maintain information in confidence;" (2) "a history, pattern, or practice of sharing confidences[;]" and (3) "information obtained from . . . [a] spouse, parent, child, or sibling[.]" 17 C.F.R. § 240.10b5-2 (Supp. II 2007). *But cf.* SEC v. Cuban, No. 3:08-CV-2050-D, 2009 WL 2096166, at *13 (N.D. Tex. July 17, 2009) (limiting the application of Rule 10b5-2 because of § 10(b)'s deception requirement).

63. *O'Hagan*, 521 U.S. at 652–53.

64. *See* Prentice, *supra* note 15, at 296.

65. *See infra* Part III (analyzing a recent hacking case).

66. *See* Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 12 (1971) ("Section 10(b) must be read flexibly, not technically and restrictively. Since

one to be free from liability despite have committed a wrong.[67] As stated by the Second Circuit, "[w]hile the 'fraud' at which 10b-5 is aimed obviously includes the classical examples of misrepresentation and nondisclosure . . . , it is by no means limited to that type of illegality."[68] The following case law demonstrates that § 10(b) liability may stem from an affirmative fraud even where a fiduciary duty is lacking. The Southern District of New York in *United States v. Teyibo*[69] addressed affirmative misrepresentation, finding that a fiduciary duty was not necessary.[70] The court stated:

> [T]he indictment does not seek to hold the defendant accountable for the non-disclosure of material facts, but rather for numerous affirmative misrepresentations allegedly made in furtherance of a scheme to defraud. Consequently, Teyibo's reliance upon *Dirks v. Securities and Exchange Commission*[71] and *Chiarella v. United States*[72] is misplaced as those cases dealt with the obligations of fiduciaries to disclose information.[73]

The Third Circuit, as stated in *Deutschman v. Beneficial Corp.*, also shares the view that a breach of a fiduciary duty is not necessary in affirmative misrepresentation cases.[74] The corporate officers in *Deutschman*

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there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b) . . . .").

67. *See* Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975) ("Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws.").

68. Green v. Santa Fe Indus. Inc., 533 F.2d 1283, 1289–90 (2d Cir. 1976), *rev'd on other grounds*, 430 U.S. 462 (1977). *See also* A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967) ("We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes . . ., whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.").

69. 877 F. Supp. 846 (S.D.N.Y. 1995).

70. *See id.* at 862.

71. 463 U.S. 646 (1983).

72. 445 U.S. 222 (1980).

73. *Teyibo*, 877 F. Supp. at 862.

74. Deutschman v. Beneficial Corp., 841 F.2d 502,506–07 (3d Cir. 1988).

made intentional, misleading statements about the corporation to the public.[75] The corporation had suffered losses that reduced its stock value; however, the Chief Executive Officer and Chief Financial Officer both issued statements assuring investors that the problems were resolved and no longer posed any adverse effects for the corporation.[76] Investors relied on those statements and purchased options in the corporation's stock.[77] The district court dismissed the complaint because the investors lacked standing to sue as option holders.[78] More important here, the court held that the corporate officers did not owe a fiduciary duty to the investors because they were only option holders and not stockholders.[79] The Third Circuit reversed, holding that the investors did have standing to sue as option holders and that affirmative misrepresentations do not require a breach of a fiduciary duty in § 10(b) cases.[80]

Nine years before *Chiarella v. United States*,[81] the Supreme Court in *Superintendent of Insurance of New York v. Bankers Life and Casualty Co.*[82] hinted that affirmative fraud is a different matter than mere nondisclosure.[83] *Bankers Life* dealt with a prospective purchaser's elaborate scheme to buy all the stock of a company with the company's own money.[84] The end result was the company was tricked into selling its securities that were then used to pay for the purchaser's acquisition of the stock without the company receiving any of the sales proceeds.[85] While the purchaser owed a fiduciary duty to the company as a controlling stockholder,[86] the Court stated the

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75. *Id.* at 503–04.

76. *Id.*

77. *Id.* at 503.

78. Deutschman v. Beneficial Corp., 668 F. Supp. 358 (D. Del. 1987), *rev'd*, 841 F.2d 502 (3d Cir. 1988).

79. *Id.*

80. *See Deutschman*, 841 F.2d at 506–07.

81. 445 U.S. 222 (1980).

82. 404 U.S. 6 (1971).

83. *Id.* at 12.

84. *See id.* at 7–8.

85. *See id.* at 8.

86. *See id.* at 12.

fiduciary relationship was irrelevant to its holding[87] because the purchaser affirmatively misrepresented his actions to the company.[88] As previously stated, the Supreme Court in *Chiarella* adopted the common law to establish the need for a fiduciary duty in § 10(b) nondisclosure cases.[89] Accordingly, common law should also apply to § 10(b) affirmative fraud cases, which do not require a breach of a fiduciary duty.[90] Therefore, *Teyibo*, *Deutschman*, *Bankers Life*, and *Chiarella* support the contention that § 10(b) does not require a fiduciary duty in affirmative fraud cases.[91] The next part explores the hacking scenario outlined in the introduction and the Second Circuit's position that hacking is an affirmative fraud, not mere nondisclosure.

III. THE SECOND CIRCUIT LOOKS BEYOND THE FIDUCIARY DUTY REQUIREMENT

Recently, in *SEC v. Dorozhko*,[92] the Second Circuit became the first court to hold that hacking violates § 10(b) because hacking is an affirmative misrepresentation that does not require a breach of a fiduciary duty.[93] On October 17, 2007, Oleksandr Dorozhko, a Ukranian citizen, hacked into Thomson Financial's ("TF") computer network and obtained the earnings report of IMS Health, Inc. ("IMS"), a publicly traded corporation.[94] TF hosted IMS's investor relations website for years and "provided secure

87. *See id.* at 10.

88. *See id.* at 8, 12.

89. *See supra* notes 37–39 and accompanying text.

90. *See* Chiarella v. United States, 445 U.S. 222, 227–28 (1980).

91. *See,e.g.*, Deutschman v. Beneficial Corp., 841 F.2d 502, at 506 (3d Cir. 1988) ("Nothing . . . can be construed to require the existence of a fiduciary relationship between a section 10(b) defendant and the victim of that defendant's affirmative misrepresentation."). *See also* Liebhard v. Square D Co., 811 F. Supp. 354, 355–56 (N.D. Ill. 1992) (finding that affirmative misrepresentations do not require a fiduciary relationship for Rule 10b-5 liability); Robert Steinbuch, *Mere Thieves*, 67 Md. L. Rev. 570, 574 n.30 (2008) (citing affirmative misrepresentation cases).

92. 574 F.3d 42 (2d Cir. 2009).

93. *Id.* at 51.

94. SEC v. Dorozhko, 606 F. Supp. 2d 321, 323, 325 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009).

webcasting and audiocasting services for. . . public release of earnings information."[95] IMS publicized that its earnings would be released after the stock market close on October 17, 2007 on TF's website.[96] As IMS had done previously, IMS sent TP PowerPoint slides that contained the earnings information, which TF transformed into a protected format on their secure server.[97] Afterwards, Dorozhko hacked into TF's servers and viewed IMS's earnings report.[98]

As the trading day was nearing its close, Dorozhko purchased all available IMS put options through his Interactive Brokers LLC account, which he had recently opened.[99] When the market closed, IMS's stock traded at $29.56 per share; however, due to the negative earnings release after the close, IMS's stock opened the next morning at $21.20 per share.[100] Immediately after the market opening, Dorozhko sold his 630 IMS put options, realizing a profit of $286,456.[101] Dorozhko's transactions in IMS options were his first trades in his newly opened account and raised suspicion; therefore, Interactive Brokers LLC froze his account and referred the matter to the SEC.[102]

The Southern District of New York held that Dorozhko did not violate § 10(b).[103] The court supported its holding by stating that " 'the [Supreme] Court, in its other cases interpreting Section 10(b), has established that a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure.' "[104] Dorozhko, a corporate outsider, did not owe

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95. *Id.* at 325. TF "provides similar services to many Fortune 500 companies." *Id.*

96. *Id.*

97. *Id.* at 325–26.

98. *Id.* at 326.

99. *Id.* at 324–26. It is noteworthy that the options Dorozhko purchased were American-style options set to expire two days after his purchase. *Id.* at 326. Therefore, Dorozhko would have lost a substantial amount, if not all, of his investment if IMS's stock did not severely decline in the two days. *See id.*

100. *Id.* at 326.

101. *Id.* at 326–27.

102. *Id.* at 327.

103. *Id.* at 330.

104. *Id.* at 330 (quoting Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 389 (5th Cir. 2007) (alteration in original).

a fiduciary duty to either IMS, TF, or IMS shareholders.[105] The court, however, denied Dorozhko's motion to dismiss because the SEC pled that an IMS insider provided Dorozhko with the earnings.[106] As long as Dorozhko knew the alleged tipper owed a duty to shareholders, Dorozhko would be liable for insider trading under the tipper-tippee theory.[107] Additionally, the court denied the SEC's motion for a preliminary injunction to freeze Dorozhko's assets, but stayed a temporary restraining order to give the SEC time to appeal.[108]

On appeal, the Second Circuit vacated the District Court's order denying the SEC's motion for a preliminary injunction because Dorozhko's hack was an affirmative fraud, not nondisclosure.[109] Under affirmative fraud "the SEC need not demonstrate a breach of a fiduciary duty[.]"[110] The court also remanded the case to the District Court to determine "whether the computer hacking in this case involved a fraudulent misrepresentation that was 'deceptive' within the ordinary meaning of Section 10(b)."[111] The Second Circuit was able to negate the District Court's, and the Fifth Circuit's,[112] finding that the Supreme Court defined deceptive as always requiring a fiduciary duty by distinguishing between nondisclosure and misrepresentation.[113]

According to the Second Circuit, the District Court's, and the legal profession's,[114] reliance on *Chiarella*, *O'Hagan*, and *Zandford* was misplaced.[115] Those three cases dealt with silence; therefore, the Second Circuit believed the fiduciary duty requirement was limited to cases

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105. *Id.* at 336.

106. *Id.* at 343.

107. *See supra* notes 57–59 and accompanying text.

108. *Dorozhko*, 606 F. Supp. 2d at 343.

109. SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

110. *Id.*

111. *Id.*

112. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 389–90 (5th Cir. 2007).

113. *Dorozhko*, 574 F.3d at 49.

114. *See, e.g.*, Silane, *supra* note 30, at 339.

115. *Dorozhko*, 574 F.3d at 48.

involving nondisclosure.[116] The Second Circuit limited the Supreme Court's definition of "deceptive" to nondisclosure cases and stated that "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[117] "In its ordinary meaning, 'deceptive' covers a *wide spectrum* of conduct involving cheating or trading in falsehoods."[118] The dictionary definition of deceptive is "tending to deceive."[119] Deceive means "trickery" and "to deprive by fraud."[120] Thus, cheating, lying, or tricking another person—or computer—is deceptive.

According to the Supreme Court, common law has generally required a breach of a fiduciary duty for nondisclosure to be fraudulent, but an affirmative misrepresentation is fraudulent with or without a fiduciary duty.[121] Simply put, fraud is deceptive.[122] As discussed in Part II, courts have held that affirmative misrepresentation constitutes a § 10(b) violation. Therefore, the Second Circuit held that "misrepresentations are fraudulent, but [that] silence is fraudulent only if there is a duty to disclose."[123] Misrepresentations include "false statements, deceptive actions, and half-truths."[124] With the increased use of the internet and its technological intricacies, the Second Circuit's aim is to increase the SEC's regulatory power by holding that hacking is a deceptive, affirmative misrepresentation that does not require a breach of a fiduciary duty. Since violations of § 10(b) require deception that is " 'in connection with' the purchase or sale of

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116. *Id.* at 49–50.

117. *Id.* at 51.

118. *Id.* at 50 (emphasis added) (citation omitted).

119. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 585 (1993).

120. *Id.* at 584.

121. *See* Chiarella v. United States, 445 U.S. 222, 227–28 (1980). *See also* RESTATEMENT (SECOND) OF TORTS §551 (1977) (requiring a fiduciary duty for nondisclosure). *But see* RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1981) (stating that nondisclosure is actionable if done in bad faith).

122. *See* Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 12 (1971).

123. SEC v. Dorozhko, 574 F.3d 42, 50 (2d Cir. 2009) (quoting Brief of Plaintiff-Appellant SEC at 44, SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV)).

124. Brief for Plaintiff-Appellant SEC, *supra* note 123, at 42.

securities[,]"[125] the next section argues that hacking meets the "in connection with" requirement.

A. *THE IN CONNECTION REQUIREMENT*

In many § 10(b) cases, the defendant's deception relates to the securities' value and would easily meet the "in connection with" requirement.[126] Hackers, however, are generally not deceptive about the value of the securities they are trading since their deception occurs during the acquisition of the information when they hack and steal it, as was the case in *Dorozhko*.[127] Nonetheless, the "in connection with the purchase or sale of any security"[128] requirement in § 10(b) is still satisfied because the deceptive act does not have to directly tie to the purchase or sale of the security, such as lying about the value of stock.[129] The Supreme Court has stated that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act."[130] The test is whether the "fraud coincided" with the transaction.[131] A hack and subsequent purchase of securities are "not independent events."[132] Also, there is no need for the deception to occur to an "identifiable purchaser or seller[,]" but only in connection with the purchase or sale of *any* security.[133]

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125. SEC v. Dorozhko, 606 F. Supp. 2d 321, 328 (S.D.N.Y. 2008), *vacated*, 547 F.3d 42 (2d Cir. 2009).

126. *See, e.g.*, Deutschman v. Beneficial Corp., 841 F.2d 502, 503–04, 506 (3d Cir. 1988).

127. *See Dorozhko*, 574 F.3d at 51.

128. 15 U.S.C. § 78j(b) (2006).

129. *See* SEC v. Zandford, 535 U.S. 813, 819 (2002). *But cf.* Moran v. Kidder Peabody & Co., 617 F. Supp. 1065, 1068 (S.D.N.Y. 1985) (finding that misrepresentations unrelated to specific securities did not satisfy Rule 10b-5's requirements).

130. *Zandford*, 535 U.S. at 819.

131. *Id. See* United States v. O'Hagan, 521 U.S. 642, 656 (1997); SEC v. Rocklage, 470 F.3d 1, 10 (1st Cir. 2006).

132. *See Zandford*, 535 U.S. at 820.

133. *O'Hagan*, 521 U.S. at 658. *Cf. id.* at 679 (Scalia, J., concurring in part and dissenting in part) (stating that the deceptive act must be aimed at the counterparty to the securities transaction).

