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Timothy A. Canning

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LETTER FROM THE EDITOR

Timothy A. Canning

In this issue of the *PIABA Bar Journal*, we are pleased to present an article from Seth Lipner and Brady Sparks on ex-employees serving as arbitrators in cases involving their ex-employers; an article from Douglas Schultz on due diligence; and an article from Peter Katt on life insurance settlements. Jason Kueser also summarizes four very interesting FINRA arbitration awards that were recently released.

We are also pleased to present three more of the best student-written articles that were submitted to PIABA's James E. Beckley Writing Competition for 2010. The student articles have been subject only to minor technical editing and formatting; what you read in here is exactly what the students wrote. The articles from the Writing Competition being published in this issue are:

The Employee-Whistleblower and the Decision to Expose Corporate Fraud: Show Me the Money, by Elizabeth Mihalek (Ms. Mihalek is finishing up her final semester of law school at the University of Notre Dame);

Developments in the Evidentiary Showing Required for Plaintiffs at the Class Certification Stage for a Civil Securities Fraud Case, by Vanessa Lu (Ms. Lu will be graduating in May from Loyola University Chicago School of Law with a trial advocacy certificate); and

Securities & Exchange Commission v. Tambone: Diminishing Liability for Underwriters and Secondary Actors in Securities Fraud, by Diana Gesualdi (Ms. Gesualdi is a second-year law student at Brooklyn Law School).

The purposes of the James E. Beckley Writing 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 Writing 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 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. In honor of his legacy, PIABA established the James E. Beckley Writing Competition and awards.

PIABA will once again be sponsoring the James E. Beckley Writing Competition for 2011; submissions will be due in mid-September, 2011. Please encourage any law students you know who are interested in writing to enter the Competition for 2011. Please check the PIABA website for more details on deadlines and requirements.

I hope you will enjoy the articles in this issue of the *PIABA Bar Journal*.

Tim Canning
Editor-in-Chief
PIABA Bar Journal

EX-EMPLOYEES OF RESPONDENTS SHOULD NOT SERVE AS ARBITRATORS

Seth E. Lipner and Brady Sparks*

Arbitration panel composition is an important concern for all participants. Arbitrators are judge and jury. They should be fair and impartial, and they should decide each case based on the evidence, applying the arbitrator's own sense of law and equity to the facts as that arbitrator finds them to be.[1]

FINRA arbitrators are drawn from the legal and business community; FINRA maintains rosters of arbitrators[2] for each location in which it holds

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* Seth E. Lipner is Professor of Law at the Zicklin School of Business, Baruch College, CUNY. He is a member of Deutsch & Lipner in Garden City, N.Y. Brady Sparks handles trials, appeals and arbitrations in securities matters and commercial litigation. Brady is a former chief felony prosecutor, is Board Certified in Civil Trials by the Texas Board of Legal Specialization, has tried over 300 cases to a verdict before a jury, and has acted as a court-appointed mediator in almost 500 cases. He won his very first federal case, a civil securities action styled *Pinter v. Dahl*, in the U.S. Supreme Court in 1987, reversing the Fifth Circuit and the trial court. In 2009, he won a significant case in the U.S. Fifth Circuit, *Bacon v. Citigroup*, for which he was featured on the cover of the Texas Lawyer. He has over thirty years' experience in a wide variety of civil and criminal matters.

The authors thank David Robbins, Len Steiner, George Friedman and Henry Simpson for their helpful comments on drafts of the article.

1. Silverman v. Benmor Coats, 61 N.Y.2d 299 (1984).

2. Under FINRA's Code of Arbitration Procedure Rule, FINRA maintains the following roster of arbitrators:

- A roster of non-public arbitrators as defined in Rule 12100(p);
- A roster of public arbitrators as defined in Rule 12100(u); and
- A roster of arbitrators who are eligible to serve as chairperson of a panel as described in Rule 12400(c).

FINRA Code of Arbitration Procedure Rule 12400(b). (As used throughout this article, the terms "Rule" and "FINRA Rule" refer to the rules contained in the FINRA Code of Arbitration Procedure, *available at* http://finra.complinet.com/en/display/display_main.html?rbid =2403&element_id=4096.)

hearings. Sometimes these arbitrators have no relationships with, and know nothing of, the parties and their attorneys. But sometimes relationships exist, past and present. FINRA policy is to automatically remove *current* employees of a party or a party's representative. But FINRA does not apply that rule to *former* employees. It should. Currently, arties must use their limited strikes to remove such arbitrators from consideration.[3] Similarly, when list exhaustion occurs and FINRA assigns a new arbitrator, that arbitrator can be a former employee of a party or its attorney.

In a recent case, a claimant received a list of proposed replacement arbitrators. One was a former employee of the respondent and another was the wife of a longtime former employee. Claimant asked the Director of Arbitration at FINRA to remove the prospective panelists because of the former association, but the Director declined, stating in a letter that FINRA will only remove arbitrators when there is a "current, readily apparent conflict-of-interest."[4] That letter also stated that in order to warrant removal, an arbitrator's interest or bias "must be definite and capable of reasonable demonstration, rather than remote or speculative,"[5] citing Rule 12407(a)(1). The response noted that Rule 12407(a)(1) also requires FINRA to "resolve close questions regarding challenges to an arbitrator by a customer in favor of the customer," implying that the Rule did not require removal.[6]

The Berry Letter, and similar scenarios that occur not infrequently, raise the question: should FINRA remove ex-employees of a party or its attorney from the lists of prospective arbitrators? The authors of this article believe that the correct answer is yes, ex-employees should be removed in the absence of facts tending to show that the ex-employee relationship was "insubstantial." FINRA should change its policy. "Insubstantial" should mean that the employment was brief, took place many years ago and was

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3. FINRA Rule 12403(c); *cf.* FINRA Rule 12403(d)(the [new] Optional All-Public Panel Rule). Arbitrator strikes are precious, and forcing a party to use strikes on arbitrators who ought not even be proposed prejudices that party's ability to select the best panel. In addition, because ex-employees are more likely to have worked for a corporate respondent than for an individual claimant, the requirement that a party use a strike to remove a potentially-biased ex-employee creates an imbalance that tends to favor respondents.

4. Correspondence from Richard W. Berry, FINRA Director of Case Administration, to Dale Ledbetter, in FINRA Case No. 09-02549 (herein, the "Berry Letter").

5. *Id.*

6. *Id.*

clerical or low-level. The principal rationale supporting this conclusion is the fact that in arbitration, parties do not have an opportunity to examine potential arbitrators the way prospective jurors are examined in litigation. The lack of *voir dire* in arbitration seriously hampers a party's ability to elicit facts that would support a causal challenge or to appropriately examine a questioned panelist's impartiality.

This article will demonstrate that in litigation, there is a comprehensive and effective mechanism for determining and addressing the potential bias of ex-employees. Part I examines that mechanism. Part II focuses on how it is used by parties to determine whether prospective jurors are fair and unbiased. Part III looks at FINRA arbitrator recusal and removal and Part IV shows why it is inadequate. Part V proposes a new and fairer approach – presumptive removal.

The logical solution to this problem is that FINRA should remove ex-employees from arbitrator lists sent to the parties unless the prior relationship may be objectively demonstrated as insubstantial. This approach will instill a greater sense of fairness in the arbitration process[7]

I. DETERMINING BIAS OF PROSPECTIVE JURORS

In jury trials, whenever a potential bias is perceived, either party may has the opportunity to examine the potential venireman in *voir dire*, sometimes outside the presence of the remaining veniremen. This examination is effective because it takes place in person, under oath, in court and almost always before the judge. Each side has the right to ask questions, and to develop lines of inquiry that will support assertions of bias or impartiality. Any potential area of bias can be explored in depth, including those arising during the exploratory examination. Often, the court will also actively participate.

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7. The problem described here became less acute on February 1, 2011, when the SEC approved, and FINRA implemented the optional all-public panel rule (now FINRA Rule 12403). S.E.C. Order Approving Panel Composition Rule, 76 Fed.Reg. 6500 (Feb. 4, 2011). Investors who choose that option receive unlimited strikes of industry arbitrators. But in cases where the option is not chosen, or an ex-employee is categorized as "public" (where the arbitrator has not been affiliated with the industry for the past three years, or where the ex-employee worked for respondent's lawyer's firm), or in industry arbitrations, the problem persists.

While some courts are more patient, and cautious, than others, and while the trial bench is normally given wide latitude in determining the presence of actual bias, both sides are usually free to conduct *voir dire* examination into any legitimate area of inquiry with a potentially biased juror. Where the prospective juror is a former employee of a party or an attorney for that party, the issue is closely scrutinized. Questions will cover every aspect of the former employment – when, what, where, how long, relationships with potential witnesses, involvement in similar facts, prior testimony for or against the company, oversight or involvement concerning the issues in the case at bar, reasons for leaving the company, and most importantly, and at every possible turn, the ability to be fair and impartial toward both sides.[8]

The right to then use the answers received from a prospective juror in making a challenge for cause is a very important aspect of jury selection. The peremptory challenge process is an essential component of a fair trial. The United States Supreme Court has termed it "a necessary part of trial by jury."[9] Indeed, a criminal defendant who can demonstrate the inability to exercise a single peremptory challenge can obtain automatic reversal of a conviction.[10] And there is no need in such a case to demonstrate on appeal that the juror would have been biased. No showing of actual prejudice is required – "[t]he denial or impairment of the right [of peremptory challenge] is reversible error without a showing of prejudice."[11] The courts have applied

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8. Typically, both sides end examination of every discrete subject discussed with questions, along the following lines: *Is there anything about the fact [e.g., that you worked for the respondent for fifteen years as a manager until 2005] that would cause to believe the respondent's witnesses over the claimant, or the claimant's witnesses? Would you accord greater credibility to one side than the other? Can you promise the court that if you disbelieved a witness on the respondent's side of the case, you would rule accordingly? Would you be just as fair to one side in the case as the other? Are you certain? Can you promise the Court that you will do your best in that regard? Do you have any hesitation about that?* One theory of jury selection suggests that voir dire "rehabilitation" is a valid phenomenon. Whether it is or not, examining the demeanor of the prospective juror is obviously critical.

9. Swain v. Alabama*,* 380 U.S 202, 219, 85 S.Ct. 824, 835 (1965).

10. Lewis v. United States, 146 U.S. 370, 376, 13 S.Ct. 136 (1892) (trial court's deprivation of defendant's peremptory challenges is reversible error).

11. *Swain,* 380 U.S. at 219, 85 S.Ct. at 835 (citations omitted).

this remedy time and time again, for over 100 years.[12] This is the rule in every federal circuit that has addressed the issue.[13]

The practical importance of a successful challenge for cause cannot be overemphasized:

> The most important goal of *voir dire* is to successfully challenge for cause as many unacceptable panelists as possible. Once you demonstrate that a given panelist has already made up her mind about some significant aspect of your case, and won't change it, the judge should disqualify her from serving on the jury. *Each time you are successful, it enhances your chance of winning exponentially*.[14]

In arbitration, the same logic applies. The ability to remove potentially biased panelists is critical to preserving fair arbitration. By ignoring the danger posed by former employee panelists, FINRA's current approach stacks the deck heavily in favor of respondents.

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12. *Lewis,* 146 U.S. at 376; Harrison v. United States, 163 U.S. 140, 142, 16 S.Ct. 961 (1896); Gulf, Colorado & Santa Fe Ry. Co. v. Shane, 157 U.S. 348, 351, 15 S.Ct. 641, 642, (1895) (reversing adverse jury verdict where civil defendant deprived of right of peremptory challenge).

13. *See, e.g.,* United States v. Turner, 558 F.2d 535, 538 (9th Cir.1977); United States v. Broussard*,* 987 F.2d 215, 221 (5th Cir.1993) ("The denial or impairment of the right to exercise peremptory challenges is reversible error without a showing of prejudice."), abrogated on other grounds by J.E.B. v. Alabama, 511 U.S. 127, 114 S.Ct. 1419 (1994); Olympia Hotels Corp. v. Johnson Wax Dev. Corp., 908 F.2d 1363, 1369 (7th Cir.1990) ("It is reversible error to deny a party to a jury trial the peremptory challenges to which the rules of procedure entitle him...."); United States v. Ruuska, 883 F.2d 262, 268 (3rd Cir.1989) (affirming the automatic reversal rule described in *Swain*, and stating that *Batson* "does not call into question this aspect of *Swain*."); United States v. Ricks, 802 F.2d 731, 734 (4th Cir.) (*en banc*), *cert. denied*, 479 U.S. 1009, 107 S.Ct. 650 (1986) (same); Carr v. Watts, 597 F.2d 830, 832 (2nd Cir.1979) (impairment of right of peremptory challenge is "reversible error without a showing of prejudice"). Other circuits have recognized the automatic reversal rule in dicta. See United States v. Cambara, 902 F.2d 144, 147 (1st Cir.1990) ("restricting a defendant's use of the lawful number of peremptory challenges is reversible error if a challenge for cause is erroneously denied"); United States v. Mosely, 810 F.2d 93, 96 (6th Cir. 1987), *cert. denied*, 484 U.S. 841, 108 S.Ct. 129 (1987) (same).

14. David Berg, *The Trial Lawyer – What it Takes to Win*, 2006 ABA SEC. LITIGATION 72 (emphasis added).

II. HOW TRIAL COURTS APPROACH INDIRECT OR PRIOR RELATIONSHIPS

It is settled law that "[a] relationship between a juror and defendant, albeit a remote one, can form the basis of a challenge for cause."[15] A challenge for cause can be on the basis of a "remote relationship."[16] In addition, "[a] juror's dishonesty is a strong indication of bias,"[17] so an effective examination that elicits inconsistent or incredible answers by itself becomes grounds for challenge. Reversal for misconduct in *voir dire* is established where a prospective juror's answers were dishonest and lead to an inference of demonstrable bias.[18] "When a prospective juror reveals actual bias, or when bias is implied because the juror has some special relationship to a party ..., the court must dismiss the prospective juror for cause."[19]

The very term *voir dire*, a French phrase in law meaning "to see and to speak,"[20] stresses the importance of a direct personal examination. A prospective juror's demeanor, the way he or she answers questions, can reveal bias. An experienced attorney knows how to use his or her senses to identify fertile areas of inquiry. Bias is often revealed through responses or changes in demeanor that surface during the course of a spontaneous examination.

The ability to examine a prospective juror in *voir dire* not only provides an opportunity to elicit facts that might tend to show bias. It also provides information that is often invaluable to the parties in exercising their peremptory strikes.

The ability to examine potential jurors is a central tenet of the guarantee of fairness that is woven into the process of trial by jury, and it is essential to due process.

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15. United States v. Perkins, 748 F.2d 1519 (11th Cir.1984).

16. *Id.* at 1532; United States v. Tucker, 137 F.3d 1016 (8th Cir. 1998).

17. United States v. Carpa, 271 F.3d 962, 967 (11th Cir. 2001) (restating the test for juror misconduct during *voir dire* set out in McDonough Power Equip. v. Greenwood, 464 U.S. 548, 104 S.Ct. 845 (1984)).

18. *McDonough Power Equipment, Inc*, 464 U.S. 548, 104 S.Ct. 845; Smith v. Phillips, 455 U.S. 209, 215-16, 102 S.Ct. 940, 945 (1982).

19. United States v. Rhodes, 177 F.3d 963, 965 (11th Cir.1999) (emphasis added).

20. *See, e.g.,* http://law.yourdictionary.com/voir-dire.

III. CHALLENGING A PANELIST IN FINRA ARBITRATION

In FINRA arbitration, there are two methods for challenging an arbitrator's impartiality. The first is a request for recusal under Rule 12409 made directly to the proposed arbitrator. [21] The second is a request for removal under Rule 12410(a)(1) made to the Director of Arbitration.[22] These methods are not mutually exclusive, nor is there any prescribed order for employing them.

A. REQUESTS FOR RECUSAL

Requests for recusal can be made at any time. The arbitrator is directed by the Rule to step aside for "good cause,"[23] but the term is not defined in the Rules. FINRA directs arbitrators to the AAA/ABA Code of Ethics for Commercial Arbitrators,[24] and expects all of its arbitrators to have read the Code and to comply with its ethical standards.[25]

Cannon I requires an arbitrator to uphold "the integrity and fairness of the arbitration process." It requires an arbitrator to be both independent and impartial,[26] but these terms are not defined. The Code of Ethics is silent on

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21. Recusal motions, under the Rule, are always decided by the arbitrator whose recusal is being sought, and never by the full panel. FINRA Rule 12406.

22. The Director is appointed by the FINRA Board. The Director's duty is to perform all the administrative duties relating to arbitrations submitted under the Code. See FINRA Rule 12103(a). The Director manages a large staff. The Director is permitted under the Rules to delegate to the Staff his or her duties when it is appropriate, "unless the Code provides otherwise." *Id*. The President of FINRA Dispute Resolution may perform any of the Director's duties. FINRA Rule 12103(c).

23. FINRA Rule 12406 (formerly Rule 12409).

24. http://www.finra.org/ArbitrationMediation/Rules/RuleGuidance/P009525 (hereinafter referred to as the "Code of Ethics").

25. *Id*. FINRA also states that the "Code of Ethics is not a substitute for nor does it supersede applicable law." *Id.*

26. See Preamble to the Code of Ethics; Cannon I(B)(1) and (2), http://www.finra.org/ ArbitrationMediation/Rules/RuleGuidance/P009525. These terms are not defined. The remainder of the Cannon's prescriptions about conflict are directed to future actions (entering into business relationships during an arbitration, or accepting employment after the arbitration concludes). Cannon I(C);

whether an arbitrator who is a former employee of a party or a former party representative is deemed to lack independence and impartiality. The Comment to the Cannon states:

> A prospective arbitrator is not necessarily partial or prejudiced by having acquired knowledge of the parties, the applicable law or the customs and practices of the business involved. Arbitrators may also have special experience or expertise in the areas of business, commerce, or technology which are involved in the arbitration. Arbitrators do not contravene this Canon if, by virtue of such experience or expertise, they have views on certain general issues likely to arise in the arbitration, but an arbitrator *may not have prejudged any of the specific factual or legal determinations to be addressed during the arbitration*.[27]

Former employment certainly confers "knowledge of the parties," as well as the party's customs and practices; former employment, by itself, is not a basis for automatic disqualification. The remainder of the paragraph, however, addresses "expertise and experience." It provides that while arbitrators may permissibly have "views on certain general issues," an arbitrator should not serve if the arbitrator has "*prejudged . . . specific factual issues*."[28] Both the Code of Ethics and FINRA Rule 12409 leave the application of these guidelines to the arbitrator.

These rules make clear that an arbitrator who has pre-judged issues should not serve.

B. REQUESTS FOR REMOVAL

Distinct from recusal, requests for removal based on impartiality are made to and determined by the Director.[29] Rule 12410(a)(1) provides that:

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http://www.finra.org/ArbitrationMediation /Rules/RuleGuidance/P009525.

27. *Id.* (emphasis added).

28. *Id.* (emphasis added).

29. FINRA Rule 12407 (formerly Rule 12410). The Rule divides such challenges into 2 categories – pre-hearing challenges and challenges after the hearing begins. This Article addresses the former type of challenge, which is addressed in Rule 12407(a). Under Rule 12407(b), after the first hearing session begins, the Director may only remove an arbitrator based only on information "that was not previously known by the parties." Since FINRA's arbitrator application requires that all former

> The Director will grant a party's request to remove an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has a direct or indirect interest in the outcome of the arbitration. The interest or bias must be definite and capable of reasonable demonstration, rather than remote or speculative. Close questions regarding challenges to an arbitrator by a customer under this rule will be resolved in favor of the customer.[30]

Decisions on requests for removal are typically delegated by the Director to a staff member.[31] Nevertheless, FINRA policies on grounds for removal are set by the Director, with input from his staff and often in consultation with the National Arbitration and Mediation Committee.[32]

On the surface, FINRA policy, as expressed in the Berry Letter,[33] is roughly equivalent to the approach applied in courts to prospective jurors: an arbitrator's former employment by a party, without *further* evidence of bias or lack of impartiality, is not a sufficient ground for removal. Instead, FINRA requires a party objecting to an ex-employee to *otherwise* establish bias or conflict that is "definite and capable of reasonable demonstration, rather than remote or speculative."[34]

That is a hard standard to meet it in the context of arbitration, and it is misguided even though it is roughly equivalent to the standard applied in court. It is wrong to place the burden of showing bias on the challenger,

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employment be disclosed, an arbitrator who as failed to make a disclosure of such a past relationship is likely to be removed by the Director, not only from the case, but also from the pool.

30. FINRA Rule 12410(a)(1).

31. *Cf.* Rule 12407(b), which expressly states that the decision whether to grant a request to remove an arbitrator after commencement of the hearings is non-delegable, and must be made personally by either the Director or the President of FINRA Dispute Resolution.

32. *See* the Berry Letter, *supra* note 4, and FINRA Rules 12102 and 12103(b).

33. *Supra* note 4.

34. Current employment by a party, and current status as a shareholder or partner, or membership or employment by a law firm offering or conducting representation to a party are examples of relationships that routinely result in removal. FINRA, *What are Challenges for Cause?* http://www.finra.org/ArbitrationMediation/Parties/Overview/ArbitrationProcedures/ P009540.

because parties to arbitration do not have the ability to elicit facts supporting assertions of bias through *voir dire* examinations. The opportunity to elicit such facts is a crucial part of the jury process. The characteristics and fact-eliciting nature of *voir dire* examination give both parties an equal and fundamentally fair opportunity to explore the potential juror's credibility as well as to develop facts supporting an assertion of bias. In arbitration, *voir dire* examination of panelists is not permitted.

IV. INADEQUACY OF BIAS-RELATED INFORMATION IN ARBITRATIONS

FINRA Rules have no provision to require a prospective arbitrator to submit to questioning. Only "disclosure" by the arbitrator is required. Rule 12408(a)(2) requires arbitrators to disclose "[a]ny . . . past financial, business, professional, family, social, or other relationships or circumstances with any party, any party's representative, or anyone who the arbitrator is told may be a witness in the proceeding, that are *likely to affect impartiality or might reasonably create an appearance of partiality or bias*."[35] Of course, this places the onus on the panelist to admit his own potential bias, or the reasonable appearance thereof. It is extremely unlikely that any panelist wishing to serve on an ongoing basis will volunteer this information except in obvious circumstances. Again, the effect is to stack the deck against the claimant.

Notwithstanding the provision of Rule 12405(a)(2) (formerly Rule 12408)(a)(2)) that only relationships "likely to affect impartiality" must be set out by a prospective panelist, FINRA's arbitrator application requires disclosure of prior employment by a party or a party's representative.[36] Such a past relationship does not, by itself, mandate removal. Nor should it. The possibilities are too varied to allow for a single conclusion. A former employee may have been richly rewarded for his service, but he may also have been wrongfully terminated. Only a thorough examination provides any real possibility of uncovering bias in either direction.

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35. See also Cannon II of the Code of Ethics, http://www.finra.org/Arbitration Mediation /Rules/RuleGuidance/P009525 (emphasis added).

36. Thus, even the Rule seems to permit the arbitrator to make a judgment about what past relationships "affect impartiality." When it comes to former employment, the judgment has already been made by FINRA – all prior employment must be disclosed.

Generally speaking, previous employment suggests a bias toward an employer -- a fact FINRA ignores. It also suggests knowledge of other employees, policies and procedures that could become important to the arbitration, circumstances which normally would only be revealed through *voir dire* examination. Both of these circumstances strongly tip the scales of fairness toward the respondent in situations like the one at hand.

FINRA's practice is to send to a prospective arbitrator any party's written requests for additional disclosure, but responses are not mandated. And even though most arbitrators will provide answers to respectfully framed requests, there is a tremendous difference between the additional disclosure process at FINRA and *voir dire*.

V. THE FAIREST COURSE – PRESUMPTIVE REMOVAL

A. THE IMPORTANCE OF FAIRNESS IN ARBITRATOR SELECTION

It is wrong for FINRA to refuse to remove an arbitrator who is a former employee only if additional facts can be stated that support a claim of bias. It will usually be impossible to explore or develop these facts. But the potential for bias is nevertheless real. And certainly, the appearance of bias in such situations is self-evident.