The "in connection" test was met in *Dorozhko* because the fraud coincided with the transaction.[134] "The hack and subsequent purchases were clearly part of a single scheme, which was not complete until the securities transactions took place."[135] Dorozhko hacked into Thomson Financial to obtain confidential, unreleased earnings for the sole purpose of buying stock options; his hack coincided with the purchase of options. Having met the "in connection with" requirement, the next Part analyzes the crucial element of a § 10(b) violation—deception.

IV. HACKING IS A DECEPTIVE ACT THAT TRIGGERS § 10(b) LIABILITY

Computer hacking is fraudulent and, therefore, deceptive under § 10(b). Under the Computer Fraud and Abuse Act ("CFAA"), one who "knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value" violates the CFAA.[136] While a violation of the CFAA, or some other fraud statute, is helpful in proving that hacking is deceptive, it is not dispositive.[137] The SEC argued in *Dorozhko* that "when a hacker penetrates a system that was designed to provide access to confidential information to a limited set of authorized individuals, *he misrepresents his identity and authority*."[138]

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134. SEC v. Dorozhko, 606 F. Supp. 2d 321, 329 (S.D.N.Y. 2008), *vacated on other grounds*, 574 F.3d 42 (2d Cir. 2009).

135. *Id.* (citing *Zandford*, 535 U.S. at 824–25). The "in connection" with requirement was not challenged on appeal. SEC v. Dorozhko, 574 F.3d 42, 46 n.3 (2d Cir. 2009).

136. 18 U.S.C.A § 1030(a)(4) (Supp. III 2008).

137. The CFAA does not require deception. *See id.*; eBay Inc. v. Digital Point Solutions, Inc., 608 F. Supp. 2d 1156, 1164 (N.D. Cal. 2009) ("[T]he CFAA only requires a showing of unlawful access; there is no need to plead the elements of common law fraud to state a claim under the Act." (citing Hanger Prosthetics & Orthotics, Inc. v. Capstone Orthopedic, Inc., 556 F. Supp. 2d 1122, 1131 (E.D. Cal. 2008))). Hacking generally has three characteristics: (1) "simplicity," (2) "mastery," and (3) "illicitness." *See* Taylor, *supra* note 2, at 15.

138. Brief for Plaintiff-Appellant SEC, *supra* note 123, at 35 (emphasis added). *See* United States v. Miller, 70 F.3d 1353, 1355 (D.C. Cir. 1995); Thrifty-Tel, Inc. v.

Hackers have two general methods to obtain confidential information: (1) "engage in false identification and masquerade as another user who has greater privileges,"[139] or (2) "exploit a weakness in the code within a program to cause the program to malfunction in a way that grants the user greater privileges."[140] Whether either method constitutes deception is debatable to most un-technologically savvy individuals[141] because "[c]omputer hacking. . . is akin to a trespass [and burglary] in cyberspace."[142] Trespass and burglary are not deceptive acts by default.

Applying the first hacking method, the Second Circuit believed that if Dorozhko falsely misrepresented himself when he entered Thomson Financial's computer network, his hack was an affirmative misrepresentation and, thus, deceptive.[143] The *Chiarella v. United States* Court would probably agree with the Second Circuit's finding on the first method because, as Justice Powell stated, "misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent."[144] When hackers represent that they are another person, they do so "for the purpose of inducing reliance"[145] by the victim computer.[146] Hackers' affirmative misrepresentations made to computers—in lieu of a person—are deceptive because hackers trick victim computers into believing they are authorized

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Bezenek, 46 Cal. App. 4th 1559, 1567 (1996); State v. Hamm, 569 S.W.2d 289, 290–91 (Mo. Ct. App. 1978).

139. Orin S. Kerr, *Cypercrime's Scope: Interpreting "Access" and "Authorization" in Computer Misuse Statutes*, 78 N.Y.U. L. REV. 1596, 1644 (2003). *Accord* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (citations omitted).

140. Kerr, *supra* note 139, at 1645. *Accord Dorozhko*, 574 F.3d at 51 (citations omitted).

141. *See* Taylor, *supra* note 2, at 1 (suggesting that lay people do not fully understand hacking or computers).

142. Kerr, *supra* note 139, at 1606.

143. *Dorozhko*, 574 F.3d at 51.

144. 445 U.S. 222, 227–28 (1980). *See also* United States v. Chestman, 947 F.2d 551, 561 (1991) (suggesting that Rule 10b-5 covers common law fraud, which includes misrepresentation); *supra* Part II (discussing case law on affirmative securities fraud and stating that there is no fiduciary duty requirement for those cases).

145. *Chiarella*, 445 U.S. at 227.

146. *See* Kerr, *supra* note 139, at 1644–45.

users.[147] It does not matter that a hacker committed securities fraud by deceiving a computer instead of a person because "[t]he basic crimes remain the same regardless of whether wrongdoers use computers or some other means to commit them."[148]

The second hacking method troubled the Second Circuit because the court was unsure if "exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft."[149] The dilemma with the second method is summarized as follows: a burglar can enter an investment bank by (1) falsely claiming to be an employee by using a stolen identification card, or (2) because the door was open and the security guard was sleeping. Scenario one results in a misrepresentation of identity and § 10(b) liability would attach if the burglar trades on confidential information obtained during his burglary.[150] Scenario two does not result in a § 10(b) violation under the Second Circuit's reasoning in *Dorozhko* because no misrepresentation of identity occurred due to the door being open and security failing to detect the burglar, similar to a hacker exploiting a computer's security weakness.[151] The result—confidential information is stolen and investors are potentially robbed—is the same under either option.

The SEC did not only argue misrepresentation of identity in *Dorozhko* and attempted to avoid leaving hackers with a loophole if they do not hack by false identification. The SEC claimed that "Dorozkho's [sic] hacking was deceptive because he employed deceit to (1) *gain unauthorized access* to secured nonpublic information, (2) retrieve the information as if he were an authorized recipient, and (3) secretly depart from the compromised computer system."[152] The Second Circuit, however, was skeptical with the SEC's theory.[153] Under the Second Circuit's logic, a hacker who does not falsely identify himself to be "one of those few persons authorized"[154] is not liable

147. *See* Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 8, 12 (1971); Deutschman v. Beneficial Corp., 841 F.2d 502, 506 (3d Cir. 1988); United States v. Teyibo, 877 F. Supp. 846, 862 (S.D.N.Y. 1995); Kerr, *supra* note 139, at 1644–45.

148. Kerr, *supra* note 139, at 1603.

149. SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

150. *See supra* Part II (discussing that misrepresentation is deceptive under § 10(b)).

151. *See supra* notes 118–20 and accompanying text (defining deceptive).

152. Brief for Plaintiff-Appellant SEC, *supra* note 123, at 25 (emphasis added).

153. *See Dorozhko*, 574 F.3d at 51.

154. Brief for Plaintiff-Appellant SEC, *supra* note 123, at 26.

for securities fraud.[155] This loophole is avoidable. The Second Circuit was correct in using the ordinary definition of deceptive,[156] but the court stopped short in its application. As previously discussed, deception is "trickery"[157] and exploiting[158] a computer's security weakness is trickery.

With this baseline definition of deceptive—trickery—it is important to understand how hackers trick computers when gaining unauthorized access to confidential information and how that is deceptive. First off, whether a hacker obtains confidential financial information by misrepresenting his identity to the computer or by exploiting a computer's weakness, the hacker "must somehow 'trick' the computer into giving the [hacker] greater privileges."[159] A hacker has no right to access protected information and misuses computers by stealing that information.[160] This is computer fraud.[161] When a hacker visits a website or IP address, as was the case in *Dorozhko*,[162] the hacker's "computer sends requests to the computer that hosts the website asking the computer to send back computer files; when the files are returned to the [hacker], the [hacker's] computer reassembles the files and presents them in the form of a website."[163] In sending the request for files, a hacker is representing that he is authorized to access the files.[164] *Unauthorized access*

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155. *See Dorozhko*, 574 F.3d at 51.

156. *See supra* notes 118–20 and accompanying text (using the ordinary definition of deceptive).

157. Webster's, *supra* note 119, at 584.

158. To exploit is to "take undue advantage of." *Id.* at 801.

159. Kerr, *supra* note 139, at 1644.

160. *Id.* at 1604 (discussing a hacker's misuse of a computer by either "using a computer that she has no authority to use, or by using the computer in a way that she is not authorized to use"). A hacker is an outsider with no access rights to the protected computer. *See id.* at 1630.

161. *See* 18 U.S.C.A. § 1030 (Supp. III 2008).

162. SEC v. Dorozhko, 606 F. Supp. 2d 321, 325 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009) ("[Dorozhko,] from Internet Protocol address ('IP address') 83.98.156.219[,] began probing the IMS Health website at Thomson Financial.").

163. Kerr, *supra* note 139, at 1620 (citing PRESTON GRALLA, HOW THE INTERNET WORKS 128–29 (2002)).

164. *See id.* at 1620, 1644–45, 1649. "When a [hacker] exploits weaknesses in a program and uses a function in an unintended way to access a computer, the thinking goes, that access is 'without authorization.' " *Id.* at 1632.

is akin to trickery, misrepresentation, and deceit.[165] Therefore, even if a hacker finds a security weakness in a computer's security code and does not falsely identify himself, the hacker is still deceptive because he is using his computer to trick another computer—in lieu of tricking a person.[166]

V. CONGRESSIONAL INTENT AND GOOD POLICY SUPPORT THE SEC'S REGULATION OF DECEPTIVE HACKERS

Congress granted the SEC the power to regulate the markets[167] because "[t]he securities markets of the United States are indispensable to the growth and health of this country's and the world's economy."[168] Also, Congress did not want § 10(b) to be strictly construed, but flexibly interpreted based on current developments.[169] The desired result was to avoid innocent investors being duped and losing money, whether by nondisclosure or affirmative misrepresentation.[170] This is the reason Congress "chose not to enact a fixed definition [of deceptive] in order to avoid limiting SEC flexibility and allowing wrongdoers to find loopholes in the law."[171]

The SEC should be able to regulate the markets so that financial information is *relatively* even between all market participants.[172] The notion

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165. *See id.* at 1644–45, 1649.

166. *See supra* note 148 and accompanying text.

167. 15 U.S.C. § 78j(b) (2006) (making it unlawful to use a "deceptive device" based on the "*rules and regulations as the Commission may prescribe* as necessary or appropriate in the public interest or for the protection of investors") (emphasis added). "Pursuant to its authority under the Act, the SEC promulgated Rule 10b-5, which is considered the primary SEC mechanism for regulating securities fraud, including insider trading." Steinbuch, *supra* note 91, at 572.

168. H.R. Rep. No. 94-229, at 91 (1975) (Conf. Rep.).

169. *See* Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 12 (1971); Chiarella v. United States, 445 U.S. 222, 247 (1980); SEC v. Zandford, 535 U.S. 813, 819 (2002).

170. *See* H.R. Rep. No. 94-229, at 91 (1975) (Conf. Rep.).

171. Prentice, *supra* note 15, at 303.

172. Market information will not be equal among all market participants, but any informational advantage should be lawfully obtained through due diligence, not by theft. Chief Justice Burger expressed this view in his *Chiarella* dissent:

that a hacker, an outright criminal, can escape the SEC's grasp is frightening.[173] While there are other statutes to punish hackers,[174] the SEC should be empowered, not hindered, to regulate all types of improper securities transactions. Limiting the SEC's reach to only those who breach a fiduciary duty leaves a significant gap in the SEC's enforcement power because many transactions do not involve a fiduciary duty. For example, a trader who purchases stock on the open market generally owes no fiduciary duty to any of the market participants. Since misappropriation, one of the insider trading theories, falls within the SEC's scope, mere thievery should as well because " 'steal' and 'misappropriate' are synonyms."[175]

> As a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation. This rule permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting. But the policies that underlie the rule also should limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.

Chiarella, 445 U.S. at 239–40 (Burger, C.J., dissenting) (internal citation omitted). *See also* SEC v. Dorozhko, 606

F. Supp. 2d 321, 331 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009) (stating that it is desirable to have some information disparity that is based on research and strategy).

173. *See, e.g.*, Prentice, *supra* note 15, at 298; Brief of Plaintiff-Appellant SEC, *supra* note 123, at 43 ("The notion that a lie is not deceptive unless it also breaches a duty is contrary to . . . good policy.").

174. *See* 18 U.S.C.A. § 1341 (Supp. II 2008) (mail fraud); 18 U.S.C.A. § 1343 (Supp. II 2008) (wire fraud); 18 U.S.C.A. § 1030 (Supp. II 2008) (computer fraud).

175. Prentice, *supra* note 15, at 298 (citation omitted). While it is debatable whether theft in the traditional sense is deceptive, make no mistake, hackers that obtain protected, confidential information are thieves. *See* Carpenter v. United States, 484 U.S. 19, 26 (1987) ("Confidential business information has long been recognized as property."); Kerr, *supra* note 139, at 1609–13 (discussing computer misuse as theft); Taylor, *supra* note 2, at 145 (comparing computer hacking to theft in normal, everyday situations).

A. *ARGUMENTS FOR HAVING A FIDUCIARY DUTY REQUIREMENT UNDER ALL CIRCUMSTANCES*

One argument against eliminating the fiduciary duty requirement is that there must be some boundary line when imposing a securities fraud violation; without a duty requirement, any act could equate to securities fraud. The Southern District of New York in *Dorozhko* summarized this argument very well:

> [I]n regulating insider trading, at the margins it becomes difficult to distinguish information that is properly obtained from that which is improperly obtained. The fiduciary requirement serves as an important delineation, a kind of shorthand that courts, market participants, and regulators may use to make the distinction. The presence of a fiduciary relationship ensures that the traded on information is that available only to insiders. Without the fiduciary requirement, the question of when market participants may trade on informational disparities becomes much more difficult.[176]

Liability for a § 10(b) violation should be premised on a fiduciary duty requirement in *nondisclosure* cases because a duty serves as an important distinctive point that would be difficult to ascertain absent a breach of a duty to disclose or abstain from trading.[177] Removing the duty requirement could cause § 10(b) liability to attach to investors who have performed legitimate market research but do not disclose their research to their counterparties because it would be difficult to determine whether that information was obtained legally or illegally.[178] It is necessary to require a duty to disclose in nondisclosure cases to avoid discouragement for good, thorough research.[179] For those that disagree with requiring a breach of a duty in nondisclosure cases, whether on policy or fairness grounds, the Supreme Court has set the

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176. SEC v. Dorozhko, 606 F. Supp. 2d 321, 343 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42) (2d Cir. 2009).

177. *See supra* note 123 and accompanying text (the rule adopted by the Second Circuit in *Dorozhko* still requires a breach of a fiduciary duty in nondisclosure cases).

178. *See* Chiarella v. United States, 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting) (proposing a rule that would not allow "persons having access to confidential material information that is not legally available to others . . . [from] trading in affected securities").