The need to maintain the highest degree of confidence in the impartiality of arbitration should persist, as was well-expressed by Justice White in his much-cited concurring opinion in *Commonwealth Coatings Corp. v. Continental Cas. Co.*:

> The arbitration process functions best when an amicable and trusting atmosphere is preserved and there is voluntary compliance with the [award], without need for judicial enforcement. This end is best served by establishing an atmosphere of frankness at the outset, through disclosure by the arbitrator of any financial transactions which he has had or is negotiating with either of the parties. In many cases the arbitrator might believe the business relationship to be so insubstantial that to make a point of revealing it would suggest he is indeed easily swayed, and perhaps a partisan of that party. [Footnote omitted.] But if the law requires the disclosure, no such imputation can arise. And it is far better that the relationship be disclosed at the outset, when the parties are free to reject the arbitrator or accept him with knowledge of the relationship and continuing faith in his objectivity, than to have the relationship come to light after the arbitration, when a suspicious or disgruntled party can seize on it as a

pretext for invalidating the award.[37]

Justice White's concern about preserving confidence in arbitration extends to requiring disclosure of relationships that are "insubstantial," and he voted with the majority in that case to vacate an award where the arbitrator had failed to make just such a disclosure.[38] And that concern applies especially to securities arbitration, which, unlike the commercial arbitration about which Justice White wrote, is the product of consumer contracts of adhesion.[39]

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37. 393 U.S. 145, 151 (1968)(White, J., concurring) (citing, in part, Canon 33 of Judicial Ethics (1927) ("Social Relations. [A judge] should, however, in pending or prospective litigation before him be particularly careful to avoid such action as may reasonably tend to awaken the suspicion that his social or business relations or friendships, constitute an element in influencing his judicial conduct.")). The 2007 Model Code of Judicial Conduct Rule 2.4(B) states: "[a] judge shall not permit family, social, political, financial, or other interests or relationships to influence the judge's judicial conduct or judgment." ABA MODEL CODE OF JUDICIAL CONDUCT R. 2.4(B) (2007), *available at* http://www.americanbar.org/groups/professional_responsibility/publications/ model_code_of_judicial_conduct.html.

38. The Court majority (which included Justice White), vacated the award because a member of arbitration panel failed to disclose financial relationships that had existed between the arbitrator and a party. Justice Black wrote:

> This rule of arbitration and this canon of judicial ethics rest on the premise that any tribunal permitted by law to try cases and controversies not only must be unbiased but also must avoid even the appearance of bias. We cannot believe that it was the purpose of Congress to authorize litigants to submit their cases and controversies to arbitration boards that might reasonably be thought biased against one litigant and favorable to another.

Commonwealth Coatings, 393 U.S. at 150.

39. The agreements brokerage firms use to force their clients into arbitration are clearly adhesion contracts, but no court has ruled them substantively unconscionable. They were declared valid by the U.S. Supreme Court in Shearson v. McMahon, 482 U.S. 220, 107 S.Ct. 2332 (1987), over a partial dissent from Justice Blackmun. In 2010, Congress authorized the SEC to prohibit or impose restrictions on the use of mandatory arbitration clauses if the SEC finds that doing so is in the public interest and for the protection of public investors. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 921(a) (codified at 15 U.S.C. §78o(o)); see also U.S. DEPT OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 72 (2009), http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf (recommending that the SEC study the use of mandatory arbitration clauses in investor contracts). No report has, to this date, been

Because the FINRA arbitration process diminishes or eliminates altogether a party's ability to uncover facts about an arbitrator that would indicate bias, it is unfair to place the burden on the challenging party to elicit facts or circumstances meeting the "definite and capable of reasonable demonstration, rather than remote or speculative" standard of Rule 12407(a)(1). An investor in arbitration ought not to be required to make a showing of facts as to which he or she is given no viable means of detection.

A former employee is not an appropriate arbitrator because such a person is likely to have formed opinions about his ex-employer from events outside the hearing room. The arbitrator is likely to have extensive knowledge of and pre-conceived beliefs about, *inter alia*, the procedures in place at the ex-employer, its ethics, its attitudes, its management, its policies and the way it behaves. This knowledge and these beliefs are likely to be far more intimate than the "general knowledge" that is permitted under the Code of Ethics.[40]

B. WRITTEN DISCLOSURES ARE AN INADEQUATE SAFEGUARD

It is unfair and unwise to expect that a party will be able to elicit subtle but important prejudices from a request for additional disclosures.[41] Fairness and the desire to create a process which bears the highest integrity demand that there be a presumption that previous employment be grounds for removal, at least in the absence of facts that would indicate, in Justice White's words, that it is so "insubstantial" that no imputation of bias can

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issued.

40. The verbiage in the Code of Ethics properly suggests a difference between knowledge acquired through "status" – *e.g.,* general knowledge of business affairs – and a "relationship" – such as past employment. Because of the numerous and extended personal affiliations usually present in the case of a former employer, the latter contains far greater danger of hidden bias or favoritism.

41. One seeking to remove an ex-employee could, for example, ask for compensation history, promissory note history (if any), reasons for termination of employment, names of supervisors and lines of authority, disciplinary history with the firm, and the nature and extent of any residual health and pension benefits the employee has received or is likely to receive. Depending on the nature and duration of the employment, the list of disclosures could be extensive. The information in the disclosures, of course, would prompt a lawyer, in *voir dire*, to develop more questions. That sequence of disclosure and questioning is not available, or feasible, in arbitration.

arise.

Support for applying this presumption already exists in the last sentence of Rule 12407(a)(1). Under the Rule, "close questions regarding challenges to an arbitrator by a customer under this rule will be resolved in favor of the customer." The fact that an ex-employee arbitrator is invariably an ex-employee of a respondent broker-dealer (rather than an ex-employee of a claimant customer) tips the scales toward the respondent. Creating a presumption of bias on the part of an ex-employee (for either side) is a fair presumption and will level the scales of justice; it is an appropriate application of the Rule. Using the Rule to justify reaching the opposite conclusion is not.

C. Other Policy and Procedural Considerations

It is important for the Director to apply such a presumption, because just like counsel attempting to make a challenge in arbitration, he lacks the facility to elicit facts and make a determination based on *voir dire* examination. Often, all he has is the fact of prior employment, without further detail, and the written but blind assurance from the arbitrator that despite the previous relationship, the arbitrator believes he or she will be impartial.

Unlike jurors, arbitrators have a financial motive for serving, providing a personal incentive for them to convince themselves that they can be appear fair and impartial. They are thus far more likely than jurors to resolve questions about their own impartiality by stating that despite their former employment, they can be trusted to remain impartial. It is the Director's job to make sure this is so in actuality. However, since arbitrators have a financial stake in the outcome, and neither the Director nor the parties have a way to test their credibility effectively, the Director has no real basis for a fully informed decision. Therefore, a *presumption of partiality* should be applied.

The Director clearly has discretion to implement and apply the presumption suggested here.[42] No change in the Rules is required. Such a presumption, grounded in recognition of the important differences between

42. *See, e.g.,* FINRA Rule 12408 (formerly 12412)("The Director may exercise discretionary authority and make any decision that is consistent with the purposes of the Code to facilitate the appointment of arbitrators and the resolution of arbitrations.")

voir dire and arbitrator selection, and of the need to elevate FINRA arbitration to the highest levels of impartiality, fairness and the appearance of fairness, would justly and impartially address potential bias inherent in arbitrators who were once employees of a party.

The FINRA Arbitration Director ought to grant motions to remove ex-employee arbitrators unless the employment was brief, took place many years ago, and was clerical or low-level. Such arbitrators should not be permitted to serve over the objection of an investor-claimant unless the former employment relationship is so remote as to be "insubstantial." Adoption of this approach would be a significant step toward maintaining the integrity that arbitration, like all legal tribunals, must have in order to inspire confidence that its process is the best that it can be.

CONCLUSION

The fairest and most logical solution to the problem of former employees serving as arbitrators is for FINRA to administratively remove ex-employees. They should be treated as a "suspect class" of arbitrator, unless it can be shown the relationship was insubstantial.

The approach proposed here will instill a greater sense of fairness in a selection process that lacks the important element of *voir dire* – a fundamental element of juror selection, and a foundation of due process. FINRA's failure to recognize how this difference in selection affects the ability of parties to show that a prospective arbitrator possesses a bias that is "definite and capable of reasonable demonstration, rather than remote or speculative," as Rule 12407(a) requires, can result in injustice.

Even where there is no actual bias, the appearance of bias that stems from a pre-existing relationship between an arbitrator and a party merits a rule of presumptive disqualification. FINRA arbitration continues to move from a system steeped in perceived bias to one that is perceived as fair. Applying the presumption of bias to ex-employees would significantly advance that movement.

Notes & Observations

DUE DILIGENCE: SECURITIES APPLICATIONS AND REGULATORY REQUIREMENTS, 2011

Douglas J. Schulz[1]

INTRODUCTION

This article is to inform and assist the individual or entity who is claiming that their securities professional and firm failed in their duty to conduct thorough, proper investigation and research, commonly known as "due diligence". Investment professionals, regulators and lawyers often inappropriately use the term due diligence, which causes confusion in both the implementation of "due diligence" work and later in the attempt to ferret out the regulatory requirements under the rules relating to due diligence. The term "due diligence" has applications in numerous investment products and services. It is of the utmost importance that all practitioners fully understand their obligations and liabilities as it relates to this investigative research guideline and rule.

DEFINITIONS

What are the accepted or appropriate definitions of the term "due diligence"? As in almost all regulatory or litigation situations, it depends on which side of the fence you are on. If you are on the defense side and you are being accused by either a regulator or an investor/claimant that you failed

1. Douglas J. Schulz has worked in the securities industry for over 30 years. He is a Certified Regulatory Compliance Professional (CRCP) and worked as a registered representative for such firms as Bear Stearns and Merrill Lynch. He has held numerous securities licenses and certifications such as the Series 24, 6, 7, and 3, and he has also worked as a Registered Investment Advisor (RIA). Since 1989, Mr. Schulz has been a securities expert witness through his company Invest Securities Consulting Inc. (Invest). Mr. Schulz has worked closely with regulators and was an arbitrator for both the NYSE and NASD/FINRA. He co-authored the book, BROKERAGE FRAUD: WHAT WALL STREET DOESN'T WANT YOU TO KNOW with Tracy Pride Stoneman, a nationally known securities attorney. He has been a prolific author of articles on securities regulation, securities arbitration, online trading and unauthorized trading. Mr. Schulz can be reached at Invest Securities Consulting, Inc., 301 Snowcrest, Westcliffe, Colorado 81252, 719-783-3230, Schulz@securitiesexpert.com, www.securitiesexpert.com.

to perform proper due diligence, your definition may be amorphous and narrow. You might claim the term is synonymous with such words as inquiry, investigation, research or review. On the other hand, if you are the investor/claimant, your definition will be more encompassing and will include such words as systematic, methodical, meticulous, scrupulous, detailed, and comprehensive. Let's begin by dissecting the term, "due diligence." Definitions of the word "due" include the following:

> [Middle English, from Old French deu, past participle of devoir, *to owe*, from Latin]; In accord with right, convention, or courtesy: appropriate: due esteem; all due respect; Meeting special requirements; sufficient: We have due cause to honor them; … (noun) Something owed or deserved: You finally received your due;[2]
>
> Justly claimed as a right or property; suitable: becoming; appropriate; fit;
>
> Such as (a thing) ought to be; fulfilling obligation; proper; lawful; regular; appointed; sufficient; exact; as, due process of law; due service; in due time;
>
> That which is owed: debt; that which one contracts to pay, or do, to for another; that which belongs or may be claimed as a right; whatever custom, law, morality requires to be done; a fee, a toll.[3]

Definitions of the word "diligence" include the following:

> Diligence: 1. the quality of being diligent: 2. steady application to business of any kind: constant effort to accomplish what is undertaken; perseverance;[4]
>
> (n) diligence (conscientiousness in paying proper attention to a task; giving the degree of care required in a given situation): diligence, industriousness, industry (persevering determination to perform a task) *"his diligence won him quick promotions";…* application, diligence (a diligent effort) *"it is a job requiring serious application"*[5]
>
> Diligence is a zealous and careful nature in one's actions and work, exemplified by a decisive work ethic, budgeting of one's time, monitoring one's own activities to guard against laziness, and putting forth full concentration in one's work. Diligence is usually promoted in work places. It is one of the seven heavenly virtues in Catholic catechism. … Diligence is the act of doing all things efficiently and

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2. Freedictionary.com, http://www.thefreedictionary.com/due.
3. Ardictionary.com, http://ardictionary.com/Due/10091.
4. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY (1996).
5. *Diligence Definition*, Wordnet Search 3.0, http://wordnetweb.princeton.edu.

> relentlessly to the best of one's ability in order to achieve success in every endeavor.[6]
>
> Vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety. Attentive and persistent in doing a thing; steadily applied; active; sedulous; laborious; unremitting; untiring. The attention and care required of a person in a given situation; the opposite of Negligence.[7]
>
> Synonyms: active, constant, earnest, industrious, laborious, painstaking, persistent, pertinacious, sedulous, steadfast, studious, tireless, unflagging, unrelenting.

There are other key words to consider, such as synonyms for the word “thorough”: full, systematic, detailed, exhaustive, in-depth, comprehensive and methodical. And when you cross reference the synonyms for these words you get: careful, thorough, contentious, systematic, methodical, painstaking, meticulous, scrupulous, detailed, comprehensive, wide ranging, broad, all-inclusive, and full.

Those firms claiming that their investigation and due diligence fulfilled their obligations will claim their research was adequate or sufficient, ample, enough, plenty, passable, satisfactory, and tolerable. Or they may claim their research was reasonable - sensible, rational, logical, practical and realistic. It doesn't take a wordsmith to deduce that the words “adequate” and “reasonable” connote a much lower standard than “thorough” or “diligence.”

The term "due" clearly connotes an obligation, something that is owed or that something is done appropriately. One of the more obvious definitions of the word "diligence" is the quality of being diligent. If you take these two words and combine them without first looking at various definitions of the term "due diligence”, it is easy to determine that the phrase means an obligation to another to perform an act and that this obligation is only fulfilled when the act is done in a vigilant, thorough, and detailed manner. Ultimately, this definition applies to the term "due diligence". The term additionally means that the act to be performed will be in the nature of investigation, research and evaluation.

Definitions of the term “due diligence” include the following:

- Due diligence is the process of investigation and evaluation, performed by investors, into the details of a potential investment,

6. http://en.wikipedia.org/wiki/Diligence.

7. WEST’S ENCYCLOPEDIA OF AMERICAN LAW (2nd Ed. 2005), *available at* http://www.answers.com/topic/diligence.

such as an examination of operations and management and the verification of the material facts.[8]

- The investigation and evaluation of management team's characteristics, investment philosophy, and terms and conditions prior to committing capital to the fund.[9]
- 1. General: Measure of prudence, responsibility, and diligence that is expected from, and ordinarily exercised by, a reasonable and prudent person under the circumstances. 2. Business: Duty of a firm's directors and officers to act prudently in evaluating associated risks in all transactions. 3. Investing: Duty of the investor to gather necessary information on actual or potential risks involved in an investment. 4. Negotiating: Duty of each party to confirm each other's expectations and understandings, and to independently verify the abilities of the other to fulfill the conditions and requirements of the agreement.[10]

THE INVESTOR'S UNDERSTANDING

Though defining terms can be tedious, in litigation the debate as to whether one party did or did not conduct its proper due diligence is often engulfed in the extent of the thoroughness or appropriateness of the research that was conducted. As a regulatory expert, it is my practice to go to the websites of both the SEC and FINRA to aid my research into how the regulators interpret terms and obligations such as "due diligence." But separately, it is important to consider the term "due diligence" without interpretations by others, but rather how an average investor would interpret the words. Securities professionals and regulators have a horrible habit of assuming that the investing public is as familiar with all the investment clichés, acronyms, and phrases that we professionals use on a regular and day-to-day basis.

But this could not be further from the truth. The non-regulatory definitions of the term are important because these are the ones an average investor and even many sophisticated investors rely upon when making

8. Venture Capital Glossary, http://www.fundingpost.com/glossary/venture-glossary.asp.

9. VCAonline, http://vcaonline.com/resources/glossary/index.asp.

10. *Definition of Due Diligence*, http://www.businessdictionary.com/definition/due-diligence.html.

investment decisions. This reliance is often a key issue in litigation. For example, it's not uncommon for a private placement memorandum (PPM) or prospectus to state that the general partner or investment advisor will conduct "due diligence" as to any investments made. An investor who buys into a limited partnership or private placement will not find a definition of the term "due diligence" in the document. Litigation then ensues over the thoroughness and appropriateness of the due diligence conducted. The investor clarifies his understanding of the obligations based on the definitions above. The defendants, on the other hand, may rely on much narrower, lighter definitions and might quote some case law that favorably defends their less than diligent "due diligence."

It is inappropriate for an entity to use the term "due diligence" in its marketing or offering materials to lead an investor to believe that the research and investigation that will be conducted on its behalf will be vigilant, thorough, and detailed when the responsible entity feels no obligation to conduct their research in such a manner. And it becomes even more inappropriate when that same entity attempts to lessen its obligations by having its lawyers quote case law that blesses even the most cursory investigations. Stockbrokers, investment advisors, money managers, and hedge funds should confine themselves to using such words as investigation, research, and inquiry when their intent and performance is below the standards established by the term "due diligence".

In securities litigation who should determine what is or is not thorough, reasonable or appropriate? Should the issue of thoroughness, appropriateness, and reasonableness be left to lawyers, briefs, and experts? Not entirely. It is a rare investor, be they naïve, average, or even sophisticated, who would invest with a securities professional or entity if they believed the underlying investments that were going to be made on their behalf would not be thoroughly, diligently, and appropriately investigated. Thus, the investor's understanding should be given great weight in any litigation.

WHY DO DUE DILIGENCE?

The answer can be as simple as "you're supposed to" or "it is the law". Or maybe the better answer is because it's to the investigating firm's benefit. The marketing of a money management business is pretty simple - if you make above average returns for your clients, you'll maintain your client base and client assets will grow in value. You'll attract new business and make more money because you are charging a percentage of the assets. So how

does conducting due diligence help the marketing department? There is no guarantee that even the most thorough due diligence translates into investment profitability. But just like any other sound business practice, adhering to regimented due diligence procedures generally should improve the soundness and success of the investments made.

> A managers' past is an excellent predictor of his future actions (results are always another story). Determining what those characteristics are, therefore will give you, the institution, the ability to recognize how the manager is likely to act in specific scenarios, and allow you to act before these actions turn disasters…People's behavioral tendencies tend to repeat, especially in times of stress…. Discovering past behavioral patterns greatly improves present decision-making by predicting and dealing with future problems, before they happen. [11]

But maybe the single most important reason to conduct due diligence is because fraud is still very much a risk in investing:

> Embezzlement, inflating profits to mask losses, lying about academic and professional credentials, stealing from retirees and then fleeing the country – these are just some examples of the types of criminal and blatantly fraudulent activities that were carried out by hedge fund managers who, for whatever reason, deluded themselves into thinking they were smarter than everyone else and above the law…. By examining the non-investment-related risk of hedge funds through such methods as background investigations and insuring independent oversight in areas such as pricing, investors can significantly reduce any exposure they may have to incidences of outright fraud….. Yes, those who are in blatant violation of certain laws can be banned from the industry and even face time in the white-collar prisons, but someone who is discovered as lying about his academic qualifications, for example, particularly if he is at a more junior level within an organization, tends to part company with the firm and move on to another one. This is particularly true within the closely knit hedge fund industry. Finally, those on the fringes of fraudulent activity, who were aware of the activity and perhaps even participated in some way but did not take the fall, are still employed throughout the industry.[12]

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11. RANDY SHAIN, HEDGE FUND DUE DILIGENCE 11, 12, 29 (2008).
12. JASON A. SCHARFMAN, HEDGE FUND OPERATIONAL DUE DILIGENCE: UNDERSTANDING THE RISKS 51, 52 (2009).

The most thorough background investigation work and due diligence has its limitations and is not intended to address certain risk associated with investing such as: market risk, economic risk, credit risk, and interest rate risk which could be categorized as general investment risk. All the investigation and back ground checks in the world cannot protect an investor or fund from these general risks.

Hedge funds are discussed in two sections of this article because of the phenomenal growth, their lack of regulatory oversight, and the fact that they are still a relatively new unknown amorphous product. "In recent years, it seems that before the newsprint is even dry reading one [hedge fund] failure another takes its place and new names are added to the hedge fund graveyard."[13] Another author addresses the growth and dangers in hedge funds by stating the following: "The industry is rife with firms who have entered the hedge fund field for the same reason that legions of investment bankers morphed themselves into head fund managers at the turn-of-the-century… Low, to no barriers to entry, combined with perceived riches to be made in a short period of time."[14]

KNOW YOUR CUSTOMER – KNOW YOUR PRODUCT

Those die-hard securities lawyers and experts who have been at it for decades and who know song and verse the regulations and interpretations of FINRA's Rule 2090, the "Know Your Customer Rule", may be unfamiliar that this same rule requires the investment professional to "Know Your Product". As recently as January 2011, FINRA clarified this point:

> The new rule makes clear that a broker must have a firm understanding of both the product and the customer. It also makes clear that the lack of such an understanding itself violates the suitability rule [15]

FINRA Rule 2011 on suitability requires any registered representative who makes a recommendation to make sure that the recommendation is

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13. *Id.* at 49.
14. SHAIN, *supra* note 11.
15. FINRA, KNOW YOUR CUSTOMER AND SUITABILITY: SEC APPROVES CONSOLIDATED FINRA RULES GOVERNING KNOW YOUR CUSTOMER AND SUITABILITY OBLIGATIONS, FINRA REGULATORY NOTICE 11-02, 4 (2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf. *See also* FINRA Manual, Rules 2111(a); 2111:04; 2111.5(a); 2111.04, 2111.05(a), http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607.

suitable for the investor. We are all too familiar with the laundry list of information that the investment advisor needs to know about the investor before he can make the recommendation - age, net worth, investment objective, risk tolerance, etc., but what about the other side of the equationThe suitability process can be summarized as an A B C process: A) the broker must know all aspects of the investor, B) the advisor must know all the aspects of the investment he is recommending, and C) the advisor must now utilize his knowledge of the investment to determine if it is suitable for the investor based upon his knowledge of the investor.

This process is the same for those brokers or registered investment advisors who manage money on a discretionary basis. The mere fact that the advisor no longer needs to consult with the investor prior to making the investment does not negate his obligation to ensure the purchases he makes on the investor's behalf are suitable. In fact, the advisor's obligations are heightened because of the fiduciary relationship created when money is managed on a discretionary basis. Either way, discretionary or nondiscretionary accounts require that due diligence be performed on each of the investments and strategies utilized in an investor's account.

On the subject of "knowing your customer," the original "know your customer" rule was NYSE Rule 405. The NYSE wrote about it:

> The emphasis here is upon due diligence and account approvals and their relationship and application to effective new account procedures. The first part of rule 405 requires the use of due diligence to learn the essential facts relative to every customer every order and every account. Its language leaves to the member organizations judgment to the determination of which facts are "essential" in the varying circumstances of each new account. Facts essential to the opening of one account, maybe insufficient or irrelevant to the opening of another.[16]

NYSE Rule 405 will be morphed into FINRA's "Know Your Customer" Rule 2090, effective October 7, 2011. The language has been altered to read "reasonable diligence" instead of "due diligence" as it relates to knowing your client. Whether the regulators intended to lessen the diligence required of advisors in knowing their clients is debatable, but the extent to which a product must be understood is not.

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16. NEW YORK STOCK EXCHANGE, PATTERNS OF SUPERVISION (1982).

ON WHOM CAN YOU RELY TO PERFORM DUE DILIGENCE?

It is hard to finish the day without reading a story where someone is blaming another for their shortfalls. It is an American pastime that has found its way into our courts and arbitrations. Witnessing these attempts to lay the blame on others is often like watching a rerun of Abbott and Costello's "Who's on first base?" The investor is allowed under the law to rely upon his broker, money manager, or registered investment advisor who is handling his brokerage accounts, partnerships, private placements, or hedge funds to conduct due diligence. But who can these investment professionals rely upon to conduct their due diligence? We can begin to answer this question by determining who is qualified to conduct due diligence.

Brokerage firms have large staffs of highly paid and hopefully highly educated and qualified analysts. Large money management firms, mutual funds, and hedge funds have similarly qualified individuals. If the investments being made by these firms are mostly in listed publicly traded stocks, the kind of investigation, research and due diligence that is being conducted is dramatically different than if they are making investments in non-publicly traded companies such as private placements, venture capital, or in such unregistered investments as sub-funds or other hedge funds. It is inappropriate to take an individual whose training and experience has been limited to evaluating publicly traded companies and expect them to translate that knowledge into conducting due diligence on a completely different kind of investment.

A sad example of the type of person one should be able to rely upon for due diligence was highlighted in the SEC's 2002 finding against almost every major brokerage firm – for the debacle involving brokerage firm analysts.[17] Hardly an investment cycle goes by without these highly paid, in-house analysts at the major brokerage firms completely missing the boat on a particular stock, à la MCI, Tyco, WorldCom, Global Crossing, and Enron. Such analysts are as pitiful when rating and ranking their sister brokerage firms such as Lehman Brothers and Bear Stearns. It is an embarrassment to the analyst profession that so many brokerage firms were touting and recommending Enron almost to the bitter end, especially considering that some of the company's more questionable practices were right there in Enron's annual and quarterly financial statements. There is far too often a

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17. SEC News Digest, Issue # 003-07 (April 28, 2003), http://www.sec.gov/news/digest /dig042303.txt. For an easier analysis read CHARLES GASPARINO, BLOOD ON THE STREET (2005).

dangerous "herd mentality" that has brokerage firm analysts working in lockstep.

Investment banker types and brokerage analysts have relatively inflated egos. You can't blame them; that is what happens when recent college graduates are paid over half a million dollars. But both they and their employers have a vision of the kind of research they do, and it does not involve snooping around. This probably bodes well for the investor, since these pin striped suited investment banker types probably don't have the credentials, experience, or the stomach for hard-nosed investigative work anyway. Investment firm employees' dislike for dealing with these "sticky" issues such as sensitive background searches is why often the investment firm will handle all the standard due diligence but leave the personal background investigation and verification to outside third party firms.