179. *See id.* at 240 (Burger, C.J., dissenting) (promoting investors to take advantage of legally obtained knowledge).

rule that nondisclosure cannot be deceptive without a breach of a fiduciary duty.[180] The Supreme Court is highly unlikely to eliminate the duty requirement in nondisclosure cases because absolving it would create a general duty to disclose among market participants, which the Court disfavors.[181]

In response to the argument that *affirmative fraud* cases should require a breach of a fiduciary duty, it is hard to overlook that not having a duty requirement in affirmative fraud cases would not blur the distinctive point where § 10(b) liability should be found because stealing financial information with the sole purpose of trading securities is unquestionably deceptive.[182] In most § 10(b) cases, the defendants obtained the information legally but then illegally breached a fiduciary duty by trading on that information.[183] Conversely, a hacker illegally obtains information and also illegally trades on that information.[184] The distinction between insider trading and hacking is in the acquisition of the information, not the trading. The SEC, however, was established to regulate trading on nonpublic information, not to regulate the acquisition of that information. A hacker violates the CFAA by hacking and obtaining information,[185] and then violates § 10(b) by trading on the information.[186] A hacker should be liable under § 10(b) because the hacker obtained the information as part of a scheme to defraud and trade. Also, the SEC's regulatory power should not be diluted simply because the thief obtained the information through a computer.[187]

Another argument against removing the fiduciary duty requirement is that courts will be flooded with unmeritorious claims. Without the necessity of a breach of a fiduciary duty, there exists a " 'danger of vexatious litigation

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180. *See, e.g.*, *id.* (majority opinion); United States v. O'Hagan, 521 U.S. 642 (1997).

181. *See, e.g.*, *Chiarella*, 445 U.S. at 233; *O'Hagan*, 521 U.S. at 661.

182. *See* Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 12 (1971); Deutschman v. Beneficial Corp., 841 F.2d 502, 506 (3d Cir. 1988); United States v. Teyibo, 877 F. Supp. 846, 862 (S.D.N.Y. 1995).

183. *See supra* Part I.A (discussing the insider trading theories).

184. *See supra* Part IV (arguing that hacking is deceptive under § 10(b)).

185. *See* 18 U.S.C.A. § 1030 (Supp. II 2008).

186. *See* 18 U.S.C. § 78j (2006); *supra* Part IV.

187. *See supra* note 148 and accompanying text (stating that computers are just a means to already existing crimes).

which could result from a widely expanded class of plaintiffs under Rule 10b-5.' "[188] This argument is ill-conceived for three reasons. First, at Parts I and II demonstrated, there never was a fiduciary duty requirement for *affirmative fraud* in the securities law context. Second, the requirement is still in place for *nondisclosure* cases.[189] Lastly, an investor, or the SEC, has to meet the pleading requirements of *Bell Atlantic Corp. v. Twombly* to get past a motion to dismiss[190]—including sufficient pleading of scienter.[191] Thus, it seems highly unlikely that a flood of investors, or the SEC, will seek restitution merely because an affirmative fraud does not require a breach of a fiduciary duty—as it never did.

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188. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975)).

189. *See supra* note 123 and accompanying text (*Dorozhko* has not changed the rule in nondisclosure cases).

190. 550 U.S. 544, 570 (2007) (requiring "enough facts to state a claim [for] relief that is plausible on its face").

191. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Id. See* SEC, Speech by SEC Staff: Insider Trading - A U.S. Perspective (1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm. Moreover, as stated by the SEC, proving insider trading has severe evidentiary hurdles:

> Direct evidence of insider trading is rare. There are no smoking guns or physical evidence that can be scientifically linked to a perpetrator. Unless the insider trader confesses his knowledge in some admissible form, evidence is almost entirely circumstantial. The investigation of the case and the proof presented to the fact-finder is a matter of putting together pieces of a puzzle. It requires examining inherently innocuous events . . . and drawing reasonable inferences based on their timing and surrounding circumstances to lead to the conclusion that the defendant bought or sold stock with the benefit of inside information wrongfully obtained.

Id. See also Orin S. Kerr, *Digital Evidence and the New Criminal Procedure*, *in* CYBERCRIME 221, 225 (Jack M Balkin, James Grimmelman, Eddan Katz, Nimrod Kozlovski, Shlomit Wagman, & Tal Zarsky eds., 2007) (discussing the steps in investigating computer crimes and the evidentiary problems).

B. *THE NEED FOR A § 10(b) REMEDY AND THE SEC'S ROLE IN PUNISHING HACKERS*

Hackers may be fined for mail fraud,[192] wire fraud,[193] and/or computer fraud,[194] but those penalties may not suffice. A hacker who violates the mail or wire fraud statutes by defrauding a financial institution might be fined up to $1,000,000,[195] leaving a potential gap for recovery. It is not rare for a securities law violator to profit over $1,000,000.[196] Alternatively, the CFAA allows "[a]ny person who suffers damages or loss *by reason of a violation of this section*" to commence a civil action against a hacker to obtain compensatory damages.[197] The CFAA, however, requires that the "damage" and "loss" be directly related to the harm caused to the computer system.[198] Thus, a person who enters into a securities transaction with a hacker cannot bring a CFAA civil action against a hacker for lost profits arising from the securities transaction.[199]

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192. 18 U.S.C.A. § 1341 (Supp. III 2008).

193. § 1343.

194. § 1030.

195. *See* §§ 1341, 1343.

196. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 648 (1997) (over $4.3 million profit); Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 8 (1971) (approximately $5 million profit).

197. § 1030(g) (emphasis added).

198. § 1030(e)(8) (defining damages as "any impairment to the integrity or availability of data, a program, a system, or information"); § 1030(e)(11) (defining loss as "any reasonable cost to any victim, including . . . any revenue lost . . . *incurred because of the interruption of service*") (emphasis added).

199. *See* Nexans Wires S.A. v. Sark-USA, Inc., 319 F. Supp. 2d 468, 472, 474, 476–77 (S.D.N.Y. 2007) (stating that the plaintiff's lost revenue was not due to the computer system being down "but rather because of the way the information was later used by defendants[,]" so the claim fails); Cenevo Corp. v. Celumsolutions Software GMBH & Co. KG, 504 F. Supp. 2d 574, 581 (D. Minn. 2007) (finding that the complaint failed to allege an interruption in service or costs incurred in assessing the damage to the computer system); Pearl Investments LLP v. Standard I/O, Inc., 257 F. Supp. 2d 326, 349 (D. Me. 2003) (holding that the plaintiff failed to provide any "cognizable evidence that the Defendants' alleged conduct damaged its system in any quantifiable amount").

More fittingly, a § 10(b) remedy would allow the SEC or a private individual[200] to seek restitution up to the "gross amount of pecuniary gain."[201] Even more, if an insider trading § 10(b) violation is found under one of the theories discussed in Part I.A, treble damages may be recovered.[202] A hacker, however, is unlikely to be liable under one of the insider trading theories—all nondisclosure theories—because of the fiduciary duty requirement.[203] Even so, whether based on nondisclosure theory or affirmative fraud theory, a § 10(b) remedy is favorable and necessary to truly hinder hackers from fraudulent financial gains.

The SEC is the agency best suited to regulate securities fraud by hackers, as the SEC is the agency created and empowered to deal with securities fraud matters and regulate the markets. The SEC correctly claims that the United States' "markets are a success precisely because they enjoy the world's highest level of confidence. Investors put their capital to work—and put their fortunes at risk—because they trust that the marketplace is honest. They know that our securities laws require free, fair, and open transactions."[204] Hindering the SEC's ability to regulate and punish violators severely diminishes the SEC's power because the current technological age brings extremely savvy computer users who could circumvent § 10(b) liability by claiming they did not owe a fiduciary duty. Due to the widespread use of the internet, the SEC created *The Office of Internet Enforcement*, which, inter alia, "aid[s] in the surveillance of the Internet for potential securities fraud and to assist in Internet-related securities fraud

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200. Generally, individual traders are unlikely to know that they have been swindled and have the ability to recover because individual traders do not know who their counterparties are due to the widespread use of brokers and investment advisors. *See* LARRY HARRIS, TRADING & EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 139, 141 (2003).

201. 15 U.S.C. § 78u(d)(3)(B) (2006).

202. § 78u-1(a)(2).

203. *See supra* Part I.A (discussing the four insider trading theories and the fiduciary duty requirement).

204. SEC, Speech by SEC Staff: Insider Trading - A U.S. Perspective (1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm (quoting Arthur Levitt, Chairman, SEC, Address before the "SEC Speaks" Conference, A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading (Feb. 27, 1998)).

investigations."[205] Thus, the SEC is equipped to handle hackers and the *Dorozhko* decision finally gives the SEC the legal power needed in the current technological environment.

CONCLUSION

Before the Second Circuit's decision in *Dorozhko*, hackers had no fear of penalties under § 10(b).[206] In fact, hackers would brag about their immunity from the securities laws.[207] *Dorozhko* is necessary to remove the "gap arising from a reliance on fiduciary principles in the legal analysis that courts have employed to define insider trading, and courts' stated goal of preserving equitable [United States'] markets."[208] This enforcement hole in American law must be eliminated to make the United States' and global markets fair. *Dorozhko* properly places fear in hackers by clearing up the confusion about affirmative securities fraud and fiduciary duty, making hackers liable for their wrongful securities violations. It is about time the SEC has the necessary power to regulate hackers, especially since Congress wanted § 10(b) to adapt to changes in technology.

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205. SEC, Internet Enforcement Program, http://www.sec.gov/divisions/enforce/internetenforce.htm (last visited Oct. 6, 2009).

206. *See* Silane, *supra* note 30, at 368.

207. *See id.* at 364 (citing How to Beat an Insider Trading Rap at IB, http://www.elitetrader.com/vb/showthread.php?threadid=132761 (last visited Oct. 15, 2009); Gaming the Market: How to Beat an Insider Trading Rap, http://www.gamingthemarket.com/how-to-beat-an-insider-trading-rap.html (last visited Oct. 15, 2009)).

208. SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009) (citing Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972)).

STRUCTURED PRODUCTS REGULATION IN THE WAKE OF THE FINANCIAL COLLAPSE

Aaron G. Stendell[*]

Within the past two years the world economy shrunk and was on the verge of collapse. While there are many reasons for the financial turmoil, critics point to structured products as one of the leading causes. Collateralized Mortgage Obligations (CMOs) were securitized and placed into structured products in order to make them easier to transact. Unbeknownst to the investors, many of these CMOs contained subprime mortgages (the term "subprime" refers not to the interest rate of the mortgage loan, but instead to the borrower – a less than optimal, or prime, lendee). Many of these subprime loans were made with Adjustable Rate Mortgages ("ARMs") where the rate of the loan increased or decreased depending on several factors. When home values began to decline in 2006 and 2007, these ARM rates increased, causing a borrower's monthly payments to also increase. Many of the subprime borrowers were unable to afford this new payment, so they defaulted on their mortgage loans. As a result of the ensuing foreclosures, the land value further deteriorated, ARM payments were further increased, and more foreclosures resulted. This had a domino effect on the entire financial industry and touched off one of the greatest recessions since the Great Depression. Due to the defaulting of so many mortgage loans, the underlying note security in a structured product was worthless, effectively rendering the entire product a loss. This crash was not isolated to the United States, but spread world-wide. Several Norwegian municipalities, who had invested in these structured products suffered significant losses. Additionally, many Norwegians themselves had similar poor results. In February 2008, the Norwegian securities regulatory effectively banned the sale of these products to retail customers. While this has been the most severe reaction by a security regulator, other nations'

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* Aaron Stendell is a 2011 candidate for Juris Doctor at Southern Methodist University's Dedman School of Law and currently holds a Bachelor of Business Administration from Southern Methodist University and a Masters of Business Administration from the University of Texas at Dallas. Mr. Stendell previously was a Senior Examiner with the Financial Investment Regulation Authority (FINRA).

His article was the third place winner for PIABA's 2010 James E. Beckley Securities Arbitration and Law Writing Competition. Mr. Stendel may be reached at astendell@mail.smu.edu.

regulators are taking or have taken steps to more closely monitor and guide investments firms and their sale of structured products. Italy was relatively unscathed by the financial crisis and its securities regular only published guidelines for the sale of structured products. Meanwhile, in the United States the Securities and Exchange Commission continues to rely on disclosure as the key to marketplace fairness, believing that as long as the investor is forewarned, he or she can do as he or she wants. This article will first explain what a structured product is and how it works. Then, the approaches to securities regulation by Norway, Italy, and the United States will be reviewed. Finally, the better regulatory method will be meted out.

Structured Products

At the end of 2007, the American Stock Exchange was trading 400 structured products and the overall market in the United States was about $114 billion, almost doubled from the previous year.[1] Retail customers made up about half of this.[2] By the end of 2008, sales sunk to only $70 billion in the light of the financial crisis.[3] However, the sales rebounded in 2009; for example, increasing by almost 50% in the United Kingdom[4]. Therefore, it appears that structured products are making a comeback, as illustrated in the graph below:

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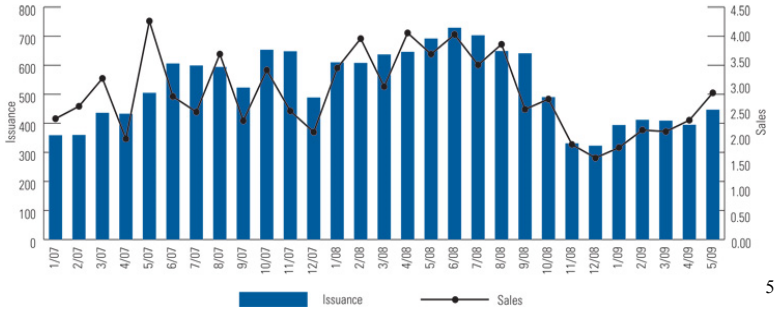
1. Christina Mucciolo, *Structured Products: The Bright Future of Securitization?*, REGISTERED REP, July 16, 2008, *available at http://registeredrep.com/newsletters/wealthmanagement/bright_future_0716/index.html.*

2. *Id*. A securities customer is generally placed into one of two categories: retail or institutional. A retail customer is an individual who buys or sells securities for his or her own account. An institutional customer is a corporation, or other business entity, that buys and sells securities in large blacks, typically for the benefit of others, like a mutual fund.