There is nothing worse than having somebody conduct due diligence for a firm who is not qualified; garbage in, garbage out. If someone does not know the right questions to ask, he is not going to get answers that are of any value.

Separate from qualifications is the issue of conflicts. The analyst debacle underscored that brokerage and investment banking firms that have an investment banking relationship with the very company they are underwriting for, have no incentive to tick off the client by asking a lot of delicate questions. Accordingly, it is a common practice of money management firms to hire outside companies that specialize in securities due diligence work.

OUTSIDE FIRMS THAT SPECIALIZE IN DUE DILIGENCE WORK

Today numerous firms offer investigative services, Kroll being one of the largest and oldest. All an individual needs to do is type into any search engine "due diligence firms" and a vast array of firms offering such services will be listed. They perform a myriad of investigative functions, sometimes incognito, such as:

- Conduct a site visit of various plants and warehouses to "kick the tires";
- Visit the operations of direct competitors;
- Conduct an exhaustive background check on key officers, managers, and participants;
- Verify college degrees, prior work and responsibilities, accolades, awards;
- Interview previous employers or employees;

- Track down and interview potentially disgruntled customers or vendors;
- Verify or discount rumors and stories, both positive and negative; and/or
- Act as a customer, consumer, vendor, or supplier and test the facilities and employees of both the target company and/or competitors.

Hiring outside firms to conduct due diligence is generally a good idea. But advisory firms considering outside investigative/due diligence firms must be cautioned: don't go cheap! In one securities arbitration case, a registered investment advisory firm hired an outside firm to conduct due diligence on a hedge fund. The consulting firm's report showed that they were unable to answer specific, important questions because of budgetary constraints and other limitations. Instead of what could have been a useful report supporting the contention that the advisory firm did proper due diligence, the report became a damaging document because the claimants showed that the due diligence was truncated and grossly inadequate.

To illustrate this predicament: a company hires an outside firm to fulfill its due diligence obligations and the firm is negligent in its investigation work. Who is responsible? The hiring firm would be guilty of not doing its "due diligence" on the very firm it hired to do its "due diligence". Leave it to the NASD to address this point in Notice to Members (NTM) 05-48:

> The procedures should include, without limitation, a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities.[18]

NTM 05-48 goes as far to state that both NASD rules 3010 and 3012 require that there must be a written supervisory policy as to conducting this proper due diligence on outside service providers.

RUBBER STAMPING

A fairly apparent practice termed "rubberstamping" refers to the art of papering a file. When an entity, for example an underwriter, is putting together an IPO and hires a private company to conduct due diligence on some individual or entity, and the underwriter a) is pretty positive nothing

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18. NASD, MEMBERS RESPONSIBILITIES WHEN OUTSOURCING ACTIVITY TO THIRD-PARTY SERVICE PROVIDERS, NASD NOTICE TO MEMBERS 05-48 (2005), *available at* http://www.finra.org/Industry/Regulation/Notices /2005/p014736.

negative will be found, b) is pretty positive they are going ahead with the deal regardless of what information is found, and c) their main reason for hiring an outside firm is so that if they are sued for not having done their due diligence, they can say they did it. This is rubber stamping. It is a dangerous practice, but it can also be effective. An investor who is contemplating suing an investment firm for a lack of due diligence, might think twice when she discovers that the defendant, not only has a large due diligence file, but in addition hired an outside service to conduct this due diligence.

But rubberstamping is a dangerous practice because it can get to be a bad habit, particularly if the investment advisor won't change its decision whether to invest or not invest based on what it discovers. Consequently, the outside firm will not do as a thorough or exhaustive an investigation as it might otherwise do. This lax style becomes habit-forming; it can be hard for the advisory firm to turn the switch off and on as whether to perform thorough due diligence, "light" investigation, or rubberstamping. And it's just a matter of time until both firms may get burned.

The following is an example of a callous and lax attitude that some firms might take toward due diligence.

> Due diligence: A process, typically undertaken by junior lawyers/paralegals, involving reviewing a company's legal and financial documents to flag up any issues that may cause problems during and/or after a transaction.[19]

Take note of two items: first, note that the work is being shoveled off to "junior" staff. Second, the work described is merely reviewing documents. This sounds like dangerous rubberstamping.

There is an additional problem with this "light" investigation work: who else may ultimately rely upon it? In large firms, does everybody understand that the investigation was a "wink, wink" transaction? Some might rely on the truncated/cursory investigation, believing that it was thorough and exhaustive due diligence that was performed. And think of the problems created in the cumulative effect of a "light" investigation: "We investigated them before and didn't find anything wrong." A subsequent firm might rely on the earlier inadequate investigation, and so on. This is one of the reasons that relying on another firm's due diligence work is so inappropriate: you simply do not know how thorough the other firm was.

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19. LAWYER 2B, *Jargon Buster*, http://l2b.thelawyer.com/useful-resources/jargon-buster#D.

CONDUCTING DUE DILIGENCE

This article does not attempt to cover every nuance of how to conduct due diligence. Not only would that require a book-length article, there is no one standard format or complete questionnaire that can cover all the bases. Since hedge funds can invest in anything under the sun, it would be near impossible to create a questionnaire or list that can anticipate every fact that should be addressed prior to investing. It is more important for investors to concentrate on what they do not know, versus what they do know. Furthermore, claimants and attorneys, when preparing for litigation, should spend less time on the strengths of the case and instead concentrate on the weaknesses and negatives. This same mentality applies to the issue of due diligence. "As any good due diligence analyst will explain, performing due diligence can be equated to peeling away the layers of an onion. In order to get to the center investors must successfully peel away layer after layer with subsequent questions and inquiries."[20]

Far too often firms that conduct due diligence concern themselves more with the volume of their due diligence file than the quality of the materials contained within. Because it is just human nature, too often those conducting the investigation are happier filling the file with positives as opposed to negatives and warnings. Many investigators shy away from conducting really thorough due diligence, because they realize a due diligence file filled with negatives can do more harm than good should litigation ensue. This is only further complicated by the fact that most individuals, especially those people who consider themselves investment bankers or money managers and not super sleuths, would be uncomfortable and unfamiliar with asking embarrassing and probing questions such as:

Do you or any of your key employees at the firm:

- have a history of drug abuse, and if so can you furnish me with the medical records?
- have a history of mental problems, and if so can you furnish me with the medical records?
- ever been accused of child or spousal abuse and what was the outcome?
- been a claimant in either civil or criminal litigation, if so please provide detailed information, as to the specifics, dates, location, parties involved, and final resolution?

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20. SCHARFMAN, *supra* note 12, at 53.

- ever a defendant or accused in either civil or criminal litigation, if so please provide detailed information as to the specifics, dates, location, parties involved, final resolution?
- ever declared bankruptcy, if so provide all written documentation?
- ever been accused of wrong doing by any securities regulatory body, if so provide all written documentation?
- please provide me with: full name and any aliases, date of birth, social security number , driver's license number, living addresses for the last 20 years, full maiden name for any spouses current or previous, full names and information provided above for all children over the age of 21?

The last bit of questioning is so that a physical or electronic background investigation can be conducted on the individuals. As a majority of people would feel uneasy asking these questions, therein lies the reason for hiring outside consulting firms who specialize in this business.

A bit of warning to those who conduct due diligence, uncover some negatives or red flags and then fail to share it with prospective or current investors. The following paragraph is from an SEC finding:

> Bell's recklessness became even more egregious after he learned, at least as early as June 2004, that Petters had previously been convicted of multiple crimes involving fraud and deception. These facts should have led Bell to question everything Petters was telling him. But instead, Bell deliberately concealed Petter's prior convictions from the Funds' investors and continued to invest the Funds' money in Petter's notes.[21]

Investment professionals should take note of the SEC's language. Point one: if you find something questionable in an individual's history, you should start second guessing and do a more exhaustive job of due diligence. Point two: if you find something negative, then disclose it; always err on the side of full disclosure and total transparency.

One last key piece of advice on conducting due diligence: when contemplating an investment in any firm or fund, negotiate on the front end that the target firm will provide a signed document or release authorizing the background investigation. In this age where identity theft is a real concern and new privacy restrictions are in place, conducting any meaningful

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21. *United States Sec. & Exch. Comm'n v. Thomas J. Petters, Gregory M. Bell, & Lancelot Investment Management LLC*, No. 09SC1750 (D. Minn. July 7, 2009), *available at* http://www.sec.gov/litigation/complaints/2009 /comp21124.pdf; *see also,* SEC Litigation Release No. 21124 (July 10, 2009), http://www.sec.gov/ litigation/ litreleases / 2009/lr21124.htm.

background investigations without the target firm's written authorization is much more difficult. The authorization and release must be all-encompassing with no restrictions or limitations and is even that much more powerful when the signature is notarized. What if the party refuses? It makes your investment decision very easy. Walk away and never look back!

In assessing whether proper due diligence was conducted, be sure to discover all communication between the due diligence firm and the target firm, particularly any such authorizations/ releases. You might find that the target firm refused to sign but the investigation went forward nonetheless. This might reveal evidence of a hampered investigation.

SHOULD DUE DILIGENCE LISTS BE UTILIZED?

Before discussing the use of lists, there is a notable distinction between a list and a questionnaire and their uses in this field. A questionnaire, at least in the area of hedge fund due diligence, is used in two ways. Many hedge funds create a questionnaire to provide to potential investors, often in the form of a "Frequently Asked Questions" wherein the hedge fund asks and then answers the questions that they think an investor would want to know. The second use of questionnaires is when the firm conducting the due diligence provides to the potential target firm a fairly extensive group of questions that the target firm itself answers. A list is an internal set of questions, investigative methods and fact finding that needs to be completed in order to document the "due diligence" being performed.

Often, the first step in any due diligence process is the furnishing of a questionnaire to the target firm. That base information is often used to conduct due diligence, but there is a problem. If a firm in and of itself (or one of its officers) has something to hide or something they would rather not disclose, relying on a questionnaire can be a dangerous start. What is being sought in proper due diligence is something the company does not want to reveal, regardless of how detailed the questionnaire is. No doubt, a significant portion of investigative due diligence is the verification of known facts. But if the investigation stops there, in the vast majority of the fraud cases that have been perpetrated on investors over the last couple of decades, little of this fraud would have been discovered.

There is often a debate among investment firms and even firms that contractually do due diligence work as to the benefits of using "lists" in conducting their investigations. The number one benefit of having lists and requiring them to be utilized is that it forces individuals to cross their T's and dot their I's. Utilizing lists also can help guard against not being unduly

influenced by any one person or piece of information. The other great thing that lists do is they allow management to delegate task to certain people. A thoroughly experienced individual who creates the list can now potentially rely on a less experienced person to conduct the due diligence, as long as that person is capable and qualified to do the work. A qualified individual should be one who understands the business that he is investigating.[22]

Yet, there are negatives that can come from the overuse of lists. Unlike many investments such as mutual funds, limited partnerships, and even ETFs, hedge funds are not regulated and are most often not limited in what they can invest in. Hedge fund investments might include a coffee plantation in Brazil; an oil shale in Canada, a recycling plant in California, and a sub-fund in Timbuktu. Can a due diligence list be created that can properly and adequately cover all of these variables and opportunities? No! Hence, herein lie the dangers with utilizing lists for conducting due diligence. In the hands of a less diligent experienced employee, the list might be conceived as all-encompassing: "If I get the answers to all of these questions, I've done my job." However, any list, no matter how thorough, should only be used as a base from which to expand the investigation.

The following is a partial list that covers several broad topics of due diligence work[23]:

- Organizational structure and control;
- Material contracts;
- Litigation;
- Regulatory compliance;
- On-site management interviews;
- Background investigations;
- Reference checks;
- Management and staff capability analysis;
- Review of policies and procedures;
- Financial statement review;
- Prior performance review;

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22. JAMES P. JAILIL, UNDERWRITERS DUE DILIGENCE; WHAT IS IT AND HOW MUCH IS ENOUGH? (2004).

23. SNYDER & KEARNEY LLC., DUE DILIGENCE OF 1031 OFFERINGS (2007), http://www.snyderkearney.com / articles/1031 _Due_ Diligence_White_Paper_ (vfinal4_)%204.pdf; *see also*, MANAGED FUNDS ASSOCIATION, MODEL DUE DILIGENCE QUESTIONNAIRE FOR HEDGE FUND INVESTORS, http://www.managedfunds.org/downloads/Due%20Dilligence%20Questionnaire.pdf.

- Prior performance disclosure;
- Overall performance;
- Identification of problem properties; and
- Analysis of internal controls and procedures

The following are a few more items to add to a due diligence list:

Securities regulatory bodies

- ADV forms and IARD for investment advisors
- CRDs
- SEC and FINRA enforcement proceedings
- Regional offices for the SEC and FINRA
- NAASA
- Individual state securities boards and commissions
- NFA

Verification of:

- Licenses
- Schooling, colleges, diplomas, accolades
- work history, responsibilities, titles, accomplishments

Press, articles, news stories, publications

- Reuters
- LEXIS-NEXIS
- Westlaw
- Wall Street Journal.com (wsj.com)
- Bloomberg
- Dialogue
- Google
- Factiva (Dow Jones)
- All local newspapers where the individual has either worked or lived

Negatives set aside, all investment management firms and individuals should have articulately crafted lists to aid them in their due diligence work.

LIMITING DUE DILIGENCE

There will always be an explanation for a less than thorough due diligence when someone is accused of being lax in their investigation. Two of the common explanations that can also be pitfalls are 1) how current is the investigation and 2) over reliance on certain factors.

HOW CURRENT IS CURRENT?

Due diligence is not always static but, depending on the circumstances, may require ongoing monitoring. It is a mistake for a firm to perform due diligence and then think "Well, that's done; now we can go back to sleep." What if an advisory firm does a thorough background check on a sub-fund which results in an investment and then six months later the advisory firm contemplates making an additional investment in this same sub-fund? Does the firm need to do the same level of investigation/due diligence for the second investment? What if the first investment was one year earlier or two years earlier? The standard is the information must be current, but how current is current? A firm should update its due diligence annually, at the very least to determine whether or not any changes have taken place. For example, let's say that you have conducted thorough background checks on all the key officers and those with investment responsibilities at a hedge fund you are thinking of placing money with. But six months later, three new employees are added. It would probably be appropriate to conduct additional background checks, thus catching these new employees, as well as new occurrences in the backgrounds of the current employees, no less than once a year.

OVER RELIANCE

Another danger is allowing one piece of information to sway the person conducting the due diligence. Commonly, it is a personal recommendation from someone you highly regard: "If Bob says he can be trusted, that's good enough for me." Thorough, exhaustive, proper due diligence is exactly that: the person/firm conducting the due diligence should never be swayed or overly influenced by any one item or group of items no matter how positive. Far too often the following items have unduly influenced advisor's decisions to invest with a particular firm or in a particular investment:

- Above average annual rates of return (maybe the most classic mistake);
- Accolades of key individuals (an MBA from Harvard guarantees attracting money is easy, and everyone assumes you are brilliant);
- Praise from other professionals (little value, just a circle of professional courtesy)
- References that are glowing (pretty worthless - who gives negative references?)
- Size (bigger is not better, you only need to review the capitalization of Bear Stearns and Lehman Brothers before they went under);

- Impressive list of major investors (these same investors invested with Bear Stearns, Lehman Brothers, Bernie Madoff and Long-Term Capital Management.);
- Hot new product area (want to buy some tulips or subprime mortgage debt?)

DUE DILIGENCE – SECTION 11 DEFENSE TO PROSPECTUS FRAUD

Section 17 of the Securities Act of 1933 contains the anti-fraud provisions that relate to false statements or omissions of material facts that occur in a securities offering, be it registered or unregistered. Section 11 spells out defenses for those officers, underwriters, and other individuals who might be held responsible for any false, misleading, or material omissions in the offering prospectus or memorandum. [24] One such defense is that these individuals were not aware of the falsehoods or material facts that were not disclosed. It requires the defendants to prove that prior to the offering materials they undertook "reasonable investigation" to discover any potential falsehoods or other material facts that needed to be disclosed.

Neither the history books nor legal research reveals how the term "due diligence" first came to be used in conjunction with this Section 11 defense.[25] Nowhere in the '33 Act or accompanying code provisions is the term "due diligence" used. But most practitioners in this field are familiar with this particular Section 11 defense being called the "Due Diligence Defense ". One of the better articles written is titled, "The Section 11 Due Diligence Defense for Director Defendants" [26]

Where a securities professional is being accused of inappropriate or inadequate investigation into the securities purchased on an investor's behalf, raising this "due diligence defense" is common, even when the claims have nothing to do with a violation of section 17 of the Securities Act of 1933. Immediately the question becomes, why is this practice so common? A more thorough reading of Section 11 clears up the question almost immediately:

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24. Securities Act of 1933, §11 (b)(3)(A), 15 U.S.C. §77K.

25. For some history and on the issue of reasonableness, see JALIL, *supra* note 22.

26. Tonay Rodriquez, Karen Petroski, *The Section 11 Due Diligence Defense for Director Defendants*, 2007 A.B.A. LIT. SEC., SECURITIES LITIG. JOURNAL (Summer, 2007); see also William K. Sjostrom Jr., *The Due Diligence Defense under Section 11 of the Securities Act of 1933*, 4 BRANDEIS L. J. 549 (2006), *available at* http://papers.ssrn.com/sol3/papers. cfm?abstract_id=864584.

> As regards any part of the registration statement not purporting to be a made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading;
>
> Standard of Reasonableness
>
> In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.[27]

The reader only need to go back and read the definitions as to the term "due diligence" and they will quickly recognize why this tactic of using this Section 11 "due diligence defense" is utilized by defense attorneys. Note that the measuring stick for the adequacy of the due diligence is only that of being "reasonable". At least there is some attempt to measure what is "reasonable" by referring to the "prudent man rule". Securities practitioners are infinitely familiar with the "prudent man rule" in connection with the overall management of investment portfolios, especially those governed by ERISA or discretionary agreements. I will not burden this article with a dissection of the "Prudent Man Rule", but will only say that it is a somewhat lesser standard than is called for under "due diligence". This is why so many defense attorneys find solace in the Section 11 "due diligence defense."

When opposing counsel tries to inappropriately inject a Section 11 defense, one reference an attorney can use is a footnote from NASD NTM 03-71:

> NASD's use of the term "due diligence" is not intended to equate the responsibilities of a member for its sales conduct obligations with the requirements of an underwriter under Section 11 of the Securities Act of 1933 and Securities Act Rule 176.[28]

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27. Securities Act of 1933, §11(b)(3)(A), 15 U.S.C. §77K.
28. NASD, NON-CONVENTIONAL INVESTMENTS, NASD NOTICE TO MEMBERS 03-71 (2003), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003070.pdf.

DUE DILIGENCE-APPLICATIONS AND REQUIREMENTS

Having debunked the notion that the "due diligence" requirements of money managers is somehow tied to Section 11 of the Securities Act of 1933, let's take a look at specific applications of the term "due diligence" to various securities professionals.

FIDUCIARY RELATIONSHIPS

Federal and state securities regulations, as well as the courts, are pretty consistent in declaring that any securities professional who is managing money for an investor on a discretionary basis has a fiduciary relationship with that investor. And it is fairly axiomatic that a fiduciary duty is a higher duty than a non-fiduciary relationship. “Fiduciaries should bear more responsibility for doing due diligence and pay a high price for neglecting this fundamental duty."[29] It is for this reason that most brokerage firms are very nervous about this issue and try to keep their stockbrokers from becoming fiduciaries. The major brokerage firms fought very hard in the last decade to keep the legislature from enacting regulations which would have made all stockbrokers fiduciaries.

STOCKBROKERS

As noted in BROKERAGE FRAUD: WHAT WALL STREET DOESN'T WANT YOU TO KNOW,[30] stockbrokers are salesmen. The technical name for stockbrokers is Registered Representatives. This is because these individuals must be both licensed and registered with a licensed and registered broker dealer. The broker dealer is licensed and registered with various self-regulatory organizations such as FINRA, MSRB etc. The most common practice of stockbrokers when working for large brokerage firms is for the broker to rely on the research conducted by the firm's in-house analyst. The typical stockbroker merely parrots these recommendations to his retail

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29. Stephen Brown, Anthony Lynch & Antti Petajisto, *Hedge Funds after Dodd-Frank*, REGULATING WALL STREET, NYU Leonard N. Stern School of Business (July 19, 2010), http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/07/hedge-funds-after-doddfrank.html.
30. DOUGLAS SCHULZ & TRACY STONEMAN, BROKERAGE FRAUD-WHAT WALL STREET DOESN'T WANT YOU TO KNOW (2002).

clients. Of course, he must first determine that these recommendations are suitable (see the "Know Your Customer-Know Your Product" section of this article).

In the last two decades more and more brokerage firms have encouraged their stockbrokers to become "money gatherers" and less traders or stock jockeys. The marketing and management concept is to gather as much money as possible and charge a fixed annual fee, averaging between 1% and 2%. In many instances the brokers will get a power of attorney for client to manage their account on a discretionary basis. And there is the more traditional way where the broker turns over the client's funds to the brokerage firm's in-house money managers or places the money in the in-house mutual funds. In both these instances, the money is managed on a discretionary basis. As stated earlier, if the stockbroker himself or any other individual at the brokerage firm is managing the investors' money on a discretionary basis there is an automatic fiduciary relationship.

CAN A STOCKBROKER RELY ON HIS FIRM'S DUE DILIGENCE?

In 1980, I was a new stockbroker (registered representative) for Merrill Lynch in Dallas, Texas. Every day on the "squawk-box," a stream of Merrill analysts pontificated about the new, hot recommendation of the day. I was young and naïve, and worse yet, trusting. I took the stock option recommendations and recommended them to my trading clients; who then lost their money before the ink was even dry on the tickets. When I tried to question the analyst about the previous day's disastrous recommendations, I was told, "We don't look backward." I recommended Merrill Lynch's proprietary underwriting "The Ginnie Mae Fund," which on the cover of the prospectus said that the fund was "Government Guaranteed." My clients quickly lost both principal and interest. Additionally, Merrill Lynch sponsored and recommended a number of insurance company's annuity products, and they were touted as very safe. Very shortly thereafter two of these very same insurance companies went down the tubes.

Throughout the late 80s, thousands of Prudential's stockbrokers recommended numerous limited partnerships which were being heavily touted by Prudential Securities. I assisted the SEC with investigating Prudential. The SEC found that numerous senior executives at Prudential had not only misled investors about these limited partnerships, but that Prudential had also misled their brokers. Many of these partnerships were riddled with conflicts of interest and were very risky, yet they were marketed and sold as safe.

So to ask the question again: under the regulations, is a broker allowed to rely on his sponsoring firm to investigate and perform due diligence for him and his clients? I can give you from firsthand knowledge Merrill Lynch's opinion at the time I worked for the firm. We were trained as salesman. Merrill wanted us to concentrate our efforts on selling. Merrill Lynch had a cadre, of highly paid, highly rated analysts and we were to rely on their recommendations.

However, brokers who rely too heavily on their firms' due diligence need to take note of the following finding by the National Adjudication Council.

> BEFORE THE NATIONAL ADJUDICATORY COUNCIL NASD
> Faber argues that he did not act recklessly because he relied on the due diligence conducted by his employer. Faber does not provide any legal support for this contention; rather, he asserts that if his position is incorrect, every individual representative will be required to investigate for him or herself the accuracy of every report, opinion, analysis, or recommendation made by a firm. Faber overstates his argument and we disregard it. First, our finding is that. —given the red flags that confronted him. —Faber acted recklessly in representing that the Interbet transaction was an IPO. Our finding is consistent with applicable case law. See Richard H. Morrow, 53 S.E.C. 772, 779 n. 10 (1998); see also Hasho, 784 F. Supp. at 1107 ("Registered representatives have certain duties that they cannot avoid by reliance on either their employer or an issuer"); Donald T. Sheldon, 51 S.E.C. 59, 71 (1992) aff'd, 45 F.3d 1515 (11th Cir. 1995) (material misstatements and omissions by registered representatives are not excused by a representative's reliance on information from his broker or dealer); William G. Berge, 46 S.E.C. 690, 694 (1976) ("Compliance with the antifraud provisions cannot be shifted entirely to a salesman's supervisor"), aff'd sub nom, Feeney v. SEC, 564 F.2d 260 (8th Cir. 1977). Second, Faber did not show that the Firm's due diligence concluded that the Interbet transaction was an IPO. We therefore reject Faber's argument that he relied on Smith Culver's due diligence.[31]

This question of "reliance" raises its head often when the issue of due diligence is discussed in the securities field. When conducting investigations, research, and due diligence often someone ends up relying or

31. *Department of Enforcement v. Dane S. Faber*, NASD Regulation, Inc. Office of Hearing Officers Complaint No. CAF010009 (May 7, 2003), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/ohodecisions/p006568.pdf.

trusting the words or reports of others. But there is a very special relationship between the stockbroker/registered representatives and his broker-dealer. The broker is not only registered and licensed with his parent firm, he is an employee (regardless of whether is characterized as an independent contractor for tax purposes). In theory they should be a cohesive team that is working in the best interest of their clients (of course, this theory does not always hold true because of the conflicts of interest within the brokerage industry resulting in thousands of lawsuits filed annually by investors). There is no doubt that a broker "should" be able to rely on his brokerage firm's product recommendations. Clearly, because of the massive staff of lawyers, economists, and analyst employed by the brokerage firm, the firm is in a better position than the individual stockbroker to dissect, analyze, and conduct due diligence on each and every product/investment that it markets through its individual brokers.

That being said, the individual broker is still not left off the hook. Each stockbroker/registered representative is an individually licensed person. He/she will have a series 7 and series 63 and maybe many other licenses. These licenses require the broker as an individual to follow a myriad of securities regulations dictated by FINRA, the SEC and other federal and state statutes and regulations. The broker must "know his customer" and "know his product." No one argues the point that it is the individual stockbroker who has the primary duty to "know his customer"; but what about the product? And more specifically, what about the product that is being specifically recommended and touted by the brokerage firm at which the individual broker is employed?

The norms of the securities industry do not require the broker to perform a redundant set of due diligence obligations on the products that are being recommended by its firm. What is required is that the broker be reasonable at taking at face value the recommendations of his firm. Let's take two examples to illustrate this point.

I earlier mentioned the incident where Prudential Securities sold hundreds of millions of dollars of illiquid, risky, conflict-laden limited partnerships to investors and touted them as anything but. Were these brokers at Prudential fulfilling their regulatory requirements under their individual licenses by taking Prudential's word and marketing materials at face value, and merely acting as a conduit and salesman to the investing public? No! These limited partnerships did not satisfy the "smell test" from the get-go. Each and every one of these limited partnerships had a prospectus. A broker selling one of these prospectus products would not be fulfilling his obligation to "know his product" by merely using the suggested sales scripts by Prudential. He/she would be required to read the prospectus. And any

licensed and properly qualified registered representative who had read one of these prospectuses would have immediately realized that the prospectus language did not jive with the sales scripts that Prudential was handing to its brokers. At this point, it is no longer reasonable or appropriate for the broker to merely "rely" on his firm and its due diligence. He is now *on notice* of a problem, or as we sometimes call it in the industry, a "red flag". Blindly recommending these limited partnerships to their clients from that point forward would be a securities violation.

A second example is those stockbrokers who found themselves working for the "bucket shops" and other sleazy, cold calling and microcap brokerage firms that so permeated the industry in the 70s and 80s. The movie Boiler Room so perfectly portrayed this type of operation. Many of these firms were a complete mockery of securities regulation. Almost each and every day it would be easier to delineate the few regulations that were followed, rather than trying to list all of the regulations that were violated. Any licensed registered representative who was working at one of these firms who might claim he was unaware of the infractions and inherent unethical business model would clearly be guilty of unreasonably and unprofessionally relying on the recommendations of his brokerage firm. One might even go so far as to accuse such a person of being brain-dead or totally blind.

These examples highlight the point that licensed stockbrokers cannot blindly rely on their parent brokerage firms when it comes to such issues as due diligence, product knowledge and suitability.

BROKER DEALERS' DUE DILIGENCE OBLIGATIONS

The "Know Your Product" obligation is a dual responsibility both on the stockbroker/registered representative and the broker-dealer itself. There are numerous places throughout the regulations that specifically use the term due diligence. The following are a couple of examples.

BROKER DEALERS RECOMMENDING MICROCAP AND OTC SECURITIES

NASD Rule 2315 is intended to address abuses in transactions involving ("microcap") securities. The rule mandates that a member conduct a due diligence review of an issuer's current financial and business information

before recommending that issuers microcap securities.[32] NASD rule 2315 was amended and the rule was changed to FINRA Rule 2114. In addition, the rule covers OTC securities and requires that the individual at the broker-dealer conducting the due diligence be either a series 24 General Principle or a series 8 General Securities Sales Supervisor. [33]

BROKER DEALERS RECOMMENDING HEDGE FUNDS

Broker-dealers who are marketing hedge funds also have specific due diligence requirements. NASD Notice to Members (NTM) 03-71 is right on point:

> **Reasonable-Basis Suitability** Under reasonable-basis suitability, a member that recommends hedge funds, directly or indirectly, must have a belief that the product is suitable for any investor. Members discharge this requirement by conducting due diligence with respect to the hedge fund, or in the case of a fund of hedge funds, with respect to the underlying hedge funds. Due diligence is especially important for hedge funds because, as noted above, many hedge funds are not registered as investment companies and are offered though unregistered private placements. Members therefore have a ***heightened*** responsibility to investigate the hedge funds and funds of hedge funds that they recommend to customers. Members must perform ***substantial due diligence*** into a hedge fund before making any recommendation to a customer, including, but not limited to: an investigation of the background of the hedge fund manager, reviewing the offering memorandum, reviewing the subscription agreements, examining references, and examining the relative performance of the fund.[34]

The words "heightened" and "substantial due diligence" are emphasized, because it is important for the licensed securities professional to recognize

32. NASD, SEC APPROVES NASD RULE 2315: RECOMMENDATIONS TO CUSTOMERS IN OTC EQUITY SECURITIES, NTM 02-66 (October 2002), *available at* http://www.finra.org /Industry /Regulation/Notices/2002/p003454.

33. FINRA, SEC APPROVES NEW CONSOLIDATED FINRA RULES, REGULATORY NOTICE 09–20 (April 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118483.pdf.

34. NASD, NASD REMINDS MEMBERS OF OBLIGATIONS WHEN SELLING HEDGE FUNDS, NTM 03-07 (February 2003)(emphasis added), *available at* http://www.finra.org/Industry /Regulation/Notices/2003/p003356.

that the regulators are insisting on a higher level of investigation when it comes to more complex, risky products. This follows decades of regulatory guidelines when it comes to less liquid, more complex, higher risk products. For the longest time, the NASD only had two sections of its manual devoted to specific products: stock options and limited partnerships. Both are more complex, higher risk, and at least as to the latter, less liquid.[35]

Because of the incredible growth in hedge funds, there has been a commoditization of research on various hedge funds. This background investigation is creating libraries of information which is aiding those conducting due diligence on hedge funds.[36]

BROKER-DEALER RECOMMENDING NONCONVENTIONAL SECURITIES

NASD Notice to Members 03-71 reminds members offering nonconventional investments (NCI's) of their obligations to conduct adequate due diligence to understand the features of the product:…[37]

> Due Diligence/Reasonable-Basis Suitability
>
> As NASD noted most recently in Notice to Members 03-07 (pertaining to hedge fund sales to customers), performing appropriate due diligence is crucial to a member's obligation to undertake the required reasonable-basis suitability analysis. A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination, discussed below, which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI only to institutional investors does not relieve the member of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

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35. The FINRA Manual now has a section on annuities, another complex, illiquid, commission laden product. See, e.g., FINRA Manual, Rule 2330, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=12069&element_id=8824&highlight=annuities#r12069.

36. SCHARFMAN, *supra* note 12, at 271.

37. NASD NOTICE TO MEMBERS 03-71, *supra* note 28.

> The type of due diligence investigation that is appropriate will vary from product to product. Members should examine these and other appropriate factors when conducting due diligence. A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document. However, reliance on such materials alone may not be sufficient for a member to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the member with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes. In such case, the member must seek additional information about the NCI or conclude that the product is not appropriate for sale to the public. In addition, members should ensure that the persons responsible for conducting due diligence have appropriate training and skill to evaluate the terms of the investment as well as the potential risks and benefits. Members must ensure that their written procedures for supervisory and compliance personnel require that (1) the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale.[38]

In Notice to Members 05-18, the NASD once again addressed the issue of conducting due diligence as it relates to even another product area. The repeated theme of the NASD (now FINRA) is that due diligence is product specific. In NTM 05-18, the NASD states:

> NTM 03-71 reminds members that the type of due diligence that is appropriate will vary from product to product. NASD staff believes that it is not appropriate for members that recommend a TIC transaction simply to rely on representations made by the sponsor in an offering document. [39]

In NTM 05-18 the NASD stated that because of the complicated tax structure surrounding tenants-in-common ("TIC") transactions, the broker-dealer and broker can only fulfill their due diligence obligations by fully understanding all the tax ramifications surrounding the recommended transaction.

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38. NASD, NOTICE TO MEMBERS 03-71, *supra* note 28; see also, NASD, NASD PROVIDES GUIDANCE CONCERNING THE SALE OF STRUCTURED PRODUCTS, NOTICE TO MEMBERS 05-59, (September 2005) *available at* http://www.finra.org/ Industry/Regulation/ Notices/2005/p014998 (similar to NTM 03-71, requiring due diligence into structured products before selling them to the public).

39. NASD, NASD ISSUES GUIDANCE ON SECTION 1031 TAX-DEFERRED EXCHANGES OF REAL ESTATE PROPERTY, NOTICE TO MEMBERS 05-18 (March 2005), *available at* http://www.finra.org/Industry/Regulation/Notices/2005/p013456.

MONEY MANAGERS & REGISTERED INVESTMENT ADVISORS

When discussing money management firms, it is best to divide them up: mutual funds and registered investment advisory firms (RIAs). There is a long laundry list of distinctions between the two but here only the relevant differences will be discussed. For the most part, the regulations that govern the mutual fund industry are under the Investment Company Act of 1940; for RIAs, it is the Investment Advisers Act of 1940.

In addition to following the securities regulations of the SEC, FINRA, etc., the overriding document that dictates the activities in a mutual fund is the fund prospectus. Herein lies the specifics of what a particular fund can and cannot do when selecting investments of the fund. Notably, the mutual fund industry attracts the least amount of lawsuits. Many people find that surprising when mutual funds almost by definition are sold to the masses in the billions of dollars. More people, more lawsuits. But because mutual funds are offered to the general public, they are generally structured to be suitable for the general public. The classic way to make a mutual fund suitable for most people is to: a) keep it conservative; b) keep it simple; and c) have fairly restrictive covenants on what the fund can invest in. It is the latter that will be discussed here.

Most mutual funds are considered diversified. To be classified as a "Diversified Investment Company" under the Investment Company Act of 1940, the fund can have no more than 5% invested in any one security with respect to 75% of its portfolio, and can own no more than 10% of the voting rights of any one company. In addition to this restriction of the amount the fund can put in any one security, the vast majority of all mutual funds are investing in publicly traded securities, be they common stocks, preferred stocks, options, corporate bonds, government bonds, municipal bonds and the like. Mutual fund management teams are often wrong and sometimes can even be stupid but it is typically not a problem related to due diligence. The mutual fund industry did have a string of funds in the last decade that had disastrous returns for investors which was mostly a result of their concentrated positions in subprime debt. The successful regulatory actions and investor lawsuits against these funds were based more on the funds not following the requirements of the prospectuses, as opposed to a lack of due diligence.

The story is somewhat the same for the vast majority of registered investment advisory firms (RIAs). The reason is because, like the mutual fund industry, most RIAs trade in publicly traded securities. It is not that trading in publicly traded securities is any guarantee of success; but the

securities requirements of reporting and public disclosure are so high on publicly traded companies, conducting research is a relatively easy task.

That being said, there is one glaring example that turns this on its head: Enron! Enron was not only publicly traded; it was a very widely held common stock and a favorite of institutions. Before its demise, there were approximately 14 analysts covering the company. Almost all of these analysts were fairly bullish on the stock almost to the bitter end. This article cannot attempt to retell the entire Enron story, but most everyone in the securities industry is fully aware of the debacle. The main point to consider here is the failure of due diligence. But what makes the failure of due diligence on the part of the analyst that were covering Enron so grevious is that the very earnings information that ultimately resulted in the downfall and implosion of Enron was reported in at least one of the company's 10-K's significantly before the implosion. A footnote in one of the 10-K's laid out that the vast majority of Enron's earnings came from a remote offshore "special-purpose entity". No credible analyst will admit that they did not review Enron's 10-K's, so what went wrong? The analyst either ignored or did not give the proper weight to this key information about Enron's earnings. The reason for this failure on the part of the analyst has filled volumes of books, which also resulted in numerous fines by the SEC against almost every major brokerage firm.

Would a claim of lack of due diligence be appropriate in this instance, when every analyst had a copy of the 10-K's in their due diligence file? Yes, but the claim may be as much gross negligence as it is a lack of due diligence. Arguably, the footnote in the 10-K's in and of itself might not have been enough information to cause the analysts to alter their bullish recommendation. But the footnote put the analysts on notice that there was a serious "red flag" as it relates to the quality of the earnings of Enron. The majority of these analysts did not investigate and conduct proper due diligence as it related to this footnote. Net result: a loss of roughly $11 billion for shareholders.

HEDGE FUNDS & REGULATION D OFFERINGS

Why group hedge funds and Regulation D offerings together? The answer is quite simple: there is no specific definition for a hedge fund except for the fact that it is unregistered. Decades ago, when there was a mere handful of hedge funds as opposed to the plethora of thousands that exist today, most hedge funds actually hedged. Today, most new hedge funds use the term simply because investors are flocking to hedge funds at

unprecedented rates. The majority of these new hedge funds do not actually hedge; one need only read the offering materials to discover this fact. Therein lies one of the major advantages of hedge funds versus other registered and more regulated securities: hedge funds can typically do almost anything they want. It is for that reason that there is no specific definition for hedge fund; it is hard to put a title on such an amorphous product.

So how do the due diligence requirements relate to hedge funds and Reg-D offerings? The answer to that question depends on the securities regulations that apply to these two investment vehicles. First, there is the issue of who is offering or selling the underlying investment. If a brokerage firm is marketing either a Reg-D offering or hedge fund, federal and state statutes and FINRA regulations still apply. If the firm making the offering is not a brokerage firm but instead a registered investment advisory firm (RIA), once again almost all the same rules and regulations apply. By definition, a Reg-D offering is unregistered much the same as hedge funds. What many people on both sides of the fence often mistake is that unregistered does not mean unregulated. Even in the case of a hedge fund where the officers and managers are not registered or licensed with the securities industry, those individuals are not exempted from securities regulations.

For example, in the course of conducting its due diligence, a hedge fund manager discovers that the CEO and president of one of the companies that it is making a major investment in is a convicted felon. At no point does the hedge fund make this disclosure to its investors. The fact that this CEO is a convicted felon is clearly a "material fact." Under the Securities Act of 1933 section 17, it is a fraudulent act to omit a material fact to an investor. Of course, under the new Dodd-Frank Wall Street Reform and Consumer Protection Act, hedge funds are finally gaining more scrutiny.

In Regulatory Notice 10-22, Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings,[40] FINRA specifically addresses the obligation relating to due diligence and reasonable investigation into securities that brokerage firms recommend.

> 3. The Presence of Red Flags
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> In the course of a reasonable investigation, a BD must note any information that it encounters that could be considered a “red flag” that would alert a prudent person to conduct further inquiry. Red

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40. FINRA, REGULATION D OFFERINGS: OBLIGATIONS OF BROKER-DEALERS TO CONDUCT REASONABLE INVESTIGATIONS, FINRA REGULATORY NOTICE 10-22 (April, 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.

> flags might arise from information that is publicly available or information that is discovered during the course of the investigation. A BD's reasonable investigation responsibilities would obligate it to follow up on any red flags that it encounters during its inquiry as well as to investigate any substantial adverse information about the issuer.
>
> When presented with red flags, the BD must do more than simply rely upon representations by issuer's management, the disclosure in an offering document or even a due diligence report of issuer's counsel. In *Kunz and Cline*, the SEC found that the broker could not justifiably rely on financial statements in private placement memoranda that had been audited and certified by an accountant when numerous "red flags" indicated that the financial statements were inaccurate. The broker had a duty, which it failed to discharge, to conduct a further, independent investigation of the financial condition of the issuer under the circumstances.[41]

RED FLAGS

The body of securities regulations, regulatory releases, articles, and case law addressing the issue of "red flags" is a book in and of itself, but will nevertheless be briefly addressed. One of the inappropriate defenses as to why a firm did not conduct proper due diligence is: "We didn't see any reason for further investigation," "We felt comfortable with all of the information we had," and "We had an ongoing relationship and felt we could trust the key individuals." In other words, "We didn't see any "red flags" that indicated we should conduct a more thorough investigation." These explanations are all excuses, attempted justifications, and mere backpedaling. They are inappropriate and unacceptable as legal defenses against the claim of lack of due diligence.

Red flags are exactly what the due diligence process is supposed to discover in the first place! A red flag is a danger signal, a warning, a concern, an unknown risk, a conflict of interest, an alarming fact, an unanswered question or just something that doesn't add up. If a number of

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41. *Id.* at 6 (footnotes omitted) (citing to, *inter alia*, *Everest Securities, Inc. v. Sec. & Exch. Comm'n*, 116 F.3d 1235, 1239 (8th Cir. 1997), stating that there the investigation that was performed was itself insufficient and that even a cursory investigation would have uncovered facts showing offering memorandum was materially misleading).

these red flags are known before any investigation or due diligence work is even commenced, why would an investor even consider making the investment in the first place? Not conducting proper due diligence is not only against the securities regulations; it is against the best interest of the investor. Going ahead with an investment without conducting exhaustive due diligence to completely dissect and unravel red flags is somewhere between a wanton disregard of money management standards and pure stupidity.

TWO EXAMPLES OF LACK OF DUE DILIGENCE

Following are two cases in which claimants/investors invested in a Reg-D offering (arguably a hedge fund), which in turn invested into two sub-funds which were hedge funds. Both sub-funds imploded, and a key issue in each case was a claim of lack of due diligence.

TOM PETTERS – PETTERS WORLDWIDE LLC – LANCELOT PARTNERS

Between 2002 and 2008 Gregory Bell raised approximately $2.6 billion by selling interests to both individual investors, investment funds and institutions in an unregistered securities offering called Lancelot Investment Management LLC. The business concept described in the PPM was that investors would make money from the sale of notes that would be used to finance what was called "purchase order inventory financing" or factoring, which would be conducted by a company called Petters Company. Thomas J. Petters who was roughly 50 years old and also resided in Minnesota, ran Petters Company in addition to running Petters Worldwide. Mr. Petters had a national reputation because of the aggressive growth of Petters Group Worldwide LLC; he made such acquisitions as Fingerhut Direct Marketing in 2002; Ubid in 2003; Polaroid Corporation in 2005, and Sun Country Airlines 2006. Petters Company's purchase order inventory financing operation turned out to be a complete Ponzi scheme and one of the larger ones in U.S. history.

Would proper due diligence conducted on the part of investors have prevented their losses? Absolutely!

Investors were aware that Tom Petters and his related companies (referred to as Petters Company) were receiving the vast bulk of the dollars that Lancelot was investing. Based on the knowledge that Petters was receiving the vast bulk of Lancelot's dollars, Petters was a key and

instrumental individual in the entire Lancelot investment. An investment company could not properly fulfill its due diligence obligations and warranty to investors that it was conducting proper investigation and monitoring the investments made with Lancelot unless this included fully investigating Petters and his related entities. Per various regulatory releases, an investment company could not fulfill its due diligence obligations by just relying on Bell or the PPM of Lancelot, without verifying and confirming information. On this point the SEC stated in their complaint against Bell and Petters:

> Bell also took virtually no steps to verify the truth of the representations that Petters made to him. Instead, blinded by the huge fees he was receiving, Bell simply repeated Petters' story to investors and potential investors in the Funds. In doing so, Bell, and through him Lancelot Management, acted with a reckless disregard for the truth of their representations to investors and potential investors.[42]

The investment company should have taken whatever was told to them by Bell with a grain of salt because there was a natural built-in conflict of interest; Bell had a long-term relationship with Petters, and Lancelot was tied at the hip to Petters. Various articles which came out shortly after the Petters Ponzi scheme became national news pointed out that some relatively simple background checks would have discovered Petters criminal and questionable past.

Petters was charged in Colorado in 1989 with forgery, larceny and fraud. In February 1990 he was extradited from Minnesota to Colorado were he reported to prison on May 31, 1990 to serve a prison sentence for these charges. In 1990, a Minnesota state court charged Petters with two counts of theft by check in the amount of $500 – $2,500. Petters pleaded guilty to one count and the other was dismissed.[43] Greg Bell the general partner for Lancelot became aware of Petters prior criminal history in June of 2004, and the SEC faulted Bell for deliberately concealing Petters prior convictions from investors and prospective investors.

A few would-be investors stayed away. Randy Shain, who does background checks, says he researched Mr. Petters for clients around 2002 and was struck by the volume of litigation against him. "For 15 solid years, there were one to two lawsuits a year for not paying for something or not

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42. Complaint in *Sec. & Exch. Comm'n v. Thomas J. Petters, et al.*, *supra* note 21.
43. *Thomas J. Petters, supra* note 21.

paying for products purchased," says Mr. Shain, of First Advantage Investigative Services in New York. His clients steered clear.[44]

As it turns out, individuals like Randy Shain, who were hired to conduct due diligence work on Mr. Petters, uncovered even more than just his criminal records; they discovered that Mr. Petters had not been truthful about his college records, and that Petters had other business failures

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WILLIAM GUNLICKS – STABLE VALUE – FOUNDERS PARTNERS

William Gunlicks was the president of Founders Partners, an investment advisory firm, which solicited investors in an unregistered offering called Founding Partners – Stable Value LLP. The investment strategy of Stable Value was the financing with securitized loans the purchase of discounted healthcare receivables by third-party entities or factoring. The Private Placement Memorandum (PPM) laid out all the specifics of how this healthcare financing/factoring would take place. After raising millions between 2004 and 2009, the fund imploded and the Securities Exchange Commission issued findings and a judgment against William Gunlicks for numerous securities violations and most predominantly section 17(a) of the Securities Act of 1933 and 10b violations of the Securities and Exchange Act of 1934.[45]

Investors in the Founders Partners – Stable Value hedge fund lost millions and were shocked and upset to find that the general partner William Gunlicks had violated numerous securities regulations. In addition to the regulations listed above, the SEC alleged that Gunlicks had represented that the investors' money would be loaned to a third party factoring company to be used purchase highly liquid, short-term commercial and healthcare receivables, when in fact the factoring company used the money to invest in longer-term, less liquid, and much riskier receivables, in addition to other impermissible uses which were not disclosed to investors.

Could individual investors and money management firms who invested millions with Mr. Gunlicks have prevented these losses if they had performed appropriate, thorough due diligence work? Absolutely!

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44. *Roots of $3 Billion Fraud Case Lie in DVD Players, Not CDO's,* THE COMPLIANCE EXCHANGE (April 22, 2009), http://compliancex.typepad.com/compliancex/2009/04/roots-of-3-billion-fraud-case-lie-in-dvd-players-not-cdos.html.
45. William L. Gunlicks, Investment Advisors Act Release No. 3004, Admin. Proc. File 3-13820 (March 17, 2010), *available at* http://www.sec.gov/litigation/admin/2010/ia-3004.pdf.

As it turned out, the March 2010 SEC finding against Mr. Gunlicks was not his first run-in with the SEC. In December 2007, the SEC issued findings, sanctions and a cease and desist order against Mr. Gunlicks. Interestingly, the infractions that the SEC found that Mr. Gunlicks had perpetrated prior to 2007, were in many aspects similar to the same violations that the SEC found against him in 2010. Mr. Gunlicks was found to have withheld key information from investors, was self-dealing, and had violated some of the covenants and restrictions of the PPM.

Almost all of the institutions and hedge funds that invested with Gunlicks could have discovered this 2007 SEC finding with even cursory due diligence. The sad reality is some hedge funds invested millions with Mr. Gunlicks even when they had discovered his prior SEC problems. That goes beyond the issue of due diligence and enters the realm of negligence. Earlier, this article addressed the topic, "Why Conduct Due Diligence." The Gunlicks matter is a perfect example of one of the additional key necessities for conducting due diligence: bad actors have a tendency to repeat their previous bad acts.

DEFENSES TO LACK OF PROPER DUE DILIGENCE

A professional money management firm accused of not performing proper due diligence may raise the following defenses to that accusation.

PERCENTAGES TOO SMALL

The firm might state that either the dollars or the percentages being made in the investment were comparably small, and thus the necessity for more than a cursory investigation was unnecessary. For example, the money management firms may state that its total annualized investment returns were supposed to be 5% – 8%. The firm then invests 5% of available funds in a deal that goes bust. The annual results for the fund were calculated on a total return basis and the return that year was 6%, before taking into account the 5% capital or principal loss in the deal that went bust. When you take into account this 5% principal loss, the fund had a net total return of 1%. So entering year two, this fund starts with a capital base of 101% of the initial investment instead of 106%. Having less money to work with could and should affect the returns for that year and years into the future. So the argument that a 5% investment is not material is specious. Another point is how FINRA has focused on costs and how a few percentage points can be a

material difference (in commissions and fees). And in this day and age of significantly reduced interest rates and yields, losing 5% means a lot more than it did 15 years ago.