3. Larry Light, *Twice Shy on Structured Products*, THE WALL STREET JOURNAL, May 28, 2009, at A25.

4. Dominic Welling, *Structured Product Market Grows 50% in 2009,* FINANCIAL TIMES, January 21, 2010.



[5]

As the above graph demonstrates, the sales and issuance of structured products both decreased in 2008, but show a resurgence by mid-2009.[6]

But, before one can begin discussing structured products, one should understand what they are. Unfortunately, this is where the confusion first sets in as there is no one accepted definition of what a structured product is.[7] They have been described as complicated, sophisticated, and "even [as] financial alchemy."[8] Indeed, securities regulators are unable to agree on a definition, too. The London Stock Exchange defines them as "a group of financial instruments with varying terms, payout and risk on a range of underlying assets."[9] Meanwhile, the Norwegian securities regulator, Kredittilsynet, has defined it as "investment products that consist of a savings or bond portion and a derivative component. The deposit or bond forms the basis for a guaranteed return for the investor, whereas the derivative component is to generate returns beyond the guaranteed amount."[10] The

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5. Lori Pizzani, *Sliced, Diced, Chopped, Chunked: A Taste of Structured Products*, The Investment Professional, *available at* http://www.theinvestmentprofessional.com/vol_2_no_3/hotzones-investmentstrategy.html.

6. *Id*.

7. *See Finance Q&A,* THE NEWS-PRESS (Fort Myers, Florida), June 22, 2008, at 1D; May Ann Gadziala, Assoc. Dir., Office of Compliance Inspections & Examinations, SEC, *Structured Finance Activities: The Regulatory Viewpoint* (Sept. 20, 2006); NASD Notice to Members 05-59, *Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products*, FIN. INDUS. REG AUTH., September 2005, at 8, n.1.

8. Patrick O'Conner, *Structured Products: The Benefits and Trade-offs*, CPA WEALTH PROVIDER, Jan. 2009, Vol. 42, No. 1 at p. 17A.

9. Feature, *Attracting New Money*, October 6, 2008.

10. Kredittilsynet Press release of February 12, 2008, *available at* http://www.finanstilsynet.no/en/Secondary-menu/Documents/Press-releases/Kredittilsynet-tightens-up-on-structured-products/.

United States' premiere self-regulatory organization[11], FINRA, defines asset-backed securities as "…any instrument involving or based on the securitization[12] of mortgages or other credits or assets…"[13] The Pacific Exchange defines them as "products that are derived from and/or based on a single security or securities, a basket of stacks, an index, a commodity, debt issuance and/or a foreign currency amount other things."[14]The most commonly accepted definition is vague and never really describes what they are.[15]

The working definition of structured product includes "any hybrid financial instrument—typically a registered note, bank deposit or private placement—linked to the performance of a derivative, i.e. an underlying asset, such as a stock, an index, a commodity, currency or other investment."[16] Structured products have many names, including "principal

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11. FINRA webpage, *available at* http://www.finra.org/AboutFINRA/index.htm. "The Financial Industry Regulatory Authority (FINRA), is the largest independent regulator for all securities firms doing business in the United States. All told, FINRA oversees nearly 4,750 brokerage firms, about 167,000 branch offices and approximately 633,000 registered securities representatives…FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange." *Id*.

12. Securitization has been defined when "an entity converts certain non-marketable assets or cash flows into a larger marketable security for resale. In the typical situation, individual assets with similar characteristics, like mortgages…, are aggregated and pooled such that investors can purchase the securities that back those assets." Richard C. Jordan, *Will the Bubble Burst? Some Subprime Lessons for Mexico, Latin America's Leaser in Asset Securitization*, 42 INT'L LAW 1181.

13. FINRA Rule 6710(m) (2010).

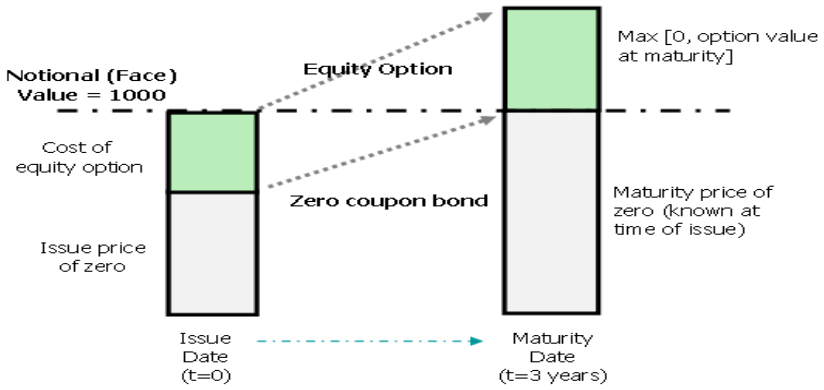
14. Self-Regulatory Organizations, Exchange Act Release No. 34-51095, 70 Fed. Reg. 6489 (Feb. 7, 2005), n.7.

15. *See Tailor-Made for Your Portfolio*, FINANCIAL EXPRESS, November 2, 2008 ("Structured Products are customized products that often combine various financial instruments in the market to come up with unique and innovative products for investors to invest in.").

16. Mucciolo, *supra* note 1.

protected notes, accelerated return notes, range notes, reverse convertibles, buffered return notes, or barrier notes."[17] The biggest difference between structured products and other similarly structured investments (securities whose performance is based on the performance of underlying securities), like mutual funds or exchange traded funds, is that structured products have a set date when the investment ends and often have an initial investment guarantee.[18] The debt element may pay interest payments to the investor, but the speculative portion will only pay when the investment matures.[19]

The following illustration may help to demonstrate how a structured product works, assuming a $1,000 initial investment in a product consisting of a zero-coupon bond (i.e. no interest paid during the life of the bond) bundled with a stock option and a three-year maturity date:[20]



[21]

17. O'Connor, *supra* note 8.

18. Jeff Benjamin, *Industry Feels Spillover Effect*, INVESTMENT NEWS, Sept. 29, 2008, at 14.

19. *Structured Products Fast Gaining Investors' Attention*, NEW STRAIGHT TIMES (Malaysia), July 8, 2009, at 10.

20. Katrina Lamb, *Understanding Structured Products*, Invesopedia, http://www.investopedia.com/articles/optioninvestor/07/structured_products.asp (last visited February 27, 2010).

21. *Id*.

At the initial purchase point, for the $1,000, the investor receives the zero coupon bond and the option. At the end of the three years, the investor receives back the original $1,000, plus any additional value of the option.

Several British brokers have raised doubts about the public's understanding about what a structured product entails[22]. They fear that due to the complexity of structured products, investors are not aware of the fees associated with them and are not aware of the inherent risks.[23] In fact, it has been suggested that even CEO's of financial institutions do not understand their own products that their firms were creating.[24] A 2007 study reported that only 15% of affluent investors ("having more than $500,000 in investable assets") understood structured products.[25] This lack of knowledge of structured products has not prevented investors from seeking them out. In 2006, retail investors were responsible for purchasing half of the United States' structured products.[26]

Background

Structured products were originally created by companies who needed to raise money, but wanted to avoid doing a debt offering, which can be quite costly.[27] Companies first started with convertible bonds,[28] which, simply stated, allow an investor to exchange a bond issued by a certain company into the stock of that company.[29] Convertible bonds are attractive to companies because they are typically a faster way to raise money than in a conventional manner and pay a lower debt interest rate.[30] In order to help convince more investors to purchase these convertible bonds, companies began adding more incentives to the bonds, such as principal protection,

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22. *IFA Reaction: Structured Products*, INVESTMENT ADVISOR , Sept. 22, 2008.

23. *Id*.

24. Charlie McCreevy, European Comm'r, Internal Market & Serv., Speech at the Workshops of the Alliance of Liberals and Democrats for Europe (Feb. 27, 2008).

25. Jonathan Ford, *A Greedy Giant Out of Control*, PROSPECT (U.K.), Oct. 23, 2008.

26. O'Connoer, *supra* note 8.

27. *Tailor-Made for Your Portfolio*, *supra* note 15.

28. *Id*.

29. *Available at:* http://www.sec.gov/answers/convertibles.htm.

30. *Id*.; *Tailor-Made for Your Portfolio*, *supra* note 15.

wherein the initial investment is safe, or increased income, such as better coupon payments.[31] These features were eventually combined and offered in one pre-packaged product – a structured product.[32] Although the sales of structured products began in the 1980s, they gained popularity with commercial customers in the Nineties and were thereafter marketed to retail investors.[33]

Benefits

The popularity of structured products is seems to be based on the capital protection guarantee.[34] These investments can partake in the upswing of a bull market, but are somewhat protected from the downside,[35] i.e. the underlying security is meant to return the investor his or her original investment, regardless of the state of the market, while any increase in the derivative can hopefully lead to a large payoff. As such, structured products also offer the investors the ability to partake in "strategies that have the ability to provide strong long-term returns,"[36] which would normally be unavailable to an investor placing his or her money in a traditional capital-protected security, such as a certificate of deposit or a corporate bond. The return rate for these investments also entice investors – some products paid interest rates up to 40%.[37] However, every upside has a downside and for structured products, it is considerable.

Risks

The risks of structured products have been vividly illustrated in recent years given the collapse of Lehman Brothers.[38] The underlying debt security is the lynchpin to the overall safety of the structured product. If the issuer of

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31. *Tailor-Made for Your Portfolio*, *supra* note 15.

32. *Id*.

33. NASD Notice to Members 05-59, *supra* note 7, at 2.

34. *Tailor-Made for Your Portfolio*, *supra* note 15; James Dunn, *Tremors Shake the Structure*, The Australian, April 9, 2008, at Wealth Edition p.5.

35. Mucciolo, *supra* note 1.

36. Dunn, *supra* note 34 at 5.

37. NASD Notice to Members 05-59, *supra* note 7, at 8 n.2.

38. Light, *supra,* note 3 at A25.

the underlying asset were to go bankrupt, then at the maturity date, the investor may not receive any of the investment and would be another creditor of the now defunct business.[39] This was the case recently as structured products associated with residential mortgage-backed securities suffered and decreased in value.[40] For example, Lehman Brothers' investment bank issued $900 million worth of structured products, but filed for Chapter 11 bankruptcy protection.[41] When the investment bank was acquired by Barclays PLC, it was announced that the debt portion of these Lehman products would not be assumed.[42] Now these Lehman investors would be happy with receiving only 20% of their investment back.[43]

Even if the underlying asset is still financially viable, if the other derivatives did not pan out, the customer can still lose money.[44] If, after the term of the investment has expired, the only money the investor receives back is the original investment, the customer still comes out at with a loss due to inflation and the "opportunity cost of what that money could be earning invested elsewhere."[45] An interest-bearing deposit account at a local bank would have earned the investor a better return.

Yet another risk of structured products is the lack of liquidity due to an ineffective secondary market.[46] As of 2008, 90% of structured products were not listed on an exchange[47], which provides access to sellers and buyers of securities. If an investor determines that he or she needs access to the money which is, at the time, tied up in a structured product, the lack of a robust secondary market where this investment may be sold may lead to difficulty in selling it.[48] Further, even if a buyer was found, the investor will likely

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39. O'Connor, *supra* note 8.

40. Denise Bedell, *Credit Derivatives; Credit Where It's Due*, GLOBAL FINANCE MAGAZINE, June 2008, at 55.

41. Benjamin, *supra* note 18.

42. *Id*.

43. Light, *supra,* note 3 at A25.

44. Dunn, *supra* note 34 at 5.

45. *Id*.

46. O'Connoer, *supra* note 8.

47. John Prestbo, *Structured Products can Collapse on Unwary Investors*, MARKETWATCH, May 21, 2008.

48. *Id*.

receive a subpar offer for the security.[49] Some issuers may state that they will repurchase the structured product from investors, but some investors have found that, given the recent financial troubles of investment banks, this doesn't always happen.[50]

Types of Structured Products

Given the lack of any commonly accepted definition for structured products,[51] it should not be surprising that there are a wide variety of investments that are pooled under the common name of 'structured products', all created to do something a little different – from capital protection to diversifying one's current investments.[52]

The Leveraged Note

This is the simplest form of a structured product wherein, as described above, the investor is provided a note with some guarantee in regards to the initial principal and derivates are attached to the product,[53] giving the investor access to more diverse investment strategies. Although the investor is giving up some of the possible earnings on the derivative, he or she is instead receiving all of the assets in a single bundle and the issuer is able to leverage its status as an institutional customer to purchase these securities below market prices.[54]

Reverse Convertibles

One of the riskiest structured products are reserves convertibles which are based upon a single stock.[55] The investment is in short-term bonds that

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49. *Id*.

50. *Id*.

51. Gadziala, *supra* note 7.

52. Lim Leong Guan, *Flexible, Innovative; Structured Products are Investments Solutions Designed to Better Manage Risk-Reward Investment Dilemmas*, THE BUSINESS TIMES SINGAPORE, October 4, 2008.

53. Michael C. Macchiarola, *Securities Linked to the Performance of Tiger Woods? Not Such a Long Shot*, 42 CREIGHTON L. REV. 29, 54 (2008-2009).

54. *Id*. at 55.

55. *Id*. at 56.

pay a high interest rate, but at maturity, the investor may, instead of receiving his or her principal back, receive shares of the underlying stock if its value falls below a preset level at any time during the note,[56], called a knock-in level, which is typically expressed as a percentage of the initial stock price.[57] If the share price upon maturity is better than the share price at the time of the sale, then the investor will receive the initial investment back, regardless of whether or not the stock price dips below the knock-in level.[58] The product typically matures within three to twelve months.[59] Dividing the initial principal amount by the stock price at the beginning of the structured product's term will give the investor the numbers of shares that he or she may receive.[60] If the underlying stock performs poorly, then the investors' converted shares may be worth much less than the original principal.[61] Reserve Convertibles were designed for investors who are moderately bullish and/or expect the price of the underlying stock to remain within a certain trading range over the term of the notes and who can bear a loss of principal if, instead, the price of the underlying stock falls below the specified barrier price.[62] As the purchase price of reverse convertible structured products are relatively low, around $1,000, the products are marketed to retail customers.[63]

In the example below, "[a] $13,000…investment includes an 80% knock-in…level, and the underlying stock's initial price is $65. If…the stock never closes at $52 or less [80% * $65 = $52], and the final price of the stock is higher than the knock-in price of $52, …[the investor will] get the original $13,000 back."[64]

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56. *Id*.

57. George D. Lambert, *Reverse Convertibles Can Turn the Tide on Investor Returns*, Invesopedia, http://www.investopedia.com/articles/bonds/08/reverse-convertible-note.asp (last visited February 28, 2010).

58. *Id*.