WE RELIED ON SOMEONE ELSE'S DUE DILIGENCE

This tactic is reminiscent of a line from Forrest Gump – "Stupid is as stupid does". It's probably one of the single most ridiculous defenses and clearly one of the more dangerous practices. When you can barely pick up a paper without being shocked at the quality of name brand firms committing fraud and the experienced and knowledgeable people who have been defrauded, relying on someone else's due diligence should not even be a consideration. We still live in a society that believes that "bigger is better". We have actually witnessed sworn testimony where one hedge fund justified their lack of due diligence and placing of millions of dollars with another sub-advisor hedge fund by stating the following: "We called around and talked to some other highly respected money management firms and they told us they were investing with this sub advisor, that was good enough for us." Professional money managers including hedge fund managers, often make one of the worst mistakes by relying on the mere suggestion that because a very large well-known investment firm has placed money with a particular fund or manager (which is often referred to as a sub-advisor) that that is a "seal of approval" for other firms to do the same. Along with clichés like "bigger is better," let's not forget "the bigger they are the harder they fall" and "too big to fail." In many respects relying on the other "big boys" is one of the more dangerous practices a firm can utilize in performing its due diligence. There often tends to be an arrogance at these larger firms: "Of course we only invest with the best."

It is this crazy, unreliable, dangerous group mentality that has been the downfall of many investment sectors: the commercial real estate bubble of the late 80s, the telecom/tech bubble of the late 90s, and the sub-prime mortgage debt debacle in just the last decade. It is always the same mentality: "Everybody's doing it, so we should too." The story goes that investors were waiting in line and begging Bernie Madoff to take their money up until the bitter end. And that is just one of many examples. This practice is actually even used in marketing. Certain funds may list their largest investors, of course with permission. It has a multiplying effect – the bigger or more prestigious the companies that invest, the bigger and more prestigious companies that are willing to invest.

THE SEC DIDN'T CATCH THE FRAUD – SO HOW ARE WE SUPPOSED TO CATCH IT?

Many readers of this article will remember the comical antics of such groups as the Marx Brothers, the Three Stooges, and Abbott and Costello. One of the more routine movie plots was where one of these groups was hired for some major undertaking, and the audience is entertained by their bungling and this cast of characters falling all over themselves. In my experience with securities regulation, the SEC is almost always the last one to know of the wrongdoing of investment professionals. The SEC often only enters the scene after some private investor has uncovered much of the fraud, a state securities commissioner uncovers the fraud, or some employee/whistleblower steps forward and hands the SEC the case on a silver platter.[46]

It is excusable that a mere retail investor might be ignorant as to how well the securities regulators are or are not protecting their investment dollars, but it is grossly negligent for any licensed professional money management person to rely on the regulators when it comes to the investigation, due diligence, supervising, and monitoring of its investment dollars. It becomes even more comical when they use the regulators as a defense for their lack of due diligence.

SUPERVISION & COMPLIANCE AS TO HIRING AND RETENTION

The term "due diligence" in the securities industry is not limited to investigation of investments or companies. The term "due diligence" is also utilized in hiring and retaining registered representatives by broker-dealers. FINRA Rule 3010 is the "Supervision Rule." Section (e), "Qualifications Investigated" states:

> Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association.[47]

Various NASD/FINRA Regulatory Notices and Notices to Members (NTM) are more specific as to the brokerage firm's investigation into the background and qualifications of their registered representatives.

46. DOUGLAS SCHULZ, *supra* note 30.
47. FINRA Manual, NASD Rule 3010, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3717.

When conducting due diligence concerning a prospecting for new registered representative, the hiring firm should seek to learn the nature of the representative's business and the extent to which he or she offers investment products for which the hiring firm would need a dealer or servicing agreement in order for the representative to sell and provide service.[48]

CONCLUSION

It is a sad commentary on the investment management community that there is a need for articles such as this one, in addition to the other publications and books written on the subject of due diligence. Practicing appropriate due diligence before each and every investment is made seems as natural as hand washing before eating. Luckily for investors, they need not be content to rely on the good manners of the investment community; numerous securities regulations and interpretations make "due diligence" the law.

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48. FINRA, SUPERVISION OF RECOMMENDATIONS AFTER A REGISTERED REPRESENTATIVE CHANGES FIRMS, FINRA REGULATORY NOTICE 07-36 (August 2007), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p036445.pdf; *see also* NASD, SPECIAL CONSIDERATIONS WHEN SUPERVISING RECOMMENDATIONS OF NEWLY ASSOCIATED REGISTERED REPRESENTATIVES, NASD NOTICE TO MEMBERS 07-06 (February 2007), *available at* http://www.finra.org/Industry/Regulation/Notices/2007/p018631.

UPDATING THE LIFE SETTLEMENT MARKET

Peter Katt[1]

INTRODUCTION

What started as a worthwhile secondary market for the very few situations when it makes sense to sell a life insurance policy has gotten completely out of control because of huge hidden fees and commissions, and the misplaced belief that life insurance policies are a great investment. Most insureds should not sell their policies until they are about to terminate. It is doubtful anyone should rent their life to be an insured only to try and sell it later, and no individual should become an investor in another's life insurance policy.

As the economy and financial markets have seen considerable turmoil so has the life settlement market with less funding now available for the purchase of policies. Nonetheless, the settlement market still bounces along with great enthusiasm. Recent experiences I have had suggest this is a good time to update attorneys on what to look out for in dealing with life settlements or pitches to invest in life insurance policies.

WHAT IS A "LIFE SETTLEMENT"?

A life settlement is the sale of a life insurance policy by the policy owner to a third party. The policy owner typically receives cash for the sale in an amount greater than the surrender value (or there would not be any reason to go through the life settlement process). The buyer assumes ownership and pays premiums it deems necessary to keep the policy solvent. In addition, the buyer receives the death benefit upon the death of the insured.

Generally speaking, life settlements are an option for high-net-worth policy owners age 65 or older. Independent estimates report that among this group, 20% of policies have a market value that exceeds the cash value offered by the carrier.

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[1] Peter Katt is a nationally recognized life insurance expert. He has been a life insurance advisor since 1979 and is a pioneer in fee-only life insurance advising. Mr. Katt can be reached at PKatt@PeterKatt.com or http://www.peterkatt.com/about.html.

The market for the buying and selling of life insurance policies for investment purposes has a rational basis. The original life settlement business plan was to buy *unwanted* or *unneeded* policies as an institutional investment from insureds over 65 whose health had deteriorated more than just from the passage of time. This provided mortality arbitrage needed to make the purchase price higher than the policies' surrender value.

SHOULD YOU SELL YOUR POLICY?

In reality, it is likely that some 95% of potential policy sellers should retain them. That there are many more policy sales than reality would dictate is a tribute to the tenacity and selling skills of those agents soliciting the sales.

There are only two situations where selling a policy is the best choice:

- One is when cash is desired and a life settlement offer exceeds the policy's surrender value.
- The other situation is a policy with heavy surrender charges, poor pricing and the insured is still in good enough health to replace the offending policy. The settlement value will be substantially higher than the surrender value even when the insured's health has not deteriorated. Prior to the sale, another policy with better pricing should be acquired to replace the policy to be sold. Obviously, this should only occur so as long as the client's net worth would justify both policies.

Almost all other possible life settlement situations should result in the policy owner retaining the policy – at least until the policy is near termination.

For example, let's say a policy owner named Don wanted to stop paying premiums on his $1,000,000 universal life policy with $100,000 cash values. Now 72 years old with health problems he did not have when he purchased the policy at age 60, Don can sell the policy now for around $275,000. But he doesn't need the cash – he just wants to stop paying premiums.

Don's best move would be to keep the policy for another five years without paying premiums. The $100,000 cash value can pay the internal policy cost-of-insurance charges for this five year period. (So long as the cash value is large enough to cover the cost of the premiums, the policy would remain in force. With each premium payment, the cash value balance would diminish.)

After five years, the policy will probably be worth around $475,000 in the life settlement market because Don's life expectancy has become shorter.

(He is now 77 instead of 72.) As a result, there is about a 35% probability Don will die between 72 and 77. Keeping the policy to age 77 allows his beneficiaries to receive $1,000,000 tax-free if he dies and Don will very likely improve his situation if he waits for five years to sell.

HIDDEN COSTS

Policyholders incur costs when the policy are sold. These costs of 10% to 20% of the purchase priced are built into the price offered to the policyholder and, as a result, are essentially hidden.

Understand that is this not what the industry wants to you know. Rather, the life settlement industry and their solicitors have created the image that many policy owners often come to the rational conclusion they want to sell their life insurance policies and then contact an agent. Almost always, it is the agent soliciting policy owners to sell their policies because of the very high commissions they are paid.

In Don's situation described above, the agent recommending the sale for $275,000 at age 72 would be paid around $55,000. That means the life settlement firm would have paid out $330,000 for the policy—but Don would not have known about the $55,000 going to the agent.

SHOULD YOU BUY LIFE INSURANCE SETTLEMENTS?

As you can see, there are pitfalls for policyholders to consider before selling a policy. But what if you are on the other side? Do life settlements make good investments?

The appetite for life settlement transactions has become so great that the industry has convinced itself that life insurance is mispriced and the policies of insureds in the same health are attractive targets as well. Settlement brokers purchase policies and repackage them to sell to small institutional and individual investors.

Some in the industry refer to this as *dumb money* because the investors are too ignorant to know how to analyze the investment potential, mainly because they don't understand that it is critical to have an accurate assessment of life expectancy. Life expectancy is often fudged by the settlement broker.

For example, a fellow in Texas (Ted) contacted me last year. During 2008 he had purchased as investments life insurance policies insuring 10 strangers for $400,000 from his financial advisor. Some months after buying

the policies it occurred to Ted that he really didn't know much about how the great yields he was promised happened. For example, although he had the names of the insureds, he didn't know anything about their health.

His advisor was no help about this, so he called the settlement broker firm that sold the policies. They refused to give him any information and stopped returning his calls. Ted, being a resourceful fellow, tracked down the phone numbers of the insureds and started calling them!

CREATING LIFE SETTLEMENT INVENTORY

Settlement firms and agents have used seminars and dinners to convince wealthy seniors to *rent* their high net worths and lives to become insured for the sole purpose of then selling the life insurance policies in two years. These transactions often involve a third party paying the premiums and providing the wealthy senior a bonus for renting his life.

There are two problems with this. First, insureds do not know who will end up owning these policies. Second, as dumb money dries up, there may be no market for the policy. Having no market is not a problem if a non-recourse note has been used. However, if the insured is responsible for paying back the premium financing, they will face a huge debt that will have to be repaid if the policy is terminated because the premiums and/or loan interest is not affordable.

PREMIUM FINANCING FOLLOWED BY LIFE SETTLEMENT

A recent premium financing client is on the hook for $949,462. Betty is 84 and in good health for a smoker. If she dies within seven years this $4,000,000 financed life insurance policy will provide a good financial return for her heirs. If not, the delayed repayment of the debt could nearly consume her estate. The family had no idea what they had gotten into and the agent did not understand it either. The family is literally in tears over the bad options they face.

The promised life settlement fall back position has failed to produce an offer much higher then the current cash value. Betty and her family have several years of agonizing moments deciding what to do.

Table 1 shows the value of this program upon Betty’s death. (The internal rate of return [IRR] is derived from what return (death benefit) Betty is getting for premiums paid. The IRR is 12% at 90, 2% at 91 and turns negative age 92.)

Table 2 shows the cost to terminate the policy if the loan interest costs become too great with Betty remaining alive. I had to prepare these estimates because the firm that sold this wouldn't provide it and the agent didn't understand what to do.

Table 1 - Estimate of Premium Financing

Age / Year	Annual Prem Loan	Annual Loan Cost@ 4.3%	Cumulative Loan	Net Death Benefits	IRR
84 / 2010	$91,132	$18,337	$2,160,637	$2,000,000	10,807%
85 / 2011	217,796	98,826	2,251,769	1,908,868	686%
86 / 2012	154,464	106,191	2,469,565	1,691,072	199%
87 / 2013	154,464	112,833	2,624,029	1,536,608	91%
88 / 2014	154,464	119,475	2,778,493	1,382,144	83%
89 / 2015	154,464	126,117	2,932,957	1,227,680	26%
90 / 2016	154,464	132,759	3,087,421	1,073,216	12%
91 / 2017	154,464	139,401	3,241,885	918,752	2%
92 / 2018	154,464	146,043	3,396,349	764,288	[6.3%]
93 / 2019	154,464	152,685	3,550,813	609,824	--
94 / 2020	154,464	159,327	3,705,277	455,360	--
95 / 2021	0	165,969	3,859,741	300,896	--
96 / 2022	0	172,611	4,014,205	146,432	--
97 / 2023	0	--	4,169,669	[9,032]	--

Annual Premium Loan – Illustrated premiums that are paid from loans.
Annual Loan Cost – Amount Betty pays out-of-pocket cumulative on premium loans.
Cumulative Loan – Loan principal from year one of this premium financing program.
Net Death Benefits – Policy's death benefits less the cumulative loan.

Table 2 – Net Cost to Terminate

Age / Year Beginning of Year	Cumulative Loan	Cash Value	Net Cost to Terminate
84 / 2010	$2,160,637	$1,211,175	$949,462
85 / 2011	2,251,769	1,288,949	962,820
86 / 2012	2,469,565	1,368,963	1,100,602
87 / 2013	2,624,029	1,442,518	1,118,511
88 / 2014	2,778,493	1,508,991	1,269,502
89 / 2015	2,932,957	1,568,758	1,364,199
90 / 2016	3,087,421	1,614,492	1,472,929
91 / 2017	3,241,885	1,632,647	1,609,238
92 / 2018	3,396,349	1,592,694	1,803,655
93 / 2019	3,550,813	1,506,998	2,043,815
94 / 2020	3,705,277	1,189,187	2,516,090
95 / 2021	3,859,741	753,633	3,106,108
96 / 2022	4,014,205	176,435	3,837,770
97 / 2023	4,169,669	0	4,169,669

Cumulative Loan – Loan principal from year one of this premium financing program.
Cash Value – Illustrated policy cash value.
Net Cost to Terminate – Cumulative loan less the cash value.

If premium financing is continued. the return could be large, but the cost of Betty not *dying in time* is probably unacceptable. If this program is continued it turns negative at age 92, which is Betty's life expectancy. If Betty lives to 92 and this policy is terminated, the cost is estimated to be $1,803,655 (see Table 2).

The current $949,462 cost to terminate this program is really the delayed cost of providing life insurance coverage for the past six years that has had a net zero cost to date. Unfortunately Betty and her family had no realization of these enormous costs involved with what is essentially a loan for the life insurance policy. What they wanted was life insurance for nothing (good luck) and the agents wanted to cash a huge commission check.

LAWSUIT ANYONE

The wackiest case I have been involved with is that of an agent purchasing $30,000,000 of life insurance *without* the insured's knowledge by paying the premiums himself and owning the policies. This came to light when the agent tried to get the insured to agree to turn over medical records

so he could try selling the policies. Litigation resulting from such *investor initiated* life settlement is fast becoming a cottage industry.

CONCLUSION

What started as a worthwhile secondary market for the very few situations when it makes sense to sell a life insurance policy has gotten completely out of control because of huge hidden fees and commissions, and the misplaced believe that policies are a great investment. Most insureds should not sell their policies until they are about to terminate. It is doubtful anyone should rent their life to be an insured only to try and sell it later, and no individual should become an investor in another's life insurance policy.

THE EMPLOYEE-WHISTLEBLOWER AND THE DECISION TO EXPOSE CORPORATE FRAUD: SHOW ME THE MONEY

Elizabeth Mihalek

Imagine you are going about your daily business as an employee at XYZ Corporation, and you discover that a major accounting fraud has been ongoing at XYZ Corporation for some time now. What do you do? Many would answer the course of action is obvious: you alert the authorities and become a national hero overnight by exposing fraud that is harming so many including perhaps your fellow employees and the public at large. However, this scenario is not always so simple. After careful consideration, you realize that exposing the fraud may lead to retaliation against you and perhaps even your family. You may lose your job, you may lose important work assignments, you may be ostracized from social groups within the workplace, or you may lose important benefits. You decide that the costs far outweigh the benefits and choose to keep quiet, hoping that perhaps someone with "less to lose" will come forward and expose the fraud in the future.

While there are many definitions for the term, a whistleblower is "an employee or other person in a contractual relationship with a company who reports misconduct to outside firms or institutions, which in turn have the authority to impose sanctions or take other corrective action against the wrongdoers."[1] Whistleblowers play an important public function in today's society by exposing fraud and corporate wrongdoing in a variety of contexts. One such context, which has seen major media coverage in recent years, is the context of the corporate world.[2] Employees are often in a position to blow

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* Elizabeth Mihalik is finishing up her final semester of law school at the University of Notre Dame. Beginning in Fall, 2001, she will be employed at the Pittsburgh office of Thorp Reed & Armstrong in the Mergers and Acquisitions practice group.

1. Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing & Insider Trading*, 105 MICH. L. REV. 1899, 1903 (2006-2007). Furthermore, "while some definitions of whistleblowing require that the misconduct be reported to people outside the organization, other definitions also include reporting misconduct up the chain of command with an organization." *Id.*

2. Arguably the two most famous corporate employee-whistleblowers in recent memory were Sherron Watkins at Enron and Cynthia Cooper at WorldCom. Watkins, a Vice-President who reported to the CFO at Enron, exposed accounting irregularities in an anonymous memo dropped in a comment box to Enron's Chairman, Ken Lay. Cooper, Vice President for Internal Auditing at WorldCom,

the whistle on corporate fraud happening in the workplace due to the multitude of information they encounter on a daily basis. Until recently, many were not protected after the decision to come forward due to vast differences in state law. Congress recognized this and implemented legislation to protect such employee-whistleblowers with the passage of the Sarbanes Oxley Act ("SOX") in 2002.

However, employee-whistleblowers are still not being protected and face a myriad of negative consequences when exposing fraud in the workplace. More legislation is not needed, as this will only complicate the already muddled picture. If the current legislation is clarified and monetary rewards are introduced as an incentive, it can adequately protect employees who take the brave and dramatic step of exposing corporate fraud in their workplace.

I. THE IMPORTANCE OF EMPLOYEES AS ACTORS IN SECURITIES FRAUD DETECTION

Professor Alexander Dyck and two of his colleagues analyzed reported fraud cases in large United States companies between 1996 and 2004.[3] With a sample size of 216 alleged corporate frauds[4] after screening for frivolous suits, Professor Dyck used the data to test three dominant views: the legal view, the finance view, and the private litigation view. The legal view "claims fraud detection belongs to auditors and securities regulators", which Professor Dyck deems the traditional actors.[5] Through the study, Professor

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continued her efforts to expose a massive accounting fraud at WorldCom even though Arthur Andersen and WorldCom's CFO told her to stop. As a result of their efforts, Watkins and Cooper were named TIME magazine's Persons of the Year in 2002. *See* Kathleen Brickey, *From Enron to WorldCom and Beyond: Life and Crime after Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 360-70 (Summer 2003) and Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 9-10 (Nov. 2002).

3. Alexander Dyck, et al., *Who Blows the Whistle on Corporate Fraud?* 08-22 (The Univ. of Chicago, Booth Sch. of Bus., Paper No. 3, 2009), *available at* http://ssrn.com/abstract=891482 at 2. "Large United States companies" were those with more than 750 million dollars in assets in the year prior to the end of the class period. In addition, the sample consisted of firms against whom a securities class action lawsuit had been filed during the time period.

4. The sample size included all of the "high profile cases such as Enron, HealthSouth, and World Com." *Id*.

5. *Id.*

Dyck found little support for the legal view as the Securities and Exchange Commission ("SEC") only exposed the fraud in seven percent of the cases and auditors in only ten percent of the cases.[6] Therefore, the actors who are thought to traditionally expose corporate fraud are actually doing so in only a small percentage of cases.

The finance view claims that "monitoring will be done by those with residual claims (equity and debt holders) and their agents (analysts and auditors)", the parties with the most payoff at risk.[7] Under the finance view, those who have a fixed-payoff, such as employees who are paid salaries or suppliers who are paid according to a contract term, are not expected to have any role in corporate monitoring.[8] Similar to the legal view, the study found minimal support for the finance view. Debt holders are "absent" from the fraud exposure role and equity holders play a very inconsequential role, only exposing the fraud in three percent of cases.[9]

The private litigation view claims that private litigation lawyers should expose corporate fraud because contingent fee payments in securities class actions create a big incentive for lawyers to discover and expose fraud.[10] Again, there was little data to support this view as plaintiffs' lawyers only reveal the fraud in three percent of the cases.[11]

So who is exposing the fraud? The study revealed that fraud detection "relies on a complex web of actors that complement each other."[12] Those who are often not considered the most "important" sources for the exposure of corporate fraud actually contribute a large percentage of fraud detection: employees accounted for seventeen percent of the cases, non-financial-market regulators accounted for thirteen percent and the media accounted for thirteen percent.[13] These groups were deemed "non-traditional actors" by the study.[14]

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6. *Id.*

7. *Id.* at 2, 7.

8. *Id.* at 7.

9. *Id.*

10. *Id.*

11. *Id.* at 12.

12. *Id.* at 28.

13. *Id.* at 3. Non-financial-market regulators were defined as industry regulators and government agencies. In addition, the results remain largely the same when the study value-weighted the cases according to the sum of fines and settlements associated with each specific fraud. Value-weighting only created one change as the media then

A. WHY NON-TRADITIONAL ACTORS ACCOUNT FOR SUCH A LARGE PERCENTAGE OF FRAUD EXPOSURE

Professor Dyck identified three reasons why these non-traditional actors account for such a high percentage of fraud exposure. First, employees can gather a large amount of information while performing daily tasks at little cost.[15] Second, the media is influenced by reputational incentives, as exposing a major corporate fraud can catapult a journalist's career.[16] Finally, in situations where the fraud was committed against the government, individuals who blow the whistle are entitled to a large monetary reward in a *qui tam* suit.[17]

Under the Federal Civil False Claims Act (also known as the *qui tam* statute), whistleblowers of fraud against the government are entitled to a large monetary reward.[18] Employees are significantly more likely to expose fraud in the healthcare industry, accounting for forty-one percent of the fraud exposure in the industry, primarily because the government accounts for a significant percentage of revenue in the healthcare industry allowing employee-whistleblowers to receive large monetary rewards.[19] In all other industries, employees only account for fourteen percent of fraud exposure.[20]

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accounted for twenty-four percent of the fraud exposure. This change suggests that the media gets involved more often in only the biggest cases. *Id.*

14. *Id.*

15. *Id.* Furthermore, "having access to inside information rather than relying just on pubic information increases an actor's probability of detecting fraud by 5 percentage points." However, when the cases are value-weighted this effect drops in half. Professor Dyck hypothesizes that this result is evidence that "the cost of gathering information is an important barrier only in smaller cases and becomes irrelevant when the stakes are higher." *Id.*

16. *Id.* Reputational incentives are not a motivating factor for most employees that are not in the upper levels of management.

17. *Id.*

18. *Id.* Individuals who reveal relevant information in a fraud case that involves a false claim against the government are entitled to fifteen to thirty percent of the money recovered by the government.

19. *Id.* at 4. Professor Dyck found that in the sample, successful employee *qui tam* whistleblowers collected $46.7 million on average. However, the "outcome of *qui tam* suits is very uncertain and very delayed in time." *Id.*

20. *Id.*

Therefore, monetary incentives work well in motivating employees to expose corporate fraud, but are only currently available in a small amount of industries where the fraud was committed against the government.

B. THE STARK REALITY EMPLOYEE-WHISTLEBLOWERS FACE

According to Professor Dyck, since employees "clearly have the best access to information: few, if any, fraud can be committed without the knowledge and often the support of several of them."[21] Given the amount of information employees encounter on a day-to-day basis, it is not surprising that employees play a prominent role in exposing corporate fraud. However, employees may shy away from exposing fraud because of the nasty repercussions others have faced when they have chosen to come forward.

In the cases analyzed by the study, forty-five percent of employee-whistleblowers did not identify himself.[22] In the fifty-five percent of cases with a self-identified employee-whistleblower, a startling eighty-two percent of the employee-whistleblowers "alleges that they were fired, quit under duress, or had significantly altered responsibilities as a result of bringing the fraud to light."[23] In light of that statistic, it is no wonder that forty-five percent of employee-whistleblowers choose to expose fraud anonymously.

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21. *Id.* at 23; *See also Private Sector Whistleblowers: Are There Sufficient Legal Protections?: Hearing Before the Subcomm. on Workforce Protections of the H. Comm. on Education & Labor*, 110th Cong. 27 (2007) [hereinafter *Hearing*] (testimony of Richard Moberly, Assistant Professor, University of Nebraska College of Law) ("Employees know more than others who might discover corporate wrongdoing (such as the government or even an independent board of directors) because they are on-the-ground inside the corporation and, collectively, know everything about its inner workings.").

22. Dyck, *supra* note 3, at 5. In contrast, when a journalist reveals the fraud, they reveal their name in seventy-four percent of cases. This further bolsters Professor Dyck's argument that journalists have a high reputational incentive for exposing corporate fraud.

23. *Id.* Prior to SOX, auditors *also* faced negative consequences for revealing fraud and were frequently fired. Since 2002 and the enactment of SOX, auditors only face negative repercussions when they *miss* fraud that should have been caught. This may be a result of the fact that the role of appointing financial auditors moved from management to the audit committee (formed only of independent directors) after 2002.

II. CURRENT LAW FAILS TO ADEQUATELY PROTECT EMPLOYEE-WHISTLEBLOWERS

With the passage of SOX in 2002, the protections for whistleblowers were supposedly tremendously expanded and increased. However, the current legal provisions are not protecting employee-whistleblowers because the laws are being construed too strictly and certain parts are being routinely misinterpreted.

Traditionally, instituting laws that protected whistleblowers was the job of the individual states.[24] As a result, the protections afforded to whistleblowers varied from state to state.[25] Different state statutes provide broad protection while others provide narrow protection to a very specific industry.[26] Certain statutes protect different types of disclosure, regulate the manner of disclosure that the statute requires, or provide differing remedies.[27]

Federal law prior to SOX provided the same piecemeal protection that state law provided. The employee-whistleblower would receive protection only if the federal statute that they reported was violated by their employer contained an anti-retaliation provision.[28] Obviously, this can lead to very different results based solely on what federal statute the employer purportedly violates.

In recognition of these problems Congress passed SOX in July 2002. SOX was "predicated upon the idea that the existing institutions designed to uncover fraud had failed, and their incentives as well as their monitoring

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24. Miriam A. Cherry, *Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASH. L. REV. 1029, 1033 (Nov. 2004).

25. *Id.* For example, Sherron Watkins and Cynthia Cooper (mentioned *supra* n. 2) would have faced very different protection pre-SOX passage. Sherron Watkin's "whistleblowing activity would not have been protected under Texas law" prior to SOX while Cynthia Cooper's "whistleblowing would have been protected under Mississippi law. There is, however, no principled distinction that can be drawn between their two situations." *Id.* at 1035.

26. *Id.* at 1046. For example, the New York whistleblower statute prior to SOX only protected employees who "report a problem that would endanger the health or safety of the public." However, New York courts did not view corporate fraud as a danger to the public. Therefore, employees who exposed corporate fraud were not protected under the New York statute. *Id.* at 1048.

27. *Id.* at 1047.

28. *Id.* at 1049.

should be increased."[29] Furthermore, SOX included whistleblower provisions because "corporate whistleblowers are left unprotected under current law. This is a significant deficiency because often, in complex fraud prosecutions, these insiders are the only firsthand witnesses to the fraud."[30] Congress also recognized the "patchwork and vagaries of current state laws, although most publicly traded companies do business nationwide. Thus, a whistleblowing employee in one state may be far more vulnerable to retaliation than a fellow employee in another state who takes the same actions."[31]

SOX requires the audit committees of public companies to "establish procedures for . . . the confidential anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.'"[32] SOX protects employees for reporting fraud or the violation of United States SEC regulations and "enhances protections for employees against being fired for coming forward with such information."[33]

If employers in a publicly-traded company do retaliate against employee-whistleblowers, the employee has a civil cause of action. SOX provides that "A person who alleges discharge or other discrimination by any person in violation of subsection (a) may seek relief . . . by filing a complaint with the Secretary of Labor" within ninety days of the date on which the violation

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29. Dyck, *supra* note 3, at 2.

30. S. REP. NO. 107-146, at 10 (2002).

31. *Id.* at 10.

32. 15 U.S.C.A. § 78j-1(m)(4)(B) (West 2009); *See also* Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. L. REV. 1107, 1140 (2006) [hereinafter *Structural Model*]. Moberly highlights that this section of SOX is a great improvement over previous protections. "First, the Act implements a whistleblower disclosure channel that provides information directly to independent corporate directors. Second, Sarbanes-Oxley mandates the implementation of a disclosure channel in every public corporation." The independence of the audit committee is a great improvement as employees formerly could only report fraud internally up-the-ladder to supervisors, executives and directors who may have a hand in the fraud. The fact that such an independent committee is now mandated cannot be understated.

33. Dyck, *supra* note 3, at 27.

occurred.[34] The Department of Labor ("DOL") has delegated its authority under the statute to OSHA.[35]

To state a prima facie case, the complaint must allege that:

> (1) the employee engaged in protected activity; (2) the employer knew, actually or constructively, of the protected activity; (3) the employee suffered an unfavorable personnel action; and (4) the circumstances raise an inference that the protected activity was a contributing factor in the personnel action.[36]

If the employer is found to have violated the statute, the employee is entitled to compensatory damages including "reinstatement with the same seniority status that the employee would have had, but for the discrimination," back pay with interest, and special damages for "litigation costs, expert witness fees, and reasonable attorney fees."[37]

In addition to the civil remedy, SOX includes a criminal provision which states:

> (e) Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.[38]

The criminal provision is not limited to publicly traded companies as is the case for the civil provision. The criminal provision also applies to private companies.[39] Second, the criminal provision's "protection extends to non-employees as well as employees" because all that is required is a defendant

34. 18 U.S.C.A. § 1514(A)(b)(1)(A) (West 2009); *See also* Fred W. Alvarez, et al., *The Sarbanes-Oxley Act: Current Issues in Whistleblower Enforcement*, SP027 A.L.I.-A.B.A. 233 (Mar. 2009).

35. Cherry, *supra* note 24, at 1066.

36. *Welch v. Chao*, 536 F.3d 269, 275 (4th Cir. 2008).

37. 18 U.S.C.A. § 1514(A)(c)(2)(A)-(C) (West 2009). Again, one has to question how much of a reward reinstatement truly is, as the employee is thrust back into a corporate community that is many times hostile and uninviting. *See* Alvarez, *supra* note 34, at 269 (Reinstatement is the "presumptive remedy" in wrongful termination cases and is effective immediately regardless of any objections or appeals by the other party.).

38. 18 U.S.C.A. § 1513(e) (West 2009).

39. *Id.* at 284.

who "interferes with" a person's "lawful employment or livelihood."[40] The term "person" is not so limited as to only include employees of the retaliating company.

Alarmingly, Professor Dyck's research shows that the percentage of employee-whistleblowers actually declines after 2002 from eighteen to thirteen percent, which seems to suggest that the "protection" claimed to be advanced by SOX is not incentivizing employees to come forward.[41] Perhaps the decline is a result of employees seeing what happens to others who come forward. Not only are they retaliated against, but also they are not winning their claims. Potential employee-whistleblowers may be seeing this trend and choosing to stay quiet instead of risk such consequences. If this is the case, a major piece of the enforcement puzzle is failing.

B. STATISTICAL EVIDENCE OF THE FAILURE OF CURRENT LAW REGARDING PROTECTION OF EMPLOYEE-WHISTLEBLOWERS

Given all the protections that SOX purportedly gives to employee-whistleblowers, employees are still not being protected which only leads to another disincentive for employees to report corporate fraud.[42] Employees have very low win rates in SOX cases. According to a study by Richard Moberly, in the first three years of the act, "only 3.6 percent of Sarbanes-Oxley whistleblowers won relief" after an Occupational Safety and Health Administration ("OSHA") investigation, and "only 6.5 percent of whistleblowers won appeals in front of an administrative law judge."[43]

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40. *Id.*

41. Dyck, *supra* note 3, at 28. One explanation advanced by Professor Dyck is that job protection is not an incentive due to the negative repercussions employees face in their jobs after they blow the whistle.

42. Pamela H. Bucy, *"Carrots & Sticks": Post-Enron Regulatory Initiatives,* 8 BUFF. CRIM. L. REV. 277, 285-86 (2004) ("Compared to other civil causes of action designed to protect corporate whistleblowers, § 1514A is fairly anemic . . . § 1514A presents a cumbersome procedural process, minimal damages, limited ability to qualify as a plaintiff, and a limited statute of limitations.").

43. *Hearing, supra* note 21, at 26 (testimony of Richard Moberly). Furthermore, Moberly states, that in fiscal year 2006, "not a single Sarbanes-Oxley whistleblower won a claim before OSHA . . . out of 159 decisions made by the Agency during that year." *Id.* Moberly's research is the preeminent research in the field. As of the writing of this paper, there was no research regarding employee-whistleblower win rates past the mid-point of 2008.

C. WHY CURRENT LAW FAILS TO ADEQUATELY PROTECT EMPLOYEE-WHISTLEBLOWERS

There are three primary reasons why employees are not being adequately protected under the latest legislation. The first primary reason is that OSHA and the Administrative Law Judges ("ALJs") are construing the law too narrowly and are dismissing cases at alarming rates if they do not fall "squarely within the law's narrow legal boundaries."[44] As evidence of this one only needs to look to the statistic that ninety-five percent of whistleblowers' SOX claims are dismissed by ALJs for failing to satisfy the law's narrow boundaries.[45] In these cases, the judges never actually hear the factual merits of the case because the claim is dismissed as a matter of law.[46]

SOX cases are also frequently dismissed for failing to satisfy the statute of limitations procedural requirements.[47] "These statutes of limitation are very short, sometimes creating insurmountable hurdles, especially for someone who has just been demoted or fired from a job."[48] The statute of limitations begins to run immediately "when an employee has knowledge of an adverse employment action."[49] The ALJs have been unforgiving in this aspect of the law and strictly enforce the ninety-day filing deadline. Equitable arguments for extending the statute of limitations period have been almost uniformly rejected.[50]

The second primary reason why SOX is failing to protect employee-whistleblowers is that OSHA and the ALJs have been misapplying SOX's

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44. *Id.*

45. *Id.* at 26.

46. *Id.*

47. *Id.* Moberly identified that SOX cases are dismissed one-third of the time because whistleblowers failed to satisfy the statute of limitations; *See also* Lawrence S. Moy, et al., *Whistleblower Claims Under the Sarbanes-Oxley Act of 2002*, 1756 Prac. L. Inst./Corp. 573, 606 (Sept.-Dec. 2009) ("As of October 2007, the DOL has dismissed 72.2% of cases because of the employee's failure to meet the statute of limitations.").

48. *Hearing, supra* note 21, at 6 (testimony of Hon. Lynn Woolsey, Chairwoman, Subcomm. on Workforce Protections).

49. Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win,* 49 WM. & MARY L. REV. 65, 107 (Oct. 2007) [hereinafter *Unfulfilled Expectations*].

50. Alvarez, *supra* note 34, at 246.

burden of causation, to the detriment of employees. *If* an employee is lucky enough to have navigated all of the procedural hurdles and is allowed to have their claim proceed on the factual merits, they still must show that "the employer knew about the whistleblower's protected activity, and that this activity was a 'contributing factor' in the adverse employment action."[51] A contributing factor is one that "tends to affect in any way the outcome of the decision."[52] The DOL has stated that the "contributing factor" test is "less onerous for an employee to satisfy than other causation tests."[53] Once the employee satisfies this test, employers face a high burden to have the claim dismissed at this stage and "must prove their rebuttal under a 'clear and convincing' standard."[54]

The low burden of proof for employees and the high burden of proof for employers should produce more favorable results for employees. At the ALJ level, this is indeed the case "as employees won 66.7% of the time when 'causation' was the issue, and 88.3% of the time when the employer was required to satisfy the 'clear and convincing' burden of proof."[55] However, at the OSHA level, employees were only able to satisfy the "contributing factor" standard 30.6 percent of the time and employers were able to meet their high "clear and convincing" burden of proof for rebuttals in an astounding 64.9 percent of cases.[56] Again, statistics at the ARB and federal court levels are unavailable at this time.

The third primary reason why SOX fails to protect employee-whistleblowers is that it is primarily defensive which does not give employees incentives to come forward.[57] Employees face the realization that if they choose to come forward to expose fraud in their workplace, and if their employer retaliates against them, then they *may* be entitled to

51. *Unfulfilled Expectations*, *supra* note 49, at 101.

52. *Id.* at 80 *quoting Klopfenstein v. PCC Flow Techs. Holdings, Inc.*, No. 04-149, at 18 (ARB May 31, 2006).

53. *Id. citing Procedures for the Handling of Discrimination Complaints Under Section 806 of the Corporate and Criminal Fraud Accountability Act of 2002*, *Title VIII of the Sarbanes-Oxley Act of 2002*, 69 Fed. Reg. 52, 107 (Aug. 24, 2004).

54. *Id.* at 144.

55. *Id.*

56. *Id.*

57. Geoffrey C. Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 95 (2007).

compensatory remedies *if* they can satisfy all of the procedural and causational hurdles OSHA and the ALJs impose upon them. For many employees, there are just too many "ifs" in the equation, and who can blame them given the low-employee win rates that come out of OSHA and ALJ proceedings.

IV. How Protection of Employee-Whistleblowers Can Be Improved

Given all of the problems with the interpretation of SOX, what can be done to improve the situation? Additional legislative protection for employee-whistleblowers should be a last resort to incentivizing more employees to come forward and expose corporate fraud. SOX is already being misconstrued, and adding more legislation to the already murky picture may do more harm than good. Instead, SOX can work properly and for its intended purpose if Congress clarifies the statute and includes a few changes.

A. How to Fix the Current Legal Provisions in order to Adequately Protect Employee-Whistleblowers

SOX has afforded employee-whistleblowers of corporate fraud protection against retaliation. However, this legislation is not being applied in such a way that is adequately shielding employee-whistleblowers from negative consequences. With clarification and a few small tweaks, the legislation can work as designed and more legislation should not be necessary.

1. Congressional Clarification of the Statute

The first major step to fixing SOX so that it protects whistleblowers the way it was designed to is for Congress to clarify the statute. If OSHA and the ALJs are construing the statute too narrowly and dismissing an overly high number of employee-whistleblowers' claims, then Congress needs to step in and clarify. If Congress does not, SOX runs the risk of being an irrelevant statute with no real teeth as protections for employees are eroded further and further by OSHA and the ALJs.

Right now, OSHA and the ALJs are making all the decisions when it comes to drawing lines and interpreting the statute. For example, these

agencies determine what is a "contributing factor" or what is a "protected activity."[58] This can be problematic because it "requires line-drawing by decision-makers that can narrow the scope of the protections more restrictively than intended by Congress."[59] Lawmakers should step in at this point and clarify what was meant by the terms that these agencies are struggling to define. "Passing legislation that clearly repudiates decisions narrowing an act's scope could alleviate the tendency of decision-makers to draw restrictive legal boundaries in whistleblower cases."[60]

2. Expand Monetary Incentives

The second most important step Congress can take is to increase the monetary incentives beyond only those industries where the government is the victim of the fraud. As discussed, employees expose fraud forty-one percent of the time in the healthcare industry where they stand to gain large monetary rewards as a result of their decision to come forward, as opposed to a fourteen percent exposure rate by employees in other industries that do not offer monetary rewards.[61] This plainly shows that employees would be much more willing to risk their careers and livelihoods if there was some chance that they could stand to gain a large monetary reward in the future.

One suggestion has been to utilize the "Fair Funds" provision of SOX[62] to reward employee-whistleblowers who expose fraud in their workplace. "The idea behind the Fair Funds provision was for the SEC to distribute civil money penalties and the proceeds of disgorgement orders . . . to harmed investors."[63] The problem here is that the Fair Funds provision was designed to compensate shareholders who were harmed by fraud, not the

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58. *Unfulfilled Expectations*, *supra* note 49, at 134.

59. *Hearing*, *supra* note 21, at 30 (testimony of Richard Moberly). Moberly further stresses that "narrow protections only encourage, or in some instances, require administrative and judicial decision-makers to define whistleblowers out of protected categories . . . Broadly defining the legal boundaries of any new protection may enable decision-makers to focus on the important factual question of causation: was this employee retaliated against for reporting something illegal?" *Id.*

60. *Id.*

61. Dyck, *supra* note 3, at 4.

62. Rapp, *supra* note 57, at 145 *citing* 17 C.F.R. §§ 201.1100-.1106 (2006).

63. *Id.*

whistleblower who exposed the fraud.[64] However, compensating employee-whistleblowers utilizing the Fair Funds provision would not impose any "additional administrative burdens on the SEC."[65]

Recently, Senate Banking Committee Chairman Senator Chris Dodd of Connecticut proposed more whistleblower protections in a discussion draft of a bill designed to overhaul the financial regulatory system. The discussion draft provides monetary rewards for whistleblowers.

Specifically, the proposed legislation would require the whistleblower to report a violation of the securities laws to the SEC in a manner to be established by the SEC.[66] The SEC would be authorized to pay between ten and thirty percent of "what has been collected of the monetary sanctions imposed in the action" to the whistleblower who presented "original information."[67]

Awards would be paid out of the "Investor Protection Fund."[68] Whistleblowers would also be entitled to "reinstatement with the same seniority status that the individual would have had, but for the discrimination; two times the amount of back pay otherwise owed to the individual, with interest; and compensation for any special damages . . . including litigation costs, expert witness fees, and reasonable attorneys' fees."[69]

Finally, in order to perhaps provide maximum incentive for employee-whistleblowers to come forward, some have argued that SOX should award punitive damages.[70] Punitive damages may go a long way in inducing employee-whistleblowers given the multitude of negative consequences these people frequently face after coming forward. Punitive damages may perhaps

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64. *Id.* at 145, 147. Further complicating matters is the fact that the "Fair Funds provision has been a logistical and administrative nightmare. Without the self-identification mechanism of private securities litigation, the SEC has found it difficult to identify those investors who are entitled to damages. As a result, the SEC has been unable to effectively distribute collected funds to wronged investors." *Id.* at 147.

65. *Id.* at 148.

66. § 922(a)(6) of the Discussion Draft, *available at* http://banking.senate.gov /public/_files/AYO09D44_xml.pdf.

67. *Id.* at § 922(a)(6)(B).

68. *Id.* at § 922(g)(2)(A).

69. *Id.* at § 922 (h)(1)(C)(i)-(iii).

70. *Structural Model, supra* note 32, at 1127.

also serve to deter employers from retaliating against employee-whistleblowers.

In response to the argument advocating increased monetary incentives, some may reply with concern that expanding monetary incentives for employee-whistleblowers would encourage an influx of frivolous claims by employees in order to enjoy a windfall of money. At first glance, this may appear to be a legitimate concern. However, if the monetary incentives are structured like the *qui tam* statute, the employee only gets a percentage of monies collected. If there is no fraud and no legitimate claim, there is no money to collect. Therefore, employees who would bring frivolous claims would not be exposing fraud and would never see any money as a result of their claim. Only those employees who exposed a legitimate fraud would ever be able to realize any money from their claims.

3. INCREASE THE STATUTE OF LIMITATIONS

The third major step Congress should take is to increase the statute of limitations. "The short statute of limitations that currently exists is unrelated to the goals of whistleblower statutes and serves no real purpose other than to trip up unsuspecting whistleblowers after they have already taken the serious risk of coming forward with information about misconduct."[71] Currently, the statute of limitations greatly impedes a whistleblower's attempt to make a claim as one-third of SOX cases are dismissed by ALJS for failure to satisfy the statute of limitations.[72] Furthermore, "The 90-day filing deadline is strictly enforced. ALJs have almost uniformly rejected equitable arguments for extending the limitations period when untimely complaints were filed."[73] This amounts to an "unnecessary procedural obstacle for employees" that is not tied to the goals of whistleblower protections.[74] Finally, a longer statute

71. *Hearing*, *supra* note 21, at 32 (testimony of Richard Moberly).

72. *Id.*

73. Alvarez, *supra* note 34, at 246. In *Ubinger v. CAE International*, a three part test was employed to determine when "equitable tolling may toll the statute: 1) the Respondent misled the Complainant concerning the filing of his complaint; 2) the Complainant was in some way extraordinarily prevented from filing his claim; or 3) the Complainant raised the issue in the wrong forum." *Id. citing Ubinger v. CAE International*, 2007-SOX-36 (A.L.J. May 22, 2007).

74. *Unfulfilled Expectations*, *supra* note 49, at 132. Moberly also points out that whistleblowers often need more than ninety days to bring a claim because many of

of limitations would not place a bigger burden on employers because "various federal statutes require most employers to keep certain records on employees for one year or more."[75]

Senator Dodd's discussion draft also includes a greatly increased statute of limitations for whistleblower claims under SOX. In the proposed legislation, an action for whistleblower protection may not be brought "more than 6 years after the date on which the violation . . . occurred; or more than 3 years after the date when facts material to the right of action are known or reasonably should have been known by the employee alleging a violation."[76]

4. INCREASE THE AMOUNT OF RESOURCES OSHA HAS AVAILABLE TO INVESTIGATE WHISTLEBLOWER CLAIMS

A fourth major step Congress should take is to give OSHA more resources to investigate employee-whistleblower retaliation claims, but not necessarily transfer the administration of these claims to another government agency. Currently, OSHA is trying to adequately enforce these claims without an increase in its budget. "When Sarbanes-Oxley was added to OSHA's responsibilities, OSHA did not receive any additional funding for cases that now consist of approximately 13% of OSHA's caseload."[77] Furthermore, as Richard Fairfax, the Director of Enforcement for OSHA testified before Congress:

> Presently we average about 1,900 cases annually, and we only have 72 investigators. While the statutes I have described have prescribed time frames for completion of the investigation and the issuance of

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them lose their jobs as a result of their decision to expose corporate fraud and are scrambling to replace their source of income. Furthermore, attorneys for whistleblowers often need more than ninety days to thoroughly investigate the claim before filing.

75. *Id.* at 133 *citing* 29 C.F.R. § 1602.14 (2006) ("EEOC regulation requiring employers to maintain certain employment records for at least one year") and 29 C.F.R. § 516.5 (2006) ("Department of Labor regulation requiring employers to maintain payroll and other wage records for three years.").

76. § 922(h)(1)(B)(iii) of the Discussion Draft, *available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

77. *Hearing*, *supra* note 21, at 31 (testimony of Richard Moberly).

> findings, we are seldom able to meet these time frames due to the complexities of the investigative process.[78]

As a result, these "highly fact-intensive cases that require resources, time, and expertise"[79] are taking entirely too long to resolve. Even though SOX requires that OSHA complete its investigation within sixty days, the average length of a SOX investigation was 127 days in 2005, up from an average of ninety-two days in 2003.[80] Even more alarmingly, Tom Devine, Legal Director of the Government Accountability Project ("GAP"), testified before Congress, "GAP has had to develop a manual on how whistleblowers can find their cases when OSHA loses them."[81]

Given the current disarray in management of whistleblower cases and the fact that OSHA investigators may find it difficult to "discern the nuances of securities fraud"[82] one may wonder why jurisdiction of SOX whistleblower claims should not be transferred to another government agency. OSHA's primary purpose originally was to investigate whistleblower complaints under a single statute; now, OSHA enforces the provisions of fourteen separate whistleblower statutes.[83] Therefore, OSHA does, in fact, have a lot of experience administering whistleblower investigations.[84] At this point, "transferring jurisdiction over Sarbanes-Oxley retaliation claims . . . would waste the experience and knowledge that OSHA has accumulated in handling these matters."[85] Therefore, before taking the drastic step of transferring jurisdiction of SOX whistleblower claims over to another government agency, Congress should give OSHA more money with which to operate since OSHA can rely upon its years of experience investigating

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78. *Id.* at 24 (testimony of Richard Fairfax, Director of Enforcement, Occupational Safety and Health Administration).

79. *Id.* at 31 (testimony of Richard Moberly).

80. *Id.*

81. *Id.* at 42 (testimony of Tom Devine, Legal Director, Government Accountability Project).

82. *Id.* at 31(testimony of Richard Moberly).

83. *Id.* at 23 (testimony of Richard Fairfax).

84. *Id.* at 23 (testimony of Richard Fairfax) (In an investigation OSHA "does not represent the complainant nor the respondent, but, in fact, is a neutral factfinder. Investigators must evaluate both the complainant's allegation and the respondent's nonretaliatory reason for the alleged adverse action.").

85. *Id.* at 38 (testimony of Lloyd Chinn, Partner, Proskauer Rose LLP).

whistleblower claims. Hopefully, this incremental step will help resolve the problems whistleblowers currently face in the administration of the investigation of their claims.

5. MANDATE THE PUBLISHING OF SOX WHISTLEBLOWER CLAIMS STATISTICS AND OSHA INVESTIGATION OUTCOMES AND DECISIONS

An additional requirement Congress could impose upon OSHA would be to mandate that OSHA and the ALJs publish statistics about the outcomes of SOX whistleblower claims and require that OSHA publish its decisions. Currently, OSHA will release statistical information about SOX claim outcomes, but only after a specific request.[86] OSHA will only release individual decision letters in response to a Freedom of Information Act request and does not publish its decisions in any summary format.[87] ALJs stopped publishing statistics about the outcome of SOX claims, but does publish all of its decisions on its website.[88] Given the lack of data post-2005 identified previously in Part III, B, it would be beneficial to have up-to-date statistics regarding the outcome of these claims. It should not have to be up to an independent researcher or an employee-whistleblower to have to compile these statistics. Rather, the government agency responsible for adjudicating these claims should make current statistics available.

Mandating the publishing of statistics regarding outcomes and decisions would provide employee-whistleblowers with the information necessary to decide whether to bring a claim or not or may help their attorneys build a case. Given that the statistics are so dauntingly in favor of employers, the initial reaction may cause potential employee-whistleblowers to remain silent. However, publishing such information may eventually "have a substantive impact on decision makers, who may reevaluate such inclinations"[89] or may alert Congress that SOX is not adequately protecting employees who are brave enough to expose corporate fraud.

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86. *Unfulfilled Expectations*, *supra* note 49, at 142.