59. Larry Light, *Reverse Converts: A Nest Egg Slasher?*, The Wall Street Journal, June 16, 2009, at C1.

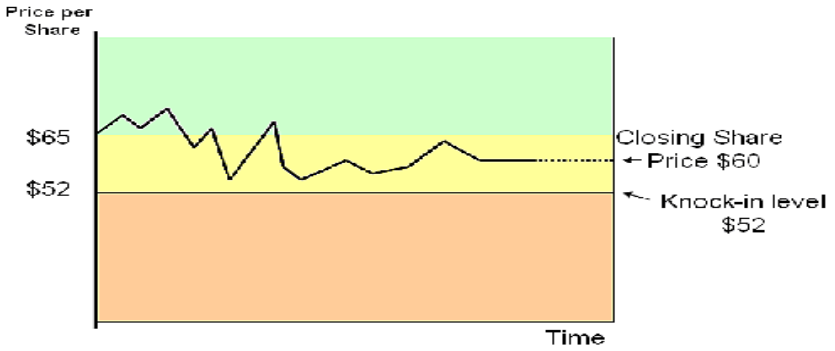
60. Lambert, *supra* note 57.

61. Light, *supra* note 59, at C1.

62. Macchaiarola, *supra* note 53, at 56.

63. Light, *supra* note 59, at C1.

64. Lampert, s*upra*, note 57.



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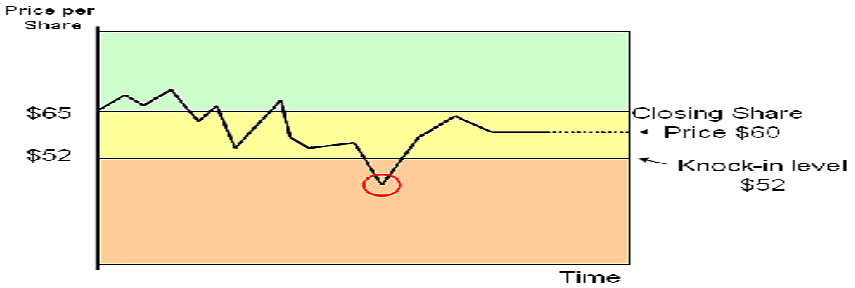
Therefore, as the stock never closed at or below $52 per share, the investor will receive the original investment back and would have collected interest on the bond itself.[66]

In another scenario illustrated below, the investor would have received 200 shares of stock ($13,000/$65) when the stock price had closed at $52 or less during the period that the note was in existence and the final price was less than the initial price of $65.[67] If the stock price upon maturity was at $60 per share, the investment would be worth $12,000 (200 shares * $60/share), causing the investor to have an unrealized loss of $1,000, less any coupon payments received.



68

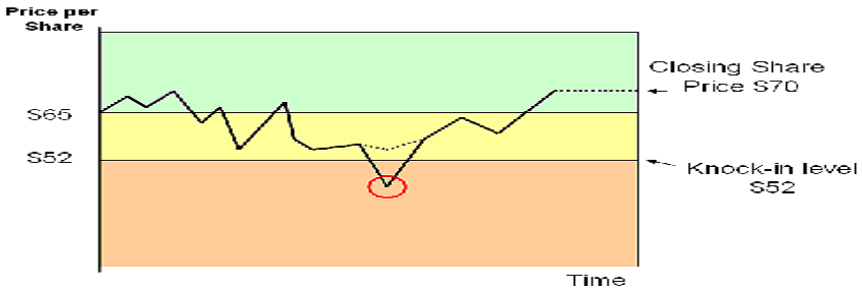
65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

The final situation demonstrates that when the stock price, upon maturity of the product, closes above the initial stock price, the investor will receive back the initial investment, regardless of the fact that the price dipped below the knock-in level during the life of the note.[69]



[70]

Principal-Protected Notes

In today's current market, the safest structured product is one where the note component is tied to an insured product, called a principal-protected note ("PPN").[71] This insured product is commonly a certificate of deposit, which is backed by the FDIC insurance up to the federal maximum.[72] Although the principal amount is protected, the investors see little gain, even if the stock market increased dramatically.[73] Additionally, investors must hold the note until maturity, usually from five to eleven years, in order to realize the return of the initial investment.[74] Typically, a structured product provider will partner with a large financial institution, for example, a well-known bank, to create the Principal-Protected Note.[75] The bank will provide

69. *Id*.

70. *Id*.

71. Light, *supra* note 3, at A25.

72. Pizzani, *supra* note 5. Currently, the FDIC insurance covers up to $250,000 per depositor per insured bank through December 31, 2013. On January 1, 2014, the amount is set to roll-back to $100,000.

73. Light, *supra* note 3, at A25.

74. Jade Hemeon, *PPN s are Hot This Season*, INVESTMENT EXECUTIVE, , February 16, 2006.

75. *Id*.

the guaranteed portion of the note and the provider will bundle that with another investment – anything from a mutual fund to futures.[76] These products are typically sold to retail investors, given the relatively low cost of anywhere from $2,000 to $5,000.[77] Of course, the "guaranteed" return may not be as sure a thing as retail investors may be lead to believe.[78] The underlying principal, which is invested in a "safe" investment of a financial institution is reliant on the financial institution still being in existence upon maturity,[79] assuming the underlying product is not covered by insurance like a Certificate of Deposit of up to $250,000 is covered by the FDIC.

To illustrate the complexity of these types of structured products, below is the possible payout of a principal-protected note.

> For example, a PPN that guarantees a 10 percent return of principal might be structured so that, if at any time up to and including the maturity date, the underlying index gains by more than 40 percent, the payout at maturity would be as follows:

If the underlying index's return is	... then the note's return is	... so the note investor gets	Examples
A gain of more than 40%	10%	110% of principal returned	Index rises to 160% of its initial level prior to the maturity date and ultimately finishes at 160% of its intitial level; note returns 110% of principal. Index rises to 150% of its initial level prior to the maturity date but ultimately finishes at 80% of its intitial level; note returns 110% of principal.

> However, if the underlying index does not gain by more than 40 percent at any time during the life of the note, then the payout would be as follows:

76. *Id*.

77. *Id*.

78. Halah Touryalai, *Principal-Protected Notes Not So Protected, FINRA Says*, REGISTERED REPRESENTATIVE, December 29, 2009.

79. *Id*.

If the underlying index's return is	... then the note's return is	... so the note investor gets	Examples
A loss of more than 10%	The underlying index return + 10%	From 10% up to (but not including) 100% of principal returned	Index loses 100% as of the maturity date; note loses 90% (*i.e.*, returns 10% of principal). Index loses 50% as of the maturity date; note loses 40% (*i.e.*, returns 60% of principal).
A loss of more than 10%	0%	100% of principal returned	Index loses 2% as of the maturity date; note returns 100% of principal. Index loses 10% as of the maturity date; note returns 100% of principal.
A loss of more than 10%	0%	100% of principal returned	
A gain of up to 40%	The underlying index return	More than 100% up to (and including) 140% of principal returned	Index rises 35% as of the maturity date; note gains 35% (*i.e.*, returns 135% of principal).

[80]

Below is an example of a note that offers 100% return of the initial investment and is linked to the spread between the 30-year and two-year constant maturity swap rates (capturing any widening of the yield curve between long-term rates and short-term rates) might be structured so that in the first year, the note pays the investor a fixed coupon of 10 percent, regardless of the spread:

If the spread between the 30-year and two-year constant maturity swap rates is	... then the note's return is	... so the note investor gets	Example
Any	10% for that year	10% after one year, paid as a coupon	Regardless of the spread, the note investor receives a coupon of 10% at the end of the first year.

80. FINRA Notice to Members 09-73, *Principal-Protected Notes*, FIN. INDUS. REG AUTH., December 2009, at 2-3.

However, after the first year:

If the spread between the 30-year and two-year constant maturity swap rates is	... then the note's return is	... so the note investor gets	Examples
Always less than 70 basis points during the year	0% for that year	No coupon payment for that year	Spread fluctuates but is always less than 40 basis points during the year; no coupon is paid.
Greater than 70 basis points on *N%* of the days in the year (on at least one day but not all days during the year)	10% multiplied by *N%* for that year	More than 0% but less than 10% for that year, paid as a coupon	Spread exceeds 70 basis points on half of the days during the year; 5% coupon is paid.
Always greater than 70 basis points during the year	10% for that year	10% for that year, paid as a coupon	Spread fluctuates but always exceeds 80 basis points during the year; 10% coupon is paid.

[81]

Structured Product Regulation for Individual Countries

Despite the collapse of Lehman Brothers structured products, most Europeans were preserved from the downfall as few held the Lehman investments.[82] Nevertheless, in the aftermath of the financial crisis, Europeans are more attentive when determining whether to purchase a structured product. For example, the issuer's name is now more important and there is a greater emphasis on the safety of the investments rather than on the potential return they may offer.[83]

81. *Id*. at 3-4.

82. Natasha de Teran, *What Does the Future Hold for Structured Products?: Entering a New World*, The Banker, July 1, 2009.

83. *Id*.

Norway

Norwegians were among the riskiest of structured product invests as they funded their purchases of these investments by taking out loans from financial institutions such as banks.[84] It is estimated that about 80% of the structured products purchased in Norway were funded in such a manner.[85] The guaranteed principal portion of a structured product is put up as collateral in exchange for the loan.[86] This subjected the investor to a tremendous risk given the low returns generated by the products.[87] However, it may not have been entirely the fault of the investors as there were numerous allegations by the end of 2007 that Norwegian banks mislead customers regarding the risks and rewards associated with structured products.[88] Eystein Kleven, of Kredittilsynet, Norway's Financial Supervisory Authority, stated in a recent speech that the most-common problems regarding the sales of structured products in Norway were that:

- "They were not sold in a regulated market, but in a non-transparent, shady market.
- They were offered to non-professional investors.
- They are more risky and costly than regular investments, with less or almost no liquidity.
- They reflect the market strength of distributors in relation to producers and misuse of investor's trust.
- They were part of, or an effect of the increased use of the securities market caused by securitization and innovations after 2001. In other words, they are elements in the current financial turmoil."[89]

The Kredittilsynet's investigation found that structured products purchased in

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84. *Norway Says No to Retail Buying of Derivatives*, EUROWEEK, Febr. 15, 2008.

85. *Id*. "Norwegians have invested a total of NOK 40.6 billion in structured products, of which NOK 32 billion [a little over $8 billion] comes from borrowed funds." Dagens Naeringsliv, *Concern About Lending in Structured Products*, Esmerk Norway News, April 10, 2008.

86. EuroWeek, *supra* note 84.

87. 2008 Global Survey, Institute of International Bankers, p. 123.

88. Bergens Tidende, *Misleading Advertising of Structured Products*, ESMERK NORWAY NEWS, April 10, 2008.

89. Eystein Kleven, Head of Securities Institutions Section, The Financial Supervisory Authority of Norway (Kredittilsynet), Supervision and regulation of the structured products market in Norway, Address Before the Structured Products Europe, London (Nov. 12, 2008).

2007 did not outperform similar hold-to-maturity investments that were comparatively risk free.[90]

In order to prevent these alleged practices from continuing, the Kredittilsynet implemented new restrictions on financial institutions that required greater disclosure to customers about the structured products offered to them.[91] Financial institutions were also to determine prior to sale whether structured products were suitable for the investor.[92] The Kredittislynet also stated that structured products should not be sold to non-professional investors and that financial institutions should stop lending to customers in order to purchase them.[93] This "effectively make[s] it illegal to sell structured bonds and other complex instruments to retail investors because…such customers often fail to understand the risks involved."[94] As a result of these restrictions, several financial institutions stopped selling structured products – specifically those purchased with loans.[95]

However, in a summary of 2008 examinations conducted on Norwegian investment firms, the Kredittislynet found, despite the aforementioned restrictions, that investment firms continued to recommend structured products that offered the best result for the firm, not the best result for the customers.[96] As a result, the Kredittislynet named three criteria that it will look for when conducting reviews of its investment firms.[97] The first is that the advisor must offer the best products for the customers.[98] The second is that the cost of the investments cannot materially reduce the potential return of the investment.[99] As structured products typically have significant costs associated with them, an investor's return may be significantly impacted.[100]

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90. *Id*.

91. Kredittilsynet, s*upra* Note 10.

92. Kleven, *supra* note 89.

93. Kredittilsynet, s*upra* Note 10.

94. Wojciech Moskwa, *Norway to Tighten Rules on Structured Products*, REUTERS UK, February 11, 2008, http://uk.reuters.com/article/idUKL1170675820080211.

95. Kleven, *supra* note 89.

96. *Id*.

97. *Id*.

98. *Id*.

99. *Id*.

100. *Id*.

Finally, the fees that the firm's receive for conducting these transactions must be "reasonable" compared to the "value added."[101] It is the Kredittislynet's hope that these new principles will curb abuse of an investor's trust by financial institutions.[102]

Italy

Italy faired the financial crisis much better than Norway, in part thanks to a traditional banking business model, sufficient regulatory oversight, and a lack of a mortgage loan collapse.[103] Italian bank did invest in structured products, but at a substantially lower level than other European countries.[104] Additionally, although Italian structured products may have had mortgage notes as the underlying security, most Italian mortgage loans had a substantial amount of equity already in place.[105]As of 2006, the average loan to value ratio was at about 50% and among the lowest of countries surveyed.[106]

CONSOB (Commissione Nazionale per le Societa e la Boras), the Italian securities regulator, has proposed changes to prevent structured products from being sold to retail customers[107] This was poorly received by brokers who argued that these investments give investors access to guaranteed returns,[108] presumably via the underlying bond. The need for reform may have been shouted down as Italy did not suffer the mortgage collapse as other countries due to less risky lending strategies[109] and Italian banks not being as

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101. *Id*.

102. *Id*.

103. Organization for Economic Co-Operation and Development, OECD Economic Surveys: Italy 46 (2009).

104. *Id*.

105. *Id*.

106. *Id*.

107. Riccardo Sabbatini, *Italian Brokers Oppose Illiquid Product Rule Changes*, IL SOLE 24 ORE, July 4, 2008.

108. *Id*.

109. Nora Colomer, *Fewer Traumas for Italy's More Conservative Mortgage Market*, Asset Securitization Report, May 1, 2009.

heavily invested in structured products as other European and U.S. banks.[110]

As a result of being unable to ban the sale of structured products, on March 2, 2009, CONSOB issued less harsh guidelines for the distribution of structured products to retail customers.[111] CONSOB's recommendations include more transparency of structured products, a clear pricing valuation, and greater suitability to match the appropriate structured product to each individual customer.[112] The Italian regulator stated in its guidance that often the only place the investor can receive information regarding a structured product is from the very firm selling the product in the first place.[113] The guidelines were issued by CONSOB in order to provide retail customers with more information in order to have a better understanding when making an investment decision as structured products can be difficult to understand.[114] Time will tell if these guidelines are sufficient to prevent customer harm.