87. *Id.*

88. *Id.*

89. *Id.* at 143. Moberly also advances an interesting theory that publishing this information may convince those with weak claims not to assert them. Moberly posits that perhaps weak claims in the past "may have led to stronger than necessary language in decisions" which led to the narrow interpretation of SOX. If statistics

CONCLUSION

Employee-whistleblowers are one of the most important groups when it comes to exposing corporate fraud. Even though there is legislation in place that is supposed to protect those who come forward, many are still facing extreme negative consequences for their decision. The current legal provisions could protect these individuals, but are being construed too narrowly to effectuate protection for employee-whistleblowers. If Congress agrees with how OSHA and the ALJs are interpreting SOX (or simply choose to ignore the outcomes and do nothing) then employees will continue to have little incentive to come forward, and an important actor in the revelation of fraud will be continually discouraged. Instead, Congress should take action to clarify the current legal provisions and bolster the current legislation with a few small tweaks, specifically with the introduction of monetary rewards for employees who blow the whistle on corporate fraud.

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and decisions are published, weak claims will fall away and in time, "a stronger overall pool of employee-complainants may help convince decision makers that a slightly broader view of the Act is appropriate to satisfy Sarbanes-Oxley's remedial aims with only a minimal risk of opening the flood gates for frivolous claims." While this theory is interesting, it is highly speculative, and Congressional clarification of SOX can be accomplished much more quickly and directly.

Notes & Observations

DEVELOPMENTS IN THE EVIDENTIARY SHOWING REQUIRED FOR PLAINTIFFS AT THE CLASS CERTIFICATION STAGE FOR A CIVIL SECURITIES FRAUD CASE

*Vanessa Lu**

Class certification, pursuant to Rule 23 of the Federal Rules of Civil Procedure, of securities class action is a procedural device vital to those seeking to deter fraud and to provide remedy for victims who almost never suffer enough damages to justify filing an individual lawsuit.[1] As argue herein, some federal circuits have improperly transformed a securities class certification proceeding into a trial on the merits.[2] As a result, victims are deprived of their Seventh Amendment right to a trial by jury and precluded from pursuing valid claims.[3]

Specifically, in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, the U.S Court of Appeal for the Fifth Circuit ruled that plaintiffs must establish loss causation at the class certification stage.[4] The Fifth Circuit created new class certification requirements, which incorrectly places the burden on plaintiffs to prove the merits of their securities claim prior to trial.[5] The Fifth Circuit's rationale in *Oscar* is inconsistent and directly conflicts with Supreme Court precedent.[6] Indeed, *Oscar* has created substantial barriers for plaintiffs pursuing class certification and seeking judicial relief.[7]

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* Vanessa T. Lu is graduating in May from Loyola University Chicago School of Law with a trial advocacy certificate. Vanessa recently clerked with the S.E.C in Chicago. Currently, she is the Publications Editor of the Children's Legal Rights Journal and works closely with Professor Neil Williams as his research assistant and contracts tutor.

1. *See generally* Stephen J. Choi, *The Evidence of Securities Class Actions*, 57 VAND. L. REV. 1465, 1522 (2004).

2. *See Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 266 (5th 2007); *In re Salomon Analyst Metromedia Litig. v. Citigroup Global Mkts. Inc.*, 455 F.3d 474, 485 (2d Cir. 2008).

3. *See Cammer v. Bloom*, 711 F. Supp. 1264, 1289-91 (D.N.J. 1989).

4. *Oscar*, 487 F.3d at 266.

5. *Compare Basic v. Levinson*, 485 U.S. 224 (1988); *with Oscar*, 487 F.3d at 266.

6. *Compare Basic*, 485 U.S. 224; *with Oscar*, 487 F.3d at 266.

7. *See Oscar*, 487 F.3d at 272 (dissenting opinion by Judge Dennis).

The Fifth Circuit's decision has influenced other courts to incorporate additional barriers that plaintiffs must overcome at the class certification stage.[8] On the other hand, other courts have either rejected the rationale of *Oscar*.[9]

This article argues that trial courts should not engage in entertaining the merits of the underlying fact of securities of case at the class certification stage because this judicial process is inappropriate and infringes on a plaintiff's right to a trial by a jury.[10] Part I of this article describes the requirements needed for class certification and what a party must prove to use the fraud-on-the-market presumption. Part II discusses the Fifth Circuit's decision of *Oscar* and the Second Circuit's decision *In re Salomon Analyst Metromedia Litig*. Part III describes how *Oscar* and *In re Salomon*, will both likely result in battles of loss causation at the class certification stage, thereby increasing the number of interlocutory appeals brought under Federal Rules of Civil Procedure Rule 23(f). Part IV argues class certification merit trials are contradictory to Supreme Court precedent and is also in compatible with the Seventh Amendment of the Constitution. Part V discusses the impact *Oscar* has for plaintiffs seeking class certification.

I. SECURITIES CLASS ACTION REQUIREMENTS

Plaintiffs must successfully meet all the requirements of Federal Rules of Civil Procedure 23 to certify a class. In particular, plaintiffs must establish commonality and reliance.[11] Plaintiffs bringing private claims under Section 10 of the Securities Exchange Act[12] and the Securities and Exchange Commission's Rule 10(b)-5 must prove damages caused by an act or

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8. Harvard Law Review Association, *Securities Litigation- Class Certification-Fifth Circuit Holds that Plaintiffs Must Prove Loss Causation Before Being Certified as a Class*, 121 HARD. L. REV. 890, 890 (2008).

9. *Schleicher v. Wendt*, United States Court of Appeals, No. 09-2154 (7th Cir. decided Aug. 20, 2010).

10. *See Cammer*, 711 F. Supp. at 1289-91.

11. *See Basic*, 485 U.S. at 225.

12. Securities Exchange Act of 1934 § 10, *15 U.S.C. § 78j* (2006).

omission due to fraud or deceit in connection with the purchase or sale of any security.[13]

A. CLASS CERTIFICATION UNDER RULE 23

The Supreme Court has long recognized three important functions of class action litigation: (1) the resolution of multiple claims in a single proceeding; (2) allowing claimants with small claims to share costs by joining their claims in a single proceeding; and (3) allowing plaintiffs with common issues to litigate before the court.[14] Under Federal Rules of Civil Procedure Rule 23(a), a party seeking class certification must satisfy meet four elements: (1) numerousity, (2) commonality, (3) typicality, and (4) adequacy of representation.[15]

In addition, a party must meet one of the three categories of Rule 23(b).[16] Under Rule 23(b)(1), class certification is granted if the defendant is at risk of inconsistent adjudication or if a limited fund is available to class members.[17] If the class seeks only injunctive relief, certification is permitted under Rule 23(b)(2).[18] Under Rule 23(b)(3), class certification is allowed when questions of law and fact are common to class members predominates over any questions affecting only individual members.[19] The predominance requirement requires a court to: "(1) identify outcome determinative issues, (2) assess which of these issues will predominate, and (3) then determine whether the issues are common to the class."[20] Furthermore, Rule 23(b)(3)

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13. *17 C.F. R. § 240, 10b-5* (1997); *see, e.g.*, *Ernst & Ernest v. Hochfelder*, 425 U.S. 185, 196 (1975) (construing Rule 10b-5 to contain an implied private right of action).

14. *See, e.g.*, *Amchem Prods. v. Windsor*, 521 U.S. 591, 618 (1997); *Gen. Tel. Col. of the Sw. v. Falcon*, 457 U.S. 147, 159 (1982); *Deposit Guar. Nat'l Bank of Jackson, Miss. v. Roper*, 445 U.S. 326, 339 (1980).

15. *Windsor*, 521 U.S. at 613-14.

16. *Fed. R. Civ. P. 23(b)*.

17. *Fed. R. Civ. P. 23(b)(1)*.

18. *Fed. R. Civ. P. 23(b)(2)*.

19. *Fed. R. Civ. P. 23(b)(3)*.

20. Michael J. Kaufman et al., *The Unjustified Judicial Creation of Class Certification Merits in Trials in Securities Fraud Cases*, 43 U. MICH. J.L. REFORM 323, 325 (2010).

requires that the class action is advantageous or superior to any alternative methods of adjudication.[21]

B. PLAINTIFFS MUST ESTABLISH ELEMENTS OF LOSS CAUSATION AND RELIANCE

Under Section 10(b) and Rule 10(b)-5, a plaintiff must allege and prove that: (1) defendant(s) made a material misrepresentation or omission, (2) defendant(s) acted with scienter or a wrongful state of mind, (3) the material misrepresentation or omission was made in connection with the purchase or sale of the a security, (4) plaintiff relied upon the material misrepresentation, (5) as a result, plaintiff suffered an economic loss, and (6) the material misrepresentation caused the loss.[22] A party may defeat class certification by showing that individual issues of fact or law predominate over class-wide issues, such as the elements of loss causation and reliance.[23]

C. FRAUD-ON-THE MARKET PRESUMPTION

The Supreme Court has found that a rebuttable presumption of reliance exists in securities cases involving publicly-traded securities: (1) "if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance;"[24] or (2) "when statements at issue become public."[25] Under "fraud-on-the-market" theory, the reliance is generally presumed because public information is quickly reflected in the market price of the security.[26] Therefore, an investor who buys or sells a security at the market price is presumed to have relied upon alleged false statements made to the public.[27] As such, plaintiffs must prove that: (1) defendant publicly made material

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21. *Fed. R. Civ. P. 23(b)(3)*.

22. *See Dura Pharms. Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (emphasis omitted).

23. *Id.* at 480.

24. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54.

25. *Basic*, 485 U.S. at 247.

26. *Id.* at 241-42.

27. *Id.*

misstatements about the stock, (2) defendant's shares were traded on an efficient market,[28] and (3) plaintiffs purchased or sold shares between the time the misrepresentations were made and the time the truth was revealed.[29]

Even if defendants are unlikely to prevail during class certification stage, they nonetheless utilize the fraud-on-the-market theory. Even though plaintiffs relied upon a public misrepresentation conveyed through the market price, this does not necessarily mean the market believes and reflects all the information it receives.[30] If other information related to the subject of the fraud is included in the market price, the market may reflect that other information.[31]

II. THE FEDERAL COURT TREND OF TURNING THE CLASS CERTIFICATION PROCESS INTO A TRIAL ON THE MERITS

Basic provides plaintiffs who purchase or sell public securities in an efficient market with the rebuttable presumption of reliance.[32] The Fifth Circuit bars reliance on the fraud-on-the-market presumption where plaintiffs are unable to establish loss causation by a preponderance of the evidence.[33] The Second Circuit, however, provides plaintiffs with a reliance presumption, but permits defendants to rebut the class-wide presumption of reliance before class certification.[34] The Second Circuit is following the Fifth Circuit's lead where class certification has become a trial on the merits.[35]

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28. *Id.* at 247-48.

29. *Oscar*, 487 F.3d at 264.

30. *Id.*

31. *Id.*

32. *Basic*, 485 U.S. at 224.

33. *Oscar*, 487 F.3d at 266; *see also Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 235 (5th Cir. 2009).

34. *In re Salomon Analyst Metromedia Litig. v. Citigroup Global Mkts. Inc.*, 455 F.3d 474, 485 (2d Cir. 2008).

35. *In re Salomon*, 455 F.3d at 485; *see also Oscar*, 473 F. 3d at 270.

A. FIFTH CIRCUIT REQUIRES PLAINTIFFS TO PROVE LOSS CAUSATION AND RELIANCE

In *Oscar*, the Fifth Circuit concluded that plaintiffs must come forward with class-wide evidence establishing loss causation by preponderance of the evidence at the class certification stage.[36] The Fifth Circuit's decision has created a formable barrier for plaintiffs at the class certification stage of a securities action. In effect, the Fifth Circuit has shifted the burden on plaintiffs to establish loss causation at the class certification stage prior to trial.[37]

1. THE DISTRICT COURT GRANTED CLASS CERTIFICATION TO PLAINTIFFS IN OSCAR

Allegiance Telecom Inc. ("Allegiance") was a publicly traded, national telecommunications provider based in Dallas Texas.[38] Allegiance sold local telephone service, long distance, broadband access, web hosting, and telecom equipment with maintenance to small and medium sized businesses.[39] Similarly like those of the telecom industry, Allegiance's stock was falling and, thus, almost lost 90% of its value in 2001.[40] In April 2001, Allegiance released its first quarter financial results that showed that its stock prices rose by 9%.[41] Similarly during the second and third quarters, Allegiance released results indicating that its stock prices again outperformed analysts' estimates.[42] In February 2002, Allegiance released its fourth quarter financial results, which missed analysts' expectations.[43] The next trading day, Allegiance's stock fell 28% from $3.70 to $2.65 per share.[44] Three

36. *Oscar*, 487 F.3d at 269-70.

37. *Id.*

38. *Id.* at 262.

39. *Id.*

40. *Id.* at 263.

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

months later, Allegiance violated its debt covenants and thereby putting its credit lines in default, and ultimately filed for bankruptcy in May 2003.[45]

Thereafter, Oscar Private Equity Investments filed a suit in the Northern District of Texas alleging Allegiance violated Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10(b)-5.[46] Plaintiffs, investors who purchased common stock of Allegiance Telecom between April 24, 2001 and February 19, 2002, alleged that Allegiance fraudulently misrepresented its line-installation count in its first three quarterly announcements for 2001.[47] Plaintiffs assert that they purchased Allegiance stocks at an artificially inflated price.[48] Furthermore, plaintiffs alleged that they were injured because of the stock decline as a result of Allegiance's public restatement.[49] Plaintiffs moved to certify a class of individuals who purchased Allegiance common stock between its first and fourth quarter releases.[50] The district court certified the class and thereby allowed plaintiffs to establish a rebuttable presumption of fraud-on-the-market theory.[51]

2. The Fifth Circuit Creates Class Certification Barriers for Plaintiffs

Defendants filed an interlocutory appeal from the district court's order certifying the class.[52] The Fifth Circuit "vacated the certification order and remand, persuaded that the class certified fails for wont of any showing that the market reacted to the corrective disclosure."[53] The Fifth Circuit referenced the Supreme Court's decision in *Basic*, which "allow[ed] each of the circuits room to develop its own fraud-on-the-market rules."[54] The Fifth

45. *Id.*

46. *Id.* at 262.

47. *Id.* at 262, 263.

48. *Id.* at 263.

49. *Id.*

50. *Id.*

51. *Id.* at 263-64.

52. *Id.* at 263.

53. *Id.* at 262.

54. *Id.* at 264.

Circuit ruled that proof of a material misstatement was not enough; plaintiffs were required to provide evidence that "the misstatement *actually moved* the market."[55] Moreover, the majority opinion stated "the plaintiff [may recover under the fraud on the market theory if he [can] prove that the defendant's non-disclosure materially affected the market price of the security."[56] Hence, the Fifth Circuit adopted the theory that plaintiffs "must establish loss causation to trigger the fraud-on-the-market presumption."[57]

The court stated its rationale for requiring plaintiffs to establish loss causation by a preponderance of the evidence at the class certification stage was driven by policy concerns.[58] Because the efficient market doctrine facilitated the extraordinary aggregation of claims against a defendant, the court reasoned "[w]e cannot ignore the *in terrorem* power to certification, continuing to abide the practice of withholding until "trial" a merit inquiry central to the certification decision.[59] The court determined that there was no sound reason "for an early 'tentative' certification, which leaves loss causation for later more focused examination" since it involved little discovery and minimal proof.[60] Furthermore, the Fifth Circuit concluded that proof could be drawn from the public data and public filings, which became "an empirical judgment that can be made [on a motion for class certification] as well as later in the litigation."[61]

Judge Dennis, writing the dissent, stated that "[t]he majority's decision is, in effect, a breathtaking revision of securities class action procedure that eviscerates *Basic*'s fraud-on-the-market presumption … [and] creates a split from other circuits by requiring mini-trials on the merits of cases at the class certification stage.[62]

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55. *Id.* at 265.

56. *Id.*

57. *Id.* at 265, 269.

58. *Id.* at 267.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at 272.

B. SECOND CIRCUIT USED FLAWED ANALYSIS PERMITTING DEFENDANTS TO REBUT THE FRAUD-ON-THE MARKET PRESUMPTION AT THE CLASS CERTIFICATION STAGE

The Second Circuit provides plaintiffs with an initial presumption of reliance through the fraud-on-the-market theory, but it also provides defendants with an opportunity to rebut this presumption.[63] While the Second Circuit's approach to class certification seems to be somewhat different from that of the Fifth Circuit's, it nonetheless transformed the Rule 23 inquiry into a premature trial on the issue of reliance.[64]

1. THE DISTRICT COURT GRANTS CLASS CERTIFICATION UNDER RULE 23

In *In re Salomon*, plaintiffs filed a securities fraud action pursuant to Section 10(b) and Rule 10(b)-5 against Citicorp USA, Inc., Salomon Smith Barney, Inc., Citigroup, Inc., and Jack Grubman, a Smith Barney analyst.[65] Plaintiffs alleged that defendants issued and disseminated research analyst reports on Metromedia, which contained materially false and misleading statements as well as omissions of material fact.[66] In order to increase Grubman's personal compensation, plaintiffs alleged that defendants violated securities laws by publicly releasing materially false statements to attract business from Metromedia for Smith Barney's investment banking division.[67]

The district court held that the complaint pleaded fraud with sufficient particularity to defeat defendants' motion to dismiss concerning the research reports issued between March 8 and July 25, 2001.[68] Plaintiffs alleged that Grubman's reports omitted or misstated material facts concerning a credit facility, where Citicorp USA was to provide Metomedia.[69] Defendants did

63. *In re Salomon*, 544 F.3d at 485-86.

64. *See Oscar*, 487 F.3d at 266; *In re Salomon*, 544 F.3d at 485-86.

65. *In re Salomon*, 544 F.3d at 476.

66. *Id.*

67. *Id.* at 477.

68. *Id.*

69. *Id.*

not contest that "Metromedia and Citicorp USA signed a commitment letter for a $350 million credit facility," however, plaintiffs alleged several problems and delays occurred involving the facility within following seven months.[70] The district court determined that Grubman had a duty to disclose information concerning the problems and delays of the facility when he chose to publicly release statements regarding the facility.[71]

Under Rule 23(a) and 23(b)(3), plaintiffs moved to certify the class of individuals who purchased Metromedia stock between November 25, 1997 and July 25, 2001.[72] The district court granted class certification concluding that plaintiffs: (1) met all the elements to raise reliance on the fraud-on-the-market presumption, and (2) showed that questions of fact and law predominated over any questions affecting individual purchasers.[73]

While defendants argued individual questions of reliance predominated over class wide issues, however, they offered no evidence or expert testimony at the Rule 23 hearing.[74] Furthermore, defendants argued that class certification was improper because the reliance presumption could not be utilized in actions against research analysts.[75] Nonetheless, the district court did not afford defendants an opportunity to present rebuttal evidence until a later stage in the litigation.[76]

C. THE SECOND CIRCUIT ATTEMPTS TO DISTINGUISH ITSELF FROM THE FIFTH CIRCUIT

The Second Circuit addressed three issues on appeal. First, whether the fraud-on-the market presumption is applicable in lawsuits against analysts or other non-issuers.[77] Second, the court addressed whether plaintiffs must make a heightened showing that misrepresentations had an "actual impact on

70. *Id.*

71. *Id.*

72. *Id.* at 476.

73. *Id.* at 478.

74. *Id.* at 479.

75. *Id.* at 480.

76. *Id.*

77. *Id.*

market price" to invoke the fraud-on-the-market presumption.[78] Finally, the court addressed whether defendants were entitled to an opportunity to rebut the fraud-on-the-market presumption before the class certification.[79]

1. THE FRAUD-ON-THE-MARKET PRESUMPTION IS APPLICABLE TO NON-ISSUERS

The Second Circuit dismissed the argument that the fraud-on-the market presumption applies only to issuers.[80] Relying upon the Supreme Court's decision in *Basic*, the Second Circuit ruled it did not matter that materially false statements were publicly made by an issuer, analyst, or other third party.[81] Applying the premise in *Basic*, the court reasoned that an efficient market reflected shared prices which indicates "all publicly available information, and, hence, any material misrepresentations."[82] In addition, the Second Circuit applied the Supreme Court's decision in *Stoneridge*, which found the fraud-on-the-market presumption is applicable to deceptive statements communicated to the public, regardless of the speaker's position in the company.[83]

2. THE SECOND CIRCUIT REJECTS THE HEIGHTENED EVIDENTIARY PROOF FOR RELIANCE

The Second Circuit rejected defendants' argument that plaintiffs were required to demonstrate a heightened evidentiary showing to benefit from the fraud-on-the-market presumption.[84] To determine whether the alleged misrepresentation was material, the Second Circuit held that the information must be viewed by a "reasonable investor" standard and not in terms of

78. *Id.* at 480.

79. *Id.*

80. *Id.* at 482.

81. *Basic*, 485 U.S. at 246; *In re Salomon*, 544 F.3d at 481.

82. *Basic*, 485 U.S. at 246; *In re Salomon*, 544 F.3d at 481.

83. *Stoneridge*, 552 U.S. at 158; *In re Salomon*, 544 F.3d at 481.

84. *In re Salomon*, 544 F.3d at 483.

"actual impact on the market price."[85] By placing the burden on defendants during the rebuttal stage, the Second Circuit rejected the holding in *Oscar* and thereby concluded that placing the burden on plaintiffs would eviscerate the presumption of reliance.[86]

Defendants further argued that a heightened evidentiary standard was necessary to deter frivolous lawsuits against non-issuers, but the Second Circuit disagreed stating that safeguards already existed to prevent plaintiffs from suing any individual who makes public statements regarding the company.[87] For example, the court pointed out the materiality requirement needed to invoke the fraud-on-the-market presumption, the ability for defendants to rebut the reliance presumption, and that predictions or opinions were generally not actionable, all served be procedural safeguards to limit frivolous lawsuits.[88]

3. THE SHOCKING SIMILARITY TO *OSCAR*: THE COURT MUST MAKE A "DEFINITIVE ASSESSMENT" OF FACTUAL RECORD REGARDING RELIANCE AT THE CLASS CERTIFICATION STAGE

Notably, in *Salomon*, the Second Circuit ordered trial courts to make a "definitive assessment" for each requirement under Rule 23 and that courts must consider all evidence and resolve factual disputes.[89] While the Second Circuit "cautioned" the trial courts not to convert the Rule 23 inquiry into a premature mini-trial on the merits, it instructed them to entertain sufficient evidence through affidavits, documents, or testimony, to ensure each element of class certification has been met.[90] The *In re Salomon* court ruled that a definitive assessment would be incomplete if defendants were not afforded the opportunity to rebut the presumption at the class certification stage.[91]

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85. *Id.* at 484.

86. *In re Salomon*, 544 F.3d at 483; *but see Oscar*, 487 F.3d at 270.

87. *In re Salomon*, 544 F.3d at 484.

88. *Id.*

89. *Id.* at 484.

90. *Id.* at 486.

91. *Id.* at 485.

Furthermore, the court held that a successful rebuttal defeats class certification.[92] Even if plaintiffs present evidence to show that the market was efficient and that public statements were made during the alleged class period, the Second Circuit requires defendants to have the opportunity to refute the reliance presumption.[93] Because the district court failed to afford defendants the opportunity to rebut, the Second Circuit vacated the class certification and remanded.[94] As demonstrated below, the result of *In re Salomon* has no different procedural effect than that of *Oscar*.

C. COMPARING THE PRACTICAL EFFECTS OF *OSCAR* AND *IN RE SALOMON*

The Second Circuit cited to *Oscar* to support is rationale that defendants must be afforded the opportunity to challenge the fraud-on-the-market presumption on a motion for class certification.[95] Consequently, the Second Circuit mandates courts to afford defendants an opportunity to rebut loss causation at the class certification stage, but places a burden of showing no price impact on defendants.[96] As a result, both parties will be forced to present evidence addressing loss causation on a motion for class certification.[97]

In re Salomon court stated a trial court has the discretion to limit discovery and the extent of reviewing evidence to determine whether Rule 23 requirements have been met.[98] Moreover, the Second Circuit provided considerable discretion to trial courts in order to avoid the risk that a Rule 23 hearing will extend into a protracted mini-trial of substantial portions of the merits of the case.[99]

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92. *Basic*, 485 U.S. at 249; *In re Salomon*, 544 F.3d at 485.

93. *In re Salomon*, 544 F.3d at 485.

94. *Id.* at 486.

95. *Compare In re Salomon*, 544 F.3d at 485; *with Oscar*, 497 F.3d at 270 (requiring plaintiffs to establish preponderance of the evidence to trigger the fraud-on-the-market presumption).

96. *In re Salomon*, 544 F.3d at 485.

97. *See id.*

98. *In re Salomon*, 544 F.3d at 486.