United States

The United States has taken a different tact in that its regulators have not prohibited structured products, but only require that investors are provided the proper disclosures.[115] The American securities market is primarily regulated by the Securities Act of 1933 ("Securities Act") and the Exchange Act of 1934 ("Exchange Act"), [116] which espouse the buyer beware

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110. OECD Economic Surveys-Italy, *Chapter 2: Weathering the Storm: The Financial System in Italy*, June 1, 2009.

111. CONSOB Communication No. 9019104, March 2, 2009.

112. Client Alert No. 845, *MiFID Guidance: Italian Securities Regulator Outlines Duties of Intermediaries to Retail Buyers of Derivatives and Illiquid Securities*, LATHAM & WATKINS, April 1, 2009.

113. *Id*.

114. *Id*.

115. Louis Loss, FUNDAMENTALS OF SECURITIES REGULATION 7 (2d ed.1988). After the stock crash of 1929, Congress debated what type of federal statutes should be put in place to regulate securities. The two general choices were between a merit-based standard or an anti-fraud principal. History reveals that the latter was chosen along with its disclosure requirement. *Id*. at 28-29.

116. Macchiarola, *supra* note 53, at 60. The Securities Act of 1933 is primarily concerned with regulating the issuance of securities and the Exchange Act of 1934 generally regulates the sales of those securities.

approach.[117] These laws are enforced by the Securities and Exchange Commission ("the SEC").[118] The Securities Act requires that structured product offerings be registered prior to distribution.[119] The Exchange Act governs trading of securities, specifically "regulation of the exchange and over-the-counter markets; prevention of fraud and market manipulation; and control of securities credit by the Board of Governors of the Federal Reserve."[120] Therefore, before an investor purchases a structured product, under the Securities Act, the investor shall "receive a preliminary prospectus supplement that describes the characteristics and risks of the structured product being offered."[121]

Currently, the regulation of structured products in the United States is still primarily limited to the registration and anti-fraud requirements of the Securities and Exchanges Acts, respectively.[122] The Securities Act contains three civil liability actions.[123] Section 11 pertains to registration statements that are materially misleading or defective, Section 12(1) is regarding unregistered securities, and Section 12(2) imposes sanctions if there are material misstatements, regardless of whether the security is registered or not.[124]

Section 11 provides recourse for investors who suffer a loss only if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[125] The investor does not have to prove reliance, other than in limited circumstances, nor does he or she have to prove causation.[126]

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117. Loss, *supra* note 115, at 32.

118. *Id*. at 35.

119. NtM 05-59, *supra* note 7, at 3.

120. Loss, *supra* note 115, at 36.

121. NtM 05-59, *supra* note 7, at 3.

122. Jennifer Bethel & Allen Ferrel, *Policy Issues Raised by Structured Products* 11 ((Harvard Law Sch., Econs. & Bus. Discussion Paper Series, Paper No. 560, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941720.

123. Loss, *supra* note 115, at 881.

124. *Id*.

125. 15 U.S.C. § 77(a) (2010).

126. Loss, *supra* note 115, at 896.

In order for an issuer to be liable for violating Section 12(1), the investor must prove:

(1)that the defendant was a seller; (2) that the mails or some means of transportation or communication in interstate commerce was used, not just in connection with the offering of the security generally but in the offer or sale to the particular plaintiff; (3) that the defendant failed to comply with either the registration or the prospectus requirement; (4) that the action is not barred by the statute of limitations; and (5) that adequate tender was made when the plaintiff is seeking rescission.[127]

The measure of damages, however, is limited to the difference between the original cost and what the investor received when the product was sold.[128]

In order to prevail on a material misstatement by the issuer, under Section 12(2), the investor again does not have to prove reliance on the misstatement or omission.[129]However, the investor does have the added burden of proving that the misstatement or omissions were intentional, or at least negligent in use.[130]

The premier anti-fraud provision created by Congress was Section 10(b) of the Exchange Act, and the SEC's subsequent adoption of Rule 10b-5.[131] Section 10(b) is a "catch-all"[132] as it gives the SEC the power to create rules and regulations as necessary to protect investors from fraud.[133] The Rule states that it is unlawful:

To employ any device, scheme, or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[134]

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127. *Id* at 883.

128. *Id* at 886.

129. *Id* at 889.

130. *Id* at 892.

131. *Id* at 702.

132. *Id* at 726.

133. *Id* at 702.

134. 17 C.F.R. § 240.10b-5 (2010). The adoption of Rule 10b-5 is itself rather underwhelming. A bank president was telling his shareholders that the bank was doing poorly, yet he was purchasing all the outstanding shares in the knowledge that the company was actually doing very well. In order to address this malfeasance, the

Rule 10b-5 was meant to be as broad as possible so as to be able to address fraud in its myriad of forms.[135]

A significant development by the SEC of structured product regulation is the issuance of the 1996 No-Action Letter to Morgan Stanley, wherein the SEC provided guidelines of these types of investments.[136] The SEC stated that investors should receive disclosures regarding both the issuer of the underlying security and the issuer of the structured product, although a shortened disclaimer of the underlying security would be allowable when "there is sufficient market interest and publicly available information regarding the issuer."[137] Morgan Stanley argued that the structured product transactions are similar to a secondary offering, wherein the security has already been registered and is in the marketplace, and therefore no disclosure to customers was needed.[138] SEC instead found that full disclosure of the two issuers was necessary given that the structured product and its underlying security acted in unison.[139] Therefore, the issuer of structured products now was subject to the Securities Act, given the need to register the security.

As early as 2005, FINRA provided guidance to its member brokers and dealers which reminded them of the requirement to present a "fair and balanced picture" of the products being offered.[140] When structured products were assigned a credit rating, FINRA cautioned that the materials distributed to customers clearly state whether this rating is based on the structured product itself or is instead based on the issuer's creditworthiness.[141] Sellers are also advised to implement a safeguard wherein a customer may only

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SEC commissioners used Section 10(b) to create Rule 10b-5. At the meeting to discuss adoption, the commissioners reviewed the proposed rule, but no one said anything. Finally, one commissioner stated " Well, we are against fraud, aren't we?" Loss, *supra* note 115, at 727.

135. Loss, *supra* note 115, at 742.

136. Morgan Stanley & Co., Inc., SEC No-Action Letter, 1996 WL 347869 (June 24, 1996).

137. *Id*.

138. Macchiarola, *supra* note 53, at 68.

139. *Id*.

140. NtM 05-59, *supra* note 7, at 3.

141. *Id*. "Members presenting a credit rating must address the fact that the creditworthiness of the issuer does not affect or enhance the likely performance of the investment other than the ability of the issuer to meet its obligations. *Id*.

purchase a structured product if that customer is approved for options trading, given the similar risk factors of both investments.[142]

FINRA also goes a step-beyond federal securities law[143] by having a suitability requirement for transactions with customers.[144] In regards to structured products, firms have a two-step suitability determination. First, they must ensure that a structured product is suitable for customers – not every customer, but some.[145] This is the reasonable basis suitability.[146] Firms can determine this if "the potential yield is not an appropriate rate of return in relation to the volatility of the reference asset based upon comparable or similar investments, in terms of structure, volatility, and risk in the market as determined at the time the structured product is issued."[147] The second step is the customer specific suitability standard in which a structured product must be appropriate for a particular customer.[148] Per NASD Rule 2310, suitability is determined by comparing the investment to the customer's tax status, investment objectives, financial status, and other reasonable information.[149] FINRA warns that the derivative portion of a structured product makes it ill-suited to be a substitution for a debt instrument as the profit and risk are from different.[150] Additionally, FINRA recently released another regulatory notice advising firms to not misstate the safety of principal-protected notes, a form of structured products.[151]

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142. *Id*.

143. *See* Gadziala, *supra* note 7.

144. NASD Rule 2310

145. NASD Notice to Members 05-59, *supra* note 7, at 5.

146. *Id*.

147. *Id*.

148. *Id*.

149. NASD Rule 2310, *supra* 144.

150. NASD Notice to Members 05-59, *supra* note 7, at 8.

151. NASD, s*upra* note 80, at 1. Further, an investors was recently awarded $200,000 by an arbitration panel that found that her broker, UBS, sold her unsuitable Lehman Brothers principal-protected notes. Although the panel did not explain its findings and arbitration awards do not sent precedent, it may influence many other similar pending arbitration disputes. Jessica Papini, *Investor Wins Lehman Note Arbitration*, WALL STREET JOURNAL, December 5, 2009, *available at* http://online .wsj.com/article/SB10001424052748703735004574576260110956526.html.

Argument

Given the various approaches illustrated above, which is the best one for a country to follow? The Norwegians have effectively banned the sale of structured products to its citizens, claiming that they are too complex. The Italians tried to follow suit, but were unable to muster the public backing to do so. Perhaps this is because Italy was not as adversely affected by the economic shakedown as Norway. Instead, Italy issued guidelines to financial institutions imploring them to provide more information to customers so that they would be better aware and less reliant on what their stock broker told them. The United States federal statutes have always provided that as long as the proper and material information is disclosed to investors, there is no recourse for investors if the investment does not perform as expected. However, the United States does have the caveat in that broker dealers must abide by the more stringent regulation of FINRA which mandates that a structured product must be a suitable investment for a customer given that person's financial status and other factors, such as age and investment experience.

As each country is different and faces its own unique problems, in general, the United States' method provides the better approach in that it explicitly bars fraud and other bad acts in its securities laws. Further, at what point does the individual assume personal responsibility for their own safety? By outlawing structured products, is the Norwegian government appearing to state that all other security investments offered by Norwegian investment advisors are safe? This provides a dangerous precedent whereby the investor may stop thinking for him- or herself and blindly rely on what his or her brokerage firm tells them simply because the government has not banned the product. Additionally, the Kredittilsynet stated that one the problems with structured products is that they were not adequately regulated. Given the guidance issued by the Kredittilsynet, this would seem to be a more rationale approach, versus the ban of sales to retail customers.

Therefore, a more tempered approach, like that of the United States, is more reasonable. The investor is aware that the government is over-sighting the financial industry, but also knows that this review is not of a merit-based variety, but one of proper disclosure. As long as there is a warning label on the product, the United States government leaves it in the hands of the individual to determine if this is the good that is right for them. However, these disclosures should be clearer to the investor and not buried in a one hundred page disclosure document formatted with eight-point font. This would not seem to be an adequate disclosure and flies in the face of the spirit of the law.

Conclusion

Despite the endeavors of security regulators, it appears that structured products are here to stay.[152] Within the first few weeks of 2010, sales of structured products in England have already surpassed £2.7 billion and are expected to grow throughout the decade.[153] The United States and other countries are also experiencing a similar resurgence of structured products. This continuing surge is partially explain by investors feeling that, after the intense review of structured products during the past year, "nothing less than best industry practice is now acceptable."[154] One is left to hope that this optimism is not misplaced.

152. Welling, *supra* note 4.

153. *Id*.

154. *Id*.

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Teresita Cintron v. BBVA Securities of PR, Inc., Jeffrey Lopez, Sonia Marbarack, and Ruben C. Fernandez
FINRA Case No. 08-03559

Claimant met with the Assistant VP of Respondent BBVA and the firm's Senior VP of Investments in early January 2006. From the very beginning of the meeting, Claimant made clear that she wanted to invest in a no-risk conservative investment in which she could receive steady income, which she needed in order to sustain her basic necessities and to care for her mother. Claimant also made clear that she had to dedicate a significant amount of time to care for her mother and this had limited her productive capacity and that the money she intended to investment was from a non-recurrent source.

Respondent's officers delivered Claimant a personalized pamphlet in which they proposed Claimant invest in the Puerto Rico Investors Tax Free Fund I, Inc., Tax Free Puerto Rico Fund II and Puerto Rico Fixed Income Fund II, Inc., which they stated would generate a dividend payment of 6.11%, as well as "The Best of America All American Gold Annuity," which they stated would provide long-term appreciation of capital. They also advised Claimant to invest a portion of her assets in a money market fund (cash) for immediate liquidity.

A few weeks later, one of the officers contacted Claimant and informed her that he had a better investment, which would be "Triple A" rated with a greater return. Specifically, he told Claimant the new investment was "just what you need." Afterwards, the officer, who at that time was still registered as a broker of BBVA, Claimant at her home with what he told her was a bond contract (hereinafter "the document").

The officer then asked Claimant to entrust him with $900,000.00. Claimant, who was vulnerable at the time, put her trust in the officer, signed the document, and turned over the $900,000.00 requested. At that time the officer said he would get in touch with Claimant in the next few days.

Ultimately, Claimant never saw or heard from the officer again. She later learned that he no longer worked at BBVA and that the bonds were actually a participation agreement for a start up corporation incorporated in

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

by the officer between the first and second meetings. Later, the corporation filed for bankruptcy. Claimant received approximately $122,550 from the officer.

Claimant asserted the following causes of action: (1) unsuitability; (2) misrepresentations/failure to disclose; (3) manipulative, deceptive, and fraudulent devices; and, (4) breach of fiduciary duty.

Award: The Panel found Respondent BBVA liable and ordered it to pay Claimants $242,000, plus witness fees of $29,450, and reimbursement of the non-refundable portion of Claimant's filing fee. The Panel also ordered Respondent BBVA to pay $19,575 of the $26,100 in hearing session fees.

Claimants' Counsel: Marie Elsie Lopez-Adames, Esq., Gonzalez-Lopez & Lopez Adames, San Juan, Puerto Rico.

Respondent's Counsel: Ramon Coto-Ojeda, Esq., Coto Malley & Tamargo, LLP, Hato Rey, Puerto Rico.

Claimant's Expert: Robert W. Lowry, RL Consulting Services, Inc.

Respondent's Expert: Howard Scherer, Howard Scherer LLC Consulting Services

Arbitrators: Mark L. Scheinbaum (Public Chairperson); Jorge R. Jiminez (Public); Armando E. Ramirez Vivoni (Non-Public)

This case is significant because although Claimant never signed a new account form, she was deemed to be a customer and her claim was allowed to be submitted to arbitration. The case is also significant because upon finding liability the arbitrators must have taken into consideration the fact that Respondent's president had been notified about the possibility that the officer had incorporated a side business (which was supposedly set up to buy a personal real estate property) and did not take further action.

Daydream Trading, LLC, et al. v. TD Ameritrade, Inc.
FINRA Case No. 09-02054

Daydream Trading, Inc. was the name of the account set up at TD Ameritrade to conduct very active, short-term trading in very sophisticated option contracts, and specifically, option spreads referred to as "iron condors." The activity created thousands of trades and hundreds of thousands of dollars in commissions. Ameritrade attracted the client's account because it represented that it could handle this kind of trading and would manually calculate the margin balances daily. As the markets became very volatile in 2008, Ameritrade panicked, and abruptly halted all trading in the client's account except for closing contracts. Because of the nature of the type of options spreading that the client was conducting and the timing of the restriction by Ameritrade, the client's account was wiped out.

Claimant's expert, Douglas Schulz, testified that despite the fact that the account was self-directed and that the account holder released TD Ameritrade from any liability in the written documents, there are nonetheless numerous securities regulations, norms, and standards that apply to TD Ameritrade and its handling of the account. Ameritrade allowed the Claimant to trade in a certain way over a number of years. And then with little to no notice, Ameritrade restricted any further trading by the client at a most inappropriate time in some of the most volatile markets. Mr. Schulz testified that the actions of Ameritrade were not only arbitrary, they were a direct violation of FINRA rule 2010: standards of commercial honor and principles of trade.

Claimant asserted the following causes of action: (1) breach of contract; (2) breach of covenant of good faith and fair dealing; (3) conversion; (4) breach of FINRA rules; (5) intentional infliction of emotional distress; (6) negligent infliction of emotional distress; (7) negligence; and, (8) tortuous interference with economic relations. Claimants also sought statutory and treble damages under the Utah Securities Act

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent's defense was primarily based on the language in the Customer Agreement, which stated that Ameritrade could restrict trading for almost any reason at any time. Ameritrade's additional defense was that the severe bear market of 2008 was unprecedented in history and required to Ameritrade to take steps to defend its equity.

Award: The panel found Respondents jointly and severally liable, and ordered them to pay Claimants: (1) compensatory damages in the amount of $6,924,538.90; and (2) $250 as reimbursement for the non-refundable portion of the initial filing fee.

Claimants' Counsel: Matthew R. Lewis, Esq., Ray, Quinney & Nebeker, Salt Lake City, Utah

Respondent's Counsel: Miles D. Hart, Saretsky Hart Michaels & Gould PC, Birmingham, Alabama

Claimant's Expert: Douglas Schulz, Invest Securities Consulting, Inc.

Respondent's Expert: Paul G. Meyers.

Arbitrators: A.O. Headman, Jr. (Public Chairperson); Richard J. Lawrence (Public); Thomas R. Bromberg (Public)

This case is significant because it represents an award of nearly $7 million, which exceeded the losses in the actively traded online "self directed" brokerage account. In addition, it is noteworthy that Ameritrade personnel had mocked the Claimants on recorded messages at the time of the trading activity and the defense attorney consistently displayed an attitude of "how dare we be sued for this" at the arbitration hearing.

Lesmir Inc. d/b/a Rosen Properties and Rosen Harbottle, et al. v. Wedbush Morgan Securities Inc., et al.

FINRA Case No. 09-02259

This case was filed by two individuals on behalf of themselves and various real estate entities they owned. Respondents sold each of the Claimants ARS issued by closed-end funds managed by Nuveen Investments, LLC. Initially, Claimants had named Nuveen as a Respondent; however, Nuveen was dismissed prior to the arbitration hearing. The remaining Respondents argued that they were not liable because they were not part of the selling group, not the originating issuer, and that they merely acted as a broker.

At the arbitration hearing, Claimants showed that they had stated that they were only interested in money market or 30-day U.S. Treasury securities. The individual Claimants showed that they had clearly expressed that these monies were to fund the companies' short-term obligations and, as such, needed the investments to remain liquid. In addition, Claimants demonstrated that the broker suggested ARS as an alternative to money market investments and T Bills.

Claimant asserted the following causes of action: (1) fraud and deceit; (2) breach of fiduciary duty; (3) negligent misrepresentation; (4) negligence; (5) violation of RCS § 21.20.010, 21.20.430 — Washington Blue Sky Laws; (6) violation of § 10(b) of the Securities Exchange Act; (7) conversion; (8) constructive fraud; (9) suitability; and, (10) rescission.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent also argued that they were entitled to all of the interest that the Claimants had earned as an offset to any losses.

Award: The panel found Respondents jointly and severally liable, and ordered them to repurchase $2,825,000.00 in ARS from Claimants, which represented the remaining amount held by all Claimants. In addition, the Panel ordered Respondents to pay Claimants a total of $245,865.14 in costs, expert witness fees, accounting fees, and attorneys' fees.

Claimants' Counsel: Steven Williams, Esq., Cotchett, Pitre & McCarthy, Burlingame, California.

Respondent's Counsel: John W. Stenson, Esq., Wedbush Morgan Securities Inc., Los Angeles, California.

Claimant's Expert: Craig McCann, Securities Consulting and Litigation Group; Bob Grosnoff, Grosnoff Litigation Consultants LLC.

Respondent's Expert: Fergus Henehan, The Sutro Group.

Arbitrators: Frederic E. Dorkin (Public Chairperson); Charles Scott McClellan (Public); Julie Eileen Gay (Public).

This case is significant because it represents a full award of rescission, plus costs, and attorneys' fees in an auction rate securities case against a "downstream" broker. In addition, the Panel appears to have acknowledged that pursuant to *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), it was not appropriate to reduce Claimants' losses or Respondents' rescissionary obligations by the amount of benefit Claimant's received (i.e., interest paid on the ARS).

James L. Snow, et al. v. Prudential Equity Group, LLC, et al.
FINRA Case No. 07-01704

Claimants hired Respondents to assist them in planning for retirement. Respondents recommended a strategy by which Claimants would take 72(t) distributions from their retirement account. In addition, Claimant's alleged that Respondents engaged in selling away and unauthorized trading.

Claimant's expert created and used a chart at the arbitration hearing that showed a number of "unsolicited" trades that occurred in each of the Claimant's accounts at the same time. From this, Claimant's expert testified that it would have been virtually impossible for each of the Claimants to have contacted prior to each of the transactions in order to authorize the trades. Claimants also presented a phone log and were able to show numerous dates on which these "unsolicited" trades were executed, but where no calls were entered.

Claimant asserted the following causes of action: (1) suitability; (2) misrepresentations; (3) negligence; (4) unauthorized trading; (5) violations of rules of NASD, NYSE, and the SEC; and, (6) violation of the laws of Alabama and Mississippi. In the Statement of Claim, Claimants requested: (1) an unspecified amount of compensatory damages; (2) rescission for all transactions executed by unauthorized discretionary authority; (3) payments for all income distributions from principal instead of from net investment income; (4) payments for losses due to unsuitable equity percentages in retiree portfolios as compared to a "well-managed" balanced portfolio suitable for a retiree's income account; (5) tax losses caused by non-disclosure of Net Unrealized Appreciation ("NUA") tax treatment of Chevron stock; (6) full interest from the time of the violations; (7) attorneys fees; and, (8) exemplary damages.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondents also requested that the Panel order Claimants to pay attorneys' fees, costs, and other relief.

Award: The panel found Respondents jointly and severally liable, and ordered them to pay Claimants: (1) compensatory damages in the amount of

$438,000; (2) punitive damages of $75,000 pursuant to *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995) and *Adams v. Securities America, Inc.*, Case No. 06-2509, 2006 U.S. Dist. LEXIS 68190 (E.D. La. Sept. 12, 2006) ; (3) post-judgment interest at a rate of 8%; and, (4) $143,000 in attorneys' fees pursuant to *Aetna Casualty v. Steele*, 373 So. 2d 797 (Miss. 1979).

Claimants' Counsel: Mack A. Bethea, Esq. and Kim Breese, Esq., Gulfport, Mississippi

Respondent's Counsel: Retta A. Miller, Esq., Jackson Walker, LLP, Dallas, Texas

Claimant's Expert: Bob Grosnoff, Grosnoff Litigation Consultants, LLC.

Respondent's Expert: James E. Brucki, Jr.

Arbitrators: Mark Myers (Public Chairperson); Kendall Hill (Public); Robert Killelea (Public)

This case is significant because the award represents a full recovery of net out of pocket losses, plus attorneys' fees and punitive damages in a 72(t) case. The Panel's award essentially put the Claimants back in the same position that they were in when they first retired. In addition, Respondents argued that the gains should be netted against the losses. Claimant's used the case of *Randall v. Loftsgaarden*, 478 U.S. 647 (1986) to demonstrate that it was not appropriate to reduce a defrauded investor's damages by the amount of benefit otherwise obtained.

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. 34-62930/SR-FINRA-2010-036- Proposed Rules Regarding an Arbitrator's Mid-Case Referral to the Director of Arbitration and Resulting Procedures Including Removal of Entire Panel Upon Request* was submitted to the Securities and Exchange Commission by Scott R. Shewan on October 11, 2010.

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

Re: File No. SR-FINRA-2010-0036 – Proposed Rules Regarding an Arbitrator's Mid-Case Referral to the Director of Arbitration and Resulting Procedures Including Removal of Entire Panel Upon Request

Dear Ms. Murphy**:**

Thank you for the opportunity to comment on the above-referenced rule proposal filed by the Financial Industry Regulatory Authority ("FINRA"). The proposed rules seek to amend FINRA Rule 12104 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code") and to create new Rule 12902(e) regarding the assessment of hearing session fees, costs, and expenses if any arbitrator makes a referral during a case that results in panel withdrawal. Corresponding rules are proposed within the Industry Code, which PIABA does not address.

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA")[1] to voice objections to the proposed rules. PIABA objects to proposed rules 12104(c) and (d) as they would create unnecessary, unfair burdens on public investors. . For instance, proposed Rules 12104(c) and (d) would create absolute rights of a party to demand a new panel when even a single arbitrator makes a disciplinary referral, and would establish procedures for 'starting over' in the arbitration forum. In our view the proposal appears to be a solution without a problem, the implementation of which would pose potentially devastating penalties on customers who have been harmed by the conduct of FINRA members. FINRA should not require

1. PIABA is an international bar association, consisting of more than 460 members, dedicated to the protection of investors' rights in securities arbitration proceedings.

public investors who are forced into the arbitration forum to thereafter bear the brunt of FINRA's own enforcement and regulatory obligations to detect fraud. The 'starting over' procedures in FINRA's current proposals are inconsistent with the provisions of Section 15A (b)(6) of the Act[2] and should be rejected.

There Is No Demonstrated Problem for This Solution

FINRA states no reason to impose an additional burden on already defrauded customers. It provides only a vague reference to "recent well publicized frauds that resulted in harm to investors" as a justification.[3] It fails to identify those frauds or to state how a mid-arbitration referral by an arbitrator might have protected investors. FINRA should be required to provide substantial justification, not vague generalizations to place substantial new burdens on customers.

FINRA's assessment that mid-case referrals would "strengthen FINRA's regulatory structure" is unfair to investors who have already suffered harm at the hands of their broker. In neither the mandatory arbitration agreement nor the uniform submission agreement are investors told they will be required to assist FINRA Enforcement at great prejudice to themselves. Indeed, FINRA regulators are provided with a copy of every statement of claim filed in arbitration by an investor. Enforcement personnel have every opportunity to investigate and charge the brokers and firms named in these claims. Little would be added by permitting mid-case disciplinary referrals. Yet the harm to the investor claimant will be significant.

Starting Over Will Unjustly Cause Customers Substantial Harm

The most disturbing aspect of the rule proposal is that a single arbitrator, by making a mid-case referral, can cause the arbitration proceeding to start over with an entirely new panel. This can result in months of delay, and a significant increase in cost to the parties to the proceeding. It is not hard to

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2. 15 U.S.C. 78o-3(b)(6).

3. FINRA fails to identify specific examples where such disasters could have been alleviated through arbitrator referrals. Moreover, FINRA could and should already urge any person with information suggesting such horrific scandals to contact FINRA's ombudsman or other authority immediately, on an anonymous basis if needed.

envision a situation where this unfairly penalizes an investor. Consider the situation where an investor's attorney conducts a two-day examination of the broker, and clearly establishes the broker's wrongdoing to the point where a panel member decides that an immediate referral must be made. Even though the case may be completed within days, the arbitrator's referral will require the panel to be disbanded, and the investor will be required to start all over with a new panel. During the interim, the broker's attorneys will have learned from the broker's examination, and will prepare the broker better for the second go-round. The investor will be required to wait months for redress, during which time the broker or firm could go out of business or have its assets wiped out by another investor claimant. Therefore, this rule proposal would have a tendency to penalize the most diligent of investor claimants.

In response to this valid concern, FINRA speculates that the industry respondent subject to the referral "would attempt to settle, rather than risk continuing the case." It is equally likely that the Respondent will begin to secrete assets, or simply go out of business. Moreover, it is unlikely that any such settlement would be as advantageous to the claimant as the award which would have been issued by the offended panel. The prospect of a settlement simply does not adequately address investors' concerns in this regard.

The Proposed Rule Would Not Work

Even if one embraces the idea of arbitrators as enforcement officers, the proposed rule is unworkable. What happens if the second panel comes upon the same information and makes the same referral? Does Claimant have to start over yet a third time? Is there any limit? Wouldn't the fact that the second panel can review the record (though not executive sessions) result in the new panel also indentifying the scandalous facts and be subject to removal as was the first panel? Will the new arbitrators know the previous panel was removed because it saw a major fraud? What will FINRA tell the new panel?

Moreover, the rule is unlikely to have any positive effect. Suppose that a referral is made a week, or two weeks, earlier than would have occurred under the new rule. What is the likelihood that FINRA Enforcement will act any faster? How often does FINRA's disciplinary force seek an immediate injunction? Will any public investors really be protected, or will the investor who pursued an arbitration claim be the only person affected?

In short, the rule proposal raises more questions than answers. It will simply be unworkable in the real world.

Customer Costs Will Be Substantial

FINRA states that a customer "could" incur additional costs if required to start over. It seeks to partially mitigate those costs by not double charging them. The truth is that a customer will invariably incur additional costs and they could be substantial. The lawyers in many cases charge by the hour and FINRA should not interfere with the parties' choice of counsel or even ability to continue with counsel.

Similarly, the proposed rule stating that prior panel decisions could remain in force is unhelpful. Respondents will file a motion to reconsider every disputed ruling on the basis that the prior panel was removed for bias. The customer will be required to argue each issue a second time and be charged for each hearing. During this entire time, investors entitled to recovery would in some instances be wrongfully deprived of property they need immediately.

FINRA ignores attendant litigation costs, beyond just hearing session costs, which would be incurred under the proposed rule. What if the customers have to fly their expert in for a second hearing date? What if the expert is not available for the next hearing date? Will the customer be expected to bear the cost of hiring a new expert who will have to review the previous record? Who is going to pay to transcribe the "record" of the hearings of the prior panel? In short, the additional costs in both time and money would be substantial and would unfairly penalize the investor who was subjected to the worst broker behavior.

Investors already have difficulty locating competent counsel to handle their claims, especially smaller ones. Increasing the risk of having to try a case twice, with all the attendant time and expense, simply makes it less likely that an investor will be able to retain a competent representative.