99. *Id.*

Two weeks after its decision of *In re Salomon*, the Second Circuit reaffirmed the district court's discretion to limit discovery and the extent of a class certification hearing in *Teamsters Local 445 Freight Division Pension Fund v. Bombardier, Inc*.[100] The Second Circuit held that the district court did not need to conduct a complete evidentiary hearing, but only required to "receive enough evidence by affidavits, documents, or testimony to be satisfied that each Rule 23 element has been met."[101] The Second Circuit used *Bombardier* to clarify the evidentiary standard a trial court may review to determine whether a party has meet Rule 23's requirements.[102] The Second Circuit found that the district court was within its discretion to require preponderance of the evidence from plaintiffs to determine whether Rule 23 requirements have been satisfied.[103] Consequently, the Second Circuit permit trial courts to follow the Fifth Circuit's decision in *Oscar* that requires preponderance of the evidence from plaintiffs.[104]

III. THE IMPORTANCE OF LOSS CAUSATION AND AN OPPORTUNITY TO REBUT THE FRAUD-ON-THE-MARKET PRESUMPTION

To defeat class certification, defendants will generally show that individual issues of reliance or loss causation predominate.[105] To establish liability under Section 10(b) and Rule 10(b)-5, reliance and loss causation are necessary elements to show the casual connection between a defendant's misrepresentation and the injury.[106] In *Oscar*, the Fifth Circuit required plaintiffs to establish loss causation by ***a preponderance of the evidence*** to trigger the fraud-on-the market presumption.[107] Plaintiffs often utilize fraud-

100. *Teamsters Loc. 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 546 F.3d 196, 204 (2d Cir. 2008).

101. *Id.*

102. *Id.*

103. *Id.*

104. *See Bombardier, Inc.*, 546 at 204; *Oscar*, 487 F.3d at 270.

105. *Fed. R. Civ. P. 23(b)(3)*; *Basic*, 485 U.S. at 249; *see also Oscar*, 487 F.3d at 270; *In re Salomon*, 544 F.3d at 485.

106. *Stoneridge*, 552 U.S. at 158; *Basic,* 485 U.S. at 224.

107. *Oscar*, 487 F.3d at 270.

on-the market theory to meet Rule 23(b) predominance requirement for class certification.[108]

In re Salomon is distinguishable from *Oscar* because the Second Circuit ***requires plaintiffs to provide persuasive evidentiary showing*** to establish that they are entitled to the reliance presumption.[109] Both parties in the Second Circuit and Fifth Circuit will be eventually forced to address issues of loss causation in detail at the class certification level, therefore well before trial.[110]

A. BATTLE OF THE EXPERTS: ADDRESSING THE ELEMENTS OF RELIANCE AND LOSS CAUSATION

In general, parties will utilize expert testimony to either challenge or establish reliance and loss causation during class certification.[111] Both the Second and Fifth Circuit require courts to "definitely assess" Rule 23 requirements to ensure all contested issues of fact are resolved.[112] Because the Supreme Court has not directly addressed the parameters of when expert testimony may be used, trial courts continuously struggle when and to what extent expert testimony is appropriate at class certification.[113] Because the federal circuits differ from one another concerning their rules on the proper admission of expert opinion at a class certification hearing, issues regarding fairness and justice are commonly debated.[114]

In re Salomon did not address the issue of whether the market was efficient, however, market efficiency is an element that a plaintiff must prove to use the fraud-on-the-market presumption.[115] The *Salomon* court addressed

108. *Id.*

109. *In re Salomon*, 544 F.3d at 478.

110. *In re Salomon*, 544 F.3d at 478; *see also Oscar*, 487 F.3d at 270.

111. Dwight J. Davis et al., *Expert Opinion in Class Certifications: Second Circuit Revisits, Disavows In Re Visa Check and Joins Majority Rule*, 74 DEF. COUNS. J. 253, 253 (2007).

112. *Oscar*, 487 F.3d at 268; *In re Initial Pub. Offerings Sec. Litig.*, 471 D.3d 24, 41 (2d Cir. 2006).

113. Davis et al., *supra note* 112, at 253-54.

114. Davis et al., *supra note* at 102, at 260.

115. *See In re Salomon*, 544 F.3d at 485.

a causation issue and, thus, misinterpreted two distinct issues.[116] The first issue was whether the plaintiff can take advantage of the reliance presumption and the second issue was whether the plaintiff did prove reliance.[117]

By not addressing these two issues separately, it is not clear that a plaintiff must only prove the presumption of reliance to meet the class certification requirements.[118] This is problematic because the Second Circuit permits a defendant an opportunity to challenge whether plaintiff has proven the element of reliance at the class certification stage.[119] Therefore, courts will be given deference to address expert testimony and its submission at the class certification stage.[120]

B. ALLOWING DEFENDANTS A REBUTTABLE PRESUMPTION PLACES PLAINTIFFS AT AN UNFAIR DISADVANTAGE DURING CLASS CERTIFICATION

Because the Fifth Circuit requires "preponderance of the evidence" and the Second Circuit requires "defendants have an opportunity to respond," these methods have substantially weakens the fraud-on-the-market presumption.[121] Because the Second Circuit affords defendants an opportunity offer evidence to rebut the fraud-on-the-market theory, the presumption is dismissed.[122] Defendants will generally always provide evidence to challenge the plaintiff's presumption.[123] As a result, the burden shifts to the plaintiff to offer evidence showing that he meets each Rule 23 requirement.[124] Indeed the practical effect of *In re Salomon* is similar to *Oscar* because the plaintiff must overcome the defendant's evidence and is

116. *Bombardier, Inc.*, 546 F.3d at 204.

117. *Id.*

118. *Id.*

119. *See In re Salomon*, 544 F.3d at 485.

120. Davis et al., *supra note* 112, at 253.

121. *See In re Salomon*, 544 F.3d at 485; *Oscar*, 487 F.3d at 269-70.

122. *See In re Salomon*, 544 F.3d at 485.

123. *Id.*

124. *Id.*

forced to establish the fraud-on-the market presumption at the class certification level.[125]

IV. MERIT TRIALS AT THE CLASS CERTIFICATION STAGE CLASHES WITH CONSTITUTIONAL PROTECTIONS AFFORDED TO LITIGANTS

The federal court's creation of class certification merit trials is inconsistent with the Constitution and well-established Supreme Court precedent.[126] Indeed, the mini-trials necessitated during the class certification stage by *Oscar* and *In re Salomon* infringe on a plaintiff's Seventh Amendment right to a trial by jury.[127] For these reasons, other circuits must not follow the Second and Fifth Circuits by depriving plaintiffs' their opportunity to seek a remedy for a securities fraud action. In *Eisen v. Carlise & Jacquelin*, the Supreme Court held that resolving merit issues are reserved only for trial and, thus, resolving merits on a motion for class certification is inappropriate.[128] When a court is reviewing a motion for class certification, *Eisen* ruled that a court does not have the authority to conduct a preliminary inquiry regarding the merits of a case.[129]

A. *OSCAR* AND *IN RE SALOMON* CONTRADICTS SUPREME COURT PRECEDENT

1. *EISEN* DOES NOT PERMIT MERIT INQUIRES AT CLASS CERTIFICATION

The Supreme Court reasoned that a plaintiff has the benefit of a class action without having to provide evidence proving all of its requirements.[130] Furthermore, the Supreme Court concluded that it may deny defendants its traditional rules and procedures applicable to civil trials because defendants

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125. *See In re Salomon*, 544 F.3d at 485; *Oscar*, 487 F.3d at 269-70.

126. *See Eisen*, 417 U.S. at 177; *Basic*, 485 U.S. at 248.

127. *See Cammer*, 711 F. Supp. at 1289.

128. *Eisen*, 417 U.S. at 177.

129. *Id.* at 177-78.

130. *Id.*

will have their opportunity to rebut at trial.[131] On a motion for class certification, the court must only decide whether the requirements of Rule 23 have been met.[132] A court is not permitted to inquire whether the plaintiff has alleged a cause of action or whether the plaintiff can prevail on its merits at the class certification stage.[133]

In *Eisen*, the Supreme Court determined that "the question is not whether the plaintiff or plaintiffs have stated a cause of action or will prevail on the merits, but rather whether the requirements of Rule 23 are met."[134] Rule 23 is a procedural device that asks whether the issues in this litigation would be most efficiently addressed through a class or through individual claims.[135]

2. *BASIC*: THE FRAUD-ON-THE-MARKET PRESUMPTION IS REBUTTAL AT TRIAL

For class certification, the Supreme Court has consistently held that all other questions be common to the class once a plaintiff provides sufficient evidence that allows the fraud-on-the-market presumption attaches.[136] On a motion for class certification, the court is only permitted to determine whether the methodology used by the plaintiff's expert can be applied to the entire class.[137]

When a court allows defendants to rebut the fraud-on-the-market presumption at class certification, this contradicts to the Supreme Court precedent set forth in *Basic*.[138] In *Basic*, the Supreme Court established that the fraud-on-the market presumption could only be rebutted at trial.[139] The issues of loss causation and the fraud-on-the-market theory both relate to the

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131. *Id.*

132. *Fed. R. Civ. P. 23*; *Eisen*, 417 U.S. at 178.

133. *Fed. R. Civ. P. 23*; *Eisen*, 417 U.S. at 178.

134. *Eisen*, 416 U.S. at 178.

135. *In re Salomon Analyst Metromedia Litig.*, 236 F.R.D. 208, 223 (S.D.N.Y. 2006).

136. *In re Credit Suisse-AOL Sec. Litig.*, 253 F.R.D. 17, 29 (D. Mass. 2008).

137. *Lapin v. Goldman Sachs & Co.*, 254 F.R.D. 168, 186 (S.D.N.Y. 2008).

138. *See Basic*, 485 U.S. at 248.

139. *Id.*

merits of the case.[140] The defendant's rebuttal burden to show that the public misstatement did not affect the market price is a matter for trial.[141] As such, the defense of "non-reliance" will be saved for trial and not resolved through the parties' experts at class certification stage.[142]

B. CLASS CERTIFICATION MERIT TRIALS IS INCOMPATIBLE WITH THE SEVENTH AMENDMENT

A plaintiff's right to a trial by jury is infringed upon when a court finds facts regarding loss causation and reliance on a motion for class certification.[143] This paper argues that all federal courts should adopt the viewpoint of the Seventh Circuit. In *Schleicher v. Wendt*, Conseco was a large, publicly traded financial-service holding company.[144] In 2001 and 2002, Conseco's stocks were doing poorly and it filed for bankruptcy in 2002.[145] A securities fraud suit against some of Conseco's managers ensued contending that the managers made unduly optimistic statements that led investors to pay too much for the shares.[146] Prior to bankruptcy, Conseco was listed on the New York Stock Exchange and included in the Standard & Poor 500 Index.[147] The district court agreed with a financial economist that Conseco's shares were efficient, as *Basic* employs and that investors may use the fraud-on-the-market theory to replace the person-specific proof of reliance and causation.[148] On appeal, the Seventh Circuit found that an "unduly optimistic false statement causes a stock's price to rise, the price will fall again when the truth comes to light."[149] In sum, the Seventh Circuit has

140. *Id.*

141. *Kaplan v. Rose*, 49 F.3d 1363, 1378 (9th Cir. 1994); *In re Micron Techs., Inc. Sec. Litig*., 247 F.R.D. 627, 634 (D. Idaho 2007) (citing *Basic*, 485 U.S. at 249).

142. *In re Micron*, 247 F.R.D. at 634.

143. *Eisen*, 416 U.S. at 178.

144. *Schleicher*, No. 09-2154 at 3 (7th Cir. decided Aug. 20, 2010).

145. *Id.*

146. *Id.* at 4.

147. *Id.*

148. *Id.*

149. *Id.*

properly found that the judiciary should not make further adjustments by reinterpreting Rule 23 and, thus, federal courts should adopt this rationale instead of that in *Oscar* and *In re Salomon*.[150]

V. CONCLUSION

Plaintiffs use the class action device to reduce the number of resources devoted to litigating and settling claims against wrongdoers. Moreover, class certification provides plaintiffs with an efficient method to seeking damages from defendants. The Fifth Circuit's decision in *Oscar* creates a formidable obstacle for plaintiffs to certify a class in a securities fraud case. Although the Second Circuit attempts to distinguish itself from the Fifth Circuit, it nonetheless has the same practical effect of depriving plaintiffs their right to trial by jury permitting courts to resolve the merits at the class certification stage. The Seventh Circuit and Supreme Court precedent has long recognized that a district court may not evaluate the strength of the merits, but rather whether plaintiffs have satisfied all the requirements for Rule 23 class certification.

150. *See Basic*, 485 U.S. at 224; *Eisen*, 417 U.S. at 178; *Schleicher*, No. 09-2154 at 13.

SECURITIES & EXCHANGE COMMISSION V. TAMBONE: DIMINISHING LIABILITY FOR UNDERWRITERS AND SECONDARY ACTORS IN SECURITIES FRAUD

*Diane Gesualdi**

INTRODUCTION

In the wake of the country's recent financial scandals and economic crisis, security fraud cases have escalated to new heights.[1] As the public demands answers, the critical "secondary actors" including underwriters, lawyers, and bankers, increasingly share the blame.[2] These secondary actors quite often play an integral role in the mounting securities fraud litigation.[3] The influence of these specialists remains strongly persuasive as 51% of investors owning individual stocks claim that they relied on the advice of such professionals.[4]

After the stock market crash of 1929, Congress sought to remedy a similar financial crisis by federalizing securities through the Securities Act of 1933 and the Securities Exchange Act of 1934.[5] The forefront of these measures centered on antifraud legislation codified in §10(b) under the 1934 Act.[6] The objective of §10(b) holds that it is unlawful for a person to "use or employ" in connection with securities "any manipulative or deceptive device."[7] In 1942, the Securities and Exchange Commission ("SEC") utilized

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* Diana Gesualdi is a second year law student at Brooklyn Law School. She is an active member of Brooklyn Law's Journal of Law and Policy and the Appellate Moot Court Team.

1. Ronald J. Colombo, Comment, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 38, 39 (2009). [R. 16.6.2].

2. *Id*. at 38. [R. 16.7].

3. *Id*. [R. 16.7].

4. Paula J. Dalley, Comment, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 61, 65 (2007). [R. 16.6.2].

5. Colombo, *Securities Fraud*, 61 ALA. L. REV. at 40. [R. 16.7].

6. *Id*. [R. 16.7].

7. 15 U.S.C.A. § 78j (West 1934). [R. 12.3].

its power under §10(b) and promulgated Rule 10b-5(b),[8] which states that it remains unlawful for an individual to "make any untrue statement of material fact" when dealing with the purchase of a security.[9]

The reasoning behind securities legislation remains well-supported by various commentaries. By requiring securities disclosure and federal involvement in securities fraud, such legislation combats the ineffective "command and control" techniques aimed at financial punishment.[10] Federalized security regulation also promotes individual choice for investors and increases public confidence.[11] Evidence also shows that disclosure though securities regulation can improve corporate governance and allocate directors with more information to evaluate the strengths and weaknesses of their companies.[12]

In the case of *Securities & Exchange Commission v. Tambone,* the first circuit solidified a dangerous meaning to text of Rule 10b-5(b) regarding securities fraud.[13] In *Tambone,* the court held that the definition of to "make any untrue statement" within Rule 10b-5(b) does not include a duty of underwriters[14] to imply the truthfulness of the terms within their prospectuses[15] for investors.[16] The court based its holding on the ordinary meaning of the text as well as alleged Supreme Court precedent.[17]

The *Tambone* decision departed from the intended usage and meaning of Rule 10b-5(b) within §10 of the Securities Exchange Act. This comment

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8. Colombo, *Securities Fraud*, 61 ALA. L. REV. at 40. [R. 16.7].

9. 17 C.F.R. § 240.10b-5(b) (1934). [R. 12.2.1].

10. Dalley, *Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. at 62. [R. 16.7].

11. *Id*. [R. 16.7].

12. *Id*. at 64. [R. 16.7].

13. *Sec. & Exch. Comm'n v. Tambone,* 597 F.3d 3,4 (1st Cir. 2010) (en banc). [R. 10.4, 10.6.1, 10.2.2].

14. An underwriter is defined as a person who has purchased a security from an issuer with a view to offer or sell that security for the issuer. 15 U.S.C.A. § 78c (West 1934). [R. 12.3].

15. A prospectus is defined as any notice, circular, letter, or communication which offers a security for sale. 15 U.S.C.A. § 78c. [R. 12.9].

16. *Tambone,* 597 F.3d at 4. [R. 10.9].

17. *Id*. [R. 10.9].

argues that by giving such a perverse meaning to Rule 10b-5(b), securities fraud will increase as the duty of underwriters now remains minimal at most. In order to solidify this claim, this comment will explore the likely result of *Tambone's* holding. Part I of this comment describes the facts and background of the *Tambone* case. Part II examines the textual reasoning of *Tambone* and illustrates a more reasonable alternative approach based on such reasoning. Finally, Part III illustrates the impact this reasonable alternative bears on Supreme Court precedent under *Central Bank of Denver v. First Interstate Bank of Denver.*

I. THE FACTS OF *TAMBONE*

The defendants, James Tambone and Robert Hussey, were senior executives at Columbia Funds Distributor, a registered broker-dealer.[18] James Tambone served as the Co-President of Columbia Distributor from 2001 to 2004 and Robert Hussey served as the managing director of national accounts for Columbia Distributor from 2002 to 2004.[19] Columbia Distributor acts a principal underwriter and vital marketer of roughly 140 mutual funds.[20] In order to sell their shares, Columbia Distributor disseminates their prospectuses to investors.[21] Columbia Management Advisors remains responsible for the representations contained in such prospectuses.[22]

The central issue of this case revolves around a concept known as "market timing" within the prospectuses utilized by the defendants. Market timing is an industry practice of frequent buying and selling of shares of a single mutual fund.[23] Although the practice itself is not illegal, it is commonly barred due to its ability to harm other investors.[24] As noted in the case *In Re Mutual Funds Investment Litigation*, market timing can harm

18. *Id*. [R. 10.9].

19. *Id*. [R. 10.9].

20. *Id*. [R. 10.9].

21. *Id*. [R. 10.9].

22. *Id*. Columbia Management Advisors Inc. acts as Columbia Fund's sponsor and is a wholly-owned subsidiary of Columbia Management. [R. 10.9].

23. *Id*. [R. 10.9].

24. *Id*. [R. 10.9].

investors by "diluting the value of shares" and escalating transaction costs.[25] The Columbia Funds' prospectuses addressed the issue of market timing by restricting the number and frequency of "round trips" for investors.[26] Additionally, in a 1999 prospectus for Acorn Fund Group, the prospectus language expressly stated that funds within the group "do not permit market timing" and have adopted means for eradicating this practice.[27] By 2003, the strict prohibitive language of market timing was included in all Columbia Funds prospectuses.[28] The defendant Hussey was deeply involved in these efforts as he co-chaired an internet working group in 2000 designed to "detect and deter" market timing within the Columbia Funds.[29] Despite this, the SEC claims that the defendants jointly and severally entered into, approved, and allowed arrangements for preferred customers to engage in market timing.[30]

Based on the defendant's approval of market timing, the SEC alleges in its complaint that the defendants violated both the Securities Act of 1933 and the Exchange Act. [31] Specifically, the complaint alleged that the defendants violated §17(a) of the Securities Act as well as §10(b) and Rule 10b-5(b) of the Exchange Act.[32] The center of the *Tambone* appeal involves the debate over the Rule 10b-5(b) claim.[33] The SEC claims that the defendants "made" false statements of material facts under Rule 10b-5(b) by utilizing the prospectuses in their sales efforts, knowing or recklessly addressing the false market timing language.[34] Additionally, the SEC claims that the defendants impliedly "made" false representations to investors in believing that the

25. *In re Mutual Funds Inv. Litig.*, 566 F.3d 26, 28 (4th Cir. 2009). [R. 10.4, 10.2.2].

26. *Tambone,* 597 F.3d at 4. [R. 10.9].

27. *Id*. [R. 10.9].

28. *Id*. at 5. [R. 10.9].

29. *Id*. at 4. As a result of Hussey's internet working group, each of the member funds were urged to take a strong stance against market timing in the future prospectuses for the company. [R. 10.9].

30. *Id*. at 5. [R. 10.9].

31. *Id*. at 4. [R. 10.9].

32. *Id*. at 5. [R. 10.9].

33. *Id*. [R. 10.9].

34. *Id*. [R. 10.9].

representations on market timing in the prospectuses were truthful.[35] The court refers to this claim as an "implied statement theory" that rests on the belief that securities professionals in offerings have a "special duty" to investigate the reasonable basis for the truthfulness in their prospectuses.[36]

On May 16, 2006, the SEC filed their complaint against the defendants in the United States District Court for the District of Massachusetts.[37] The District Court granted the defendant's motion to dismiss.[38] In regards to the Rule 10b-5(b) claim, the court applied a "bright line" test and held that the SEC claim on the use of the prospectuses remained too conclusive to satisfy the requirements of the Federal Rule of Civil Procedure 9(b) for fraud and found the other arguments unconvincing.[39] A divided Court of Appeals panel reversed the dismissal of all the claims.[40] The panel majority agreed with the SEC on the implied representation theory of underwriters regarding the truthfulness of their prospectuses.[41] The defendants consequentially filed petitions for en banc review and the panel ordered a rehearing on the Rule 10b-5(b) issues.[42] The en banc panel consequentially dismissed the SEC's Rule 10b-5(b) claim.[43] The panel based its decision on the rejection of any implied duty for underwriters regarding the truthfulness of their prospectuses and interpreted Rule 10b-5(b) according to a textual interpretation and case precedent.[44]

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35. *Id*. at 6. [R. 10.9].

36. *Id*. The majority notes that underwriters do have "special" duties but none that are consistent with those responsibilities outlined by the SEC or dissent. *Id.* at 12. [R. 10.9].

37. *Id*. at 5. [R. 10.9].

38. *Id*. [R. 10.9].

39. *Id*. [R. 10.9].

40. *Id*. at 6. [R. 10.9].

41. *Id*. [R. 10.9].

42. *Id*. [R. 10.9].

43. *Id*. at 12. Furthermore, the SEC's 17(a)(2) and "aiding and abetting" claims were remanded to the District Court for further proceedings. [R. 10.9].

44. *Id.* at 4. While not the focus of this comment, the court also noted that a ruling for the plaintiffs would pave the way for lawsuits against securities professionals not in special fiduciary relationships. *Id*. at 11. [R. 10.9].

CASE HISTORY PRIOR TO *TAMBONE*

The decision in *Tambone* regarding Rule 10b-5(b) and the liability for secondary actors in securities fraud have been a matter of debate in case law. In 1994, the Supreme Court case *Central Bank* held that private plaintiffs are permitted to bring suit under Rule 10b-5(b) for "primary violations" only.[45] The Court went against hundreds of judicial and administrative proceedings with this holding.[46] However, Congress then amended the Exchange Act to proclaim that the SEC can bring suit against "aiders and abettors," who might commonly fall under the title of "secondary violators."[47] This holding significantly ties into *Tambone* as the majority believes that the SEC definition of "make" within Rule 10b-5(b) constitutes the behavior of aiders and abettors.[48] The court states the SEC definition, therefore, blurs the line between primary and secondary violations that remains important for private individuals and therefore would not be in line with Supreme Court precedent.[49]

In 2009, the fourth circuit explored second party liability in the case *In Re Mutual Funds Litigation*.[50] In their decision, despite the involvement of private plaintiffs, the court found a sufficient claim against Janus Capital Management ("JCM") under primary, not secondary, liability as authorized by *Central Bank*.[51] In *Mutual Funds,* certain shareholders alleged JCM was responsible for "misleading statements" in their prospectuses regarding market timing.[52] The prospectuses stated that market timing was discouraged and there would be measures to deter such behavior.[53] However, fund managers like JCM permitted such market timing to continue for years.[54]

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45. *Id*. at 9 (citing *Cent. Bank of Denver v. First Interstate Bank of Denver,* 511 U.S. 164 (1994)). [R. 10.9, 10.6.2].

46. Colombo, *Securities Fraud*, 61 ALA. L. REV. at 44. [R. 16.7].

47. *Tambone,* 597 F.3d at 9. [R. 10.9].

48. *Id.* at 10 (citing 17 C.F.R. § 240.10b-5(b)). [R. 10.9, 10.6.2].

49. *Id.* at 10. [R. 10.9].

50. *Mutual Funds,* 566 F.3d at 27. [R. 10.9].

51. *Id.* [R. 10.9].

52. *Id.* [R. 10.9].

53. *Id.* [R. 10.9].

54. *Id.* at 28. [R. 10.9].

This case illustrates that the activities of secondary "actors" are not necessarily secondary in liability.

II. A CRITIQUE OF *TAMBONE*

A. TEXTUAL MISCONSTRUCTION

Despite attempting to construe Rule 10b-5(b) under an evaluation of a common textual interpretation, the court took an unfortunate digression from the main purpose of §10.[55] Since the word "make" is not expressly defined within the rule, the court looked to accepted canons of construction for its appropriate meaning.[56] In particular, the court utilized Webster's Third Dictionary and proclaimed that the word "make" includes phrases such as "create or cause."[57] Although "make" can undoubtedly be defined with such words, the court blatantly ignores the plethora of other meanings under acceptable canons of construction. In his dissent, Justice Lipez notes that quite commonly the definition of "make" includes words like "deliver" or "put forth."[58] In addition, common sense illustrates that one can always "make" a statement through his or her conduct alone.[59] The court ignores such interpretations and simply holds that since underwriters do not "create" or "cause" the wording in their prospectuses, the SEC definition can hold no legal weight.

Taking their interpretation a step further, the court then looks to the meaning of Rule 10b-5(b) in conjunction with the main §10(b) wording of the Exchange Act of 1934. The court observes that §10(b) grants the SEC broad authority to act against conduct that may "use" or "employ" a means of deception in securities fraud.[60] Instead of viewing such language as indicative of the section's overall purpose, the