The Current Rule Should Not Be Changed

Currently, Rule 12104 requires a panel to wait until after they have issued an award before making a disciplinary referral. We are unaware of any situation where the public was harmed by waiting until the hearing is concluded. The current rule is not in need to revision, and should be left intact.[4]

We thank you again for the opportunity to comment upon this rule proposal, and we urge the SEC to reject this misguided effort.

Respectfully,
Scott R. Shewan
President

4. If FINRA insists that it perceives a need to enlist arbitrators as enforcement officers, there is a more workable solution. Arbitrators could be permitted to make anonymous referrals. FINRA Enforcement could then investigate the arbitrator referral and determine whether violations are occurring. However, FINRA Enforcement should not be confused with FINRA Dispute Resolutions. These are two separate functions, both of which are necessary to protect the investing public. They should not be combined to the benefit of the arbitrating member firm and the detriment of the arbitrating customer. Anonymous referrals would provide the desired benefit without the unacceptable collateral damage.

The following PIABA Comment Letter regarding *Release No. 34-62718A/SR-FINRA-2010-039- Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook* was submitted to the Securities and Exchange Commission by Scott R. Shewan on September 9, 2010.

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

Re: SR-FINRA-2010-039 Rule Proposal Rules 2090 (Know Your Customer) and 2111 (Suitability)

Dear Ms. Harmon:

Thank you for the opportunity to comment on the Rule Proposals of the Financial Industry Regulatory Authority ("FINRA") to adopt FINRA Rule 2111 (Suitability) and FINRA Rule 2090 (Know Your Customer) as part of the Consolidated FINRA Rulebook. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA")[1] in general support of the above-referenced rule proposals. The proposed rules would be a step in the right direction to codify suitability and know-your-customer standards for FINRA members. PIABA respectfully asks the SEC to accept the proposed rule for a number of reasons but hopes that additional changes are made to this proposal.

Proposed Rule 2111

PIABA supports proposed Rule 2111 regarding suitability. Current NASD Rule 2310 applies to recommendations of a "purchase, sale or exchange of any security." The inclusion of both "recommended transaction[s]" and "investment strateg[ies]" under the proposed Rule 2111 is a welcome change. Today, brokers-dealers and their representatives make recommendations for not only individual purchases but also for particular strategies or plans. Brokers should have a reasonable basis for recommending an overall strategy in addition to recommending an individual investment.

1. PIABA is an international bar association, consisting of more than 460 members, dedicated to the protection of investors' rights in securities arbitration proceedings.

PIABA also supports the inclusion of the listed factors to be considered when determining a reasonable basis for recommendations. Brokers and their firms will have clearer guidance from FINRA that they should consider these factors when making the recommendations. It is also encouraging that brokers should also ascertain "any other information the customer may disclose to the member or associated person in connection with such recommendation."

The addition of the supplementary materials to proposed Rule 2111 should benefit investors and the member firms for the most part. These materials will help provide more guidance to the firms in making recommendations. Importantly, we support the inclusion of Supplementary Material .03, which identifies three suitability analyses that firms and brokers should consider when making a recommendation. Moreover, Supplementary Material .04 is helpful, as brokers should not make a recommendation that is inconsistent with the customer's ability to meet such a financial commitment. It makes common sense that a broker should not make a recommendation knowing that the customer may not be able to afford the particular investment or strategy.

PIABA does not support the inclusion of Supplementary Material .02, which specifically excludes a number of communications from Rule 2111's coverage. Brokers and firms often use asset allocation models when making recommendations to clients, particularly when the broker or firm are recommending a particular, overall portfolio strategy. Part C of Supplementary Material .02 would seem to not require a broker to include this information when discussing a strategy with a client. Securities customers should be informed of this information when their broker and firm recommend a strategy to them.

The most glaring omission from Rule 2111 is that there is no definition of "recommended" or "recommendation." PIABA believes that omitting a definition for this key term would create a loophole for brokers and firms to attempt to get around the suitability rules. PIABA supports clarifying this important term from sources used in the past by the industry.

NYSE Rule 472.40(1) defines a recommendation as "any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell or hold a security." PIABA supports the inclusion of this definition into Rule 2111 or its supplementary materials. This would provide a framework for brokers and firms to understand what would constitute a recommendation.

Importantly, PIABA hopes that FINRA and the SEC would include this definition to clarify that recommendations to "hold" a security are covered by the new rule. In reality, brokers make just as many recommendations to hold

a security or not to sell a security at a particular time, as they would for purchases or sales. Many customers rely on this advice from their broker in determining a course of action to take. A recommendation to hold is almost just as important (and sometimes more important) to a customer than the decision to buy. Changes in the market conditions or the client's individual circumstances may prompt a decision to sell or hold a security. The inclusion of recommendations to hold within this rule would provide a great benefit to investors, who should be afforded a reasonable opportunity to have such a claim considered by the arbitrators.

We therefore think it would be detrimental to exclude a part of the rule that creates suitability obligations for recommendations to hold. The mere absence of suitability obligations for recommendations to hold would send a signal to member firms and brokers that its absence is indicative that FINRA did not intend to include such in the rule. PIABA hopes that FINRA will consider this issue and propose language to include suitability obligations for recommendations to hold as well (or at least make the language clearer to indicate that recommendations to hold are covered under proposed Rule 2111).

Also, we believe that the proposed rule should be broader to include suitability obligations for all transactions, not just broker recommendations. In today's securities brokerage industry, most brokers are more than just mere order-takers. Many brokers provide advice to their customers about which securities to buy, sell, or hold, and many brokers hold themselves out as "financial planners."

A broker should have the same obligations to a customer who himself or herself decides which security to buy, sell, or hold. Brokers are often in a better position to evaluate the risks and characteristics of a given investment product than the client is. Brokers have better access to research reports, prospectuses, marketing materials, brochures, etc., than their clients, and many times are in a better position to understand the available information. This should prompt brokers to consider and discuss with the client the suitability of such investment. Today's brokers should consider the suitability factors when discussing all transactions, including customer-initiated transactions. This treatment would also be more consistent with goals to better harmonize the duties among brokers and other financial professional and decrease public confusion concerning multiple professional designations.

Proposed Rule 2090

PIABA also supports the inclusion of the NYSE's "Know Your Customer" rule as part of proposed Rule 2090. This proposed rule complements proposed Rule 2111 well. This will provide better protection to investors, as it requires the firms to use diligence to know and retain important and essential information about each customer and persons acting on behalf of the customer (such as trustees or powers of attorney).

However, PIABA is concerned that the proposed rule does not require the broker to do anything more than learn this information. The proposed rule should clarify that this rule requires the broker to use that knowledge not only for recommendations to buy and sell but for recommendations to hold as well. This is especially important in the context where securities are transferred from one firm to another. The broker at the transferee firm should be required to not only know the customer at that point but also to make recommendations based on the customer's individual circumstances and what securities are held in that customer's portfolio. If that customer's portfolio does not match his or her investment objectives, risk tolerances, or financial resources, then the broker should be required to take an active approach and do more than just learn of the customer's "essential facts." Most public customers believe that brokers are undertaking these professional tasks as a matter of course, especially when fees or compensation of any kind are involved.

In addition, we believe that the proposed rule should clarify that the broker should be required not only to know the essential facts about his customer, but also to know the essential facts about the order or recommendation. This would require the broker to not only "know your customer" but also to "know your security."

Recently in FINRA Notice to Members 10-22, FINRA stated "The Securities and Exchange Commission (SEC) and federal courts have long held that a BD that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it." A number of cases have stated that even in non-discretionary accounts, a broker has a duty to "recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis." *Leib vs. Merrill Lumch, Pierce, Fenner & Smith*, 461 F.Supp. 951, 953 (E.D. Mich. S.D. 1978); see also *Patsos v. First Albany Corp.*, 741 N.E.2d 841, 849-50 (Mass. 2001); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990); *Burns v. Prudential Securities, Inc.*, 857 N.E.2d 621 (Ohio App. 2006). At a time when investments are becoming increasingly complex, and novel

investments are created routinely, FINRA should enforce the notion that the brokers selling these products have an adequate understanding of the risks and characteristics of the investments they are selling in order to explain them to the customers.

Conclusion

In sum, PIABA supports these new rule proposals but hopes that FINRA and the SEC would make some additional changes in order to better protect the investing public. I would like to thank you once again for the opportunity to comment on this rule proposal.

Sincerely,
Scott R. Shewan
President

The following PIABA Comment Letter regarding *Study Regarding Obligations of Brokers, Dealers, and Investment Advisers* was submitted to the Securities and Exchange Commission by Scott R. Shewan on September 3, 2010.

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

Re: Release No. 34-62577; IA-3058; File No. 4-606
Study Regarding Obligations of Brokers, Dealers, and Investment Advisors

Dear Ms. Murphy:

On behalf of the Public Investors Bar Association ("PIABA"), I thank the Commission for this opportunity to comment on the above-referenced study regarding the standards of care for brokers, dealers and investment advisors when providing personalized investment advice and recommendations about securities to retail investors. 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 the current standards and any action the Commission may take with regard to the standards referenced above.

PIABA recommends that the Commission create a uniform standard with regard to brokers, dealers and investment advisors when providing personalized investment advice and recommendations about securities to retail investors. Such standard should encompass the broad fiduciary duty that currently applies to investment advisors. Today, brokers[1] and investment advisors are regulated under two different regulatory schemes with different standards of conduct. Notwithstanding this distinction, the services each offers are marketed in a way that makes them indistinguishable to investors. To complicate matters further, brokers often use titles that contain the word "advisor", leaving customers with no clear guidance on what rules apply to the accounts they hold. This confusion is clearly set forth

1. As used herein, the term broker includes dealers as well.

in the Treasury Department's report entitled "Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation"[2]:

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

Case law has consistently held that the Investment Advisors Act of 1940 (IAA)[3] has established a "federal fiduciary standard to govern the conduct of investment advisers, broadly defined, see *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 17, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979)."[4] Therefore, if an account is being handled pursuant to the IAA, the adviser has a fiduciary duty to the customer. 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.[5]

When it comes to the standard applicable to brokers, the answer is not as clear cut. There is no federal fiduciary standard that applies to brokers. Under the current regulatory structure, whether or not a fiduciary duty applies is dependent on state law, and as such, customers located in different states are owed different duties.

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2. http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (June 17, 2009).
3. 15 U.S.C. §80b-1 et seq.
4. *Financial Planning Ass'n v. Securities and Exchange Commission*, 482 F.3d 481, 490 (D.C. 2007).
5. 15 U.S.C. §80b-2(a)(11).

Courts have routinely held that when an account is discretionary, the broker has a fiduciary duty to the client. In *Leib v. Merrill, Lynch, Pierce, Fenner & Smith*[6], the court specifically set forth the duties a broker owed the customer when the account was a discretionary account:

> 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*, supra) ; (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).

However, when the account is not discretionary, the standards of duty owed by a broker to a customer vary widely from state to state. Certain states recognize a fiduciary duty in every broker – customer relationship. See *Duffy v. Cavalier,* 215 Cal.App.3d, 1517, 1530 (1989). Other states vary in terms of when the broker – customer relationship is a fiduciary one. In *Marchese v. Nelson*[7], the court laid out the ways various courts have addressed this issue:

> [I]n *Leib*, the court indicated that in a nondiscretionary account, the "broker is 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." *Leib*, 461 F.Supp. at 952-53. Notwithstanding this apparently limited duty, the *Leib* court identified six duties associated with nondiscretionary accounts: (1) the duty to recommend stock only after becoming informed about the stock; (2) the duty to promptly carry out the customer's orders; (3) the duty to inform the customer of the risks involved in a transaction; (4) the duty to refrain from self-dealing; (5) the duty not to misrepresent any fact material to a transaction; and (6) the duty to transact business only after prior authorization from the customer. *Id.* at 953.
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> …

6. 461 F.Supp. 951, 953 (E.D.Mich.1978)
7. 809 F.Supp. 880, 893 (D. Utah 1993)

> 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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> …
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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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> 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 recognized that apart from discretionary and non-discretionary accounts, there exists a hybrid-type 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."[8]

In addition to the discretionary-nondiscretionary nature of the account, the type of fees a customer pays is also relevant in determining whether or not a fiduciary duty exists. As mentioned above, 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. In 1999, the Commission expressed concern that the various fee structures that brokerage firms had begun to

8. 461 F.Supp. at 954.

offer would make firms subject to the IAA.[9] The Commission recognized that the nature of the services offered to the customer often did not vary depending on the type of account, but rather it was only the broker's compensation that varied. In light of this view, the Commission took the position that it did not believe that Congress intended these accounts to be covered by the IAA.[10] However, in 2007, the Court of Appeals for the D.C. Circuit struck down the rule, holding that the Commission did not have authority to broaden the exception set forth in the IAA.[11] 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.

The duties owed by the individual a customer is doing business with will vary widely depending on the individual's title, compensation structure, and the state in which the individual is located. Customers are left with differing degrees of protection. Because the services offered are so similar, customers should be afforded the same level of protection, regardless of whether they are dealing with a broker or an investment advisor. This may be done by either eliminating the broker exclusion contained within the IAA, or by adding language to the Securities Exchange Act of 1934 which mirrors that contained in the IAA. We believe the latter would alleviate any burden on brokers to additionally register as investment advisors. We would be supportive of any effort by the Commission to create high, uniform standards for investment professionals, regardless of the capacity in which they interact with customers.

If a uniform fiduciary standard is to be adopted, it must be a true fiduciary standard. A standard which is denominated "fiduciary" is not truly such, unless it has the historical hallmarks of fiduciary status. These include: (a) the duty of loyalty; (b) the duty to make full disclosure; (c) the duty to carry out the client's instructions faithfully; (d) the duty to act in the highest good faith; and (e) the duty to place the client's interest before the fiduciary's own interest. While a uniform fiduciary standard is a good idea, it must not be a watered-down standard masquerading as a fiduciary standard.

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9. S.E.C. Notice of Proposed Rulemaking, 64 Fed. Reg. 61,228 (Nov. 10, 1999). 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 http://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.

10. *Id.*

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

Finally, we urge the Commission to consider creating a private right of action to pursue a breach of a federal fiduciary duty. Presently, only a limited private remedy is recognized pursuant to the IAA.[12] In order for a federal fiduciary duty to be meaningful, it is essential that aggrieved customers be permitted to pursue legal remedies for a violation of that duty. Additionally, the federal fiduciary duty should represent the minimum standard to which brokers must adhere. To the extent that individual states wish to impose higher standards on brokers, it is important that states retain that right. It should be explicit that any federal fiduciary duty does not preempt any existing or forthcoming state fiduciary duty.

We thank the commission for the opportunity to share our views on this topic. To the extent the Commission has any questions or would like any further information, please do not hesitate to contact me.

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

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12. *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.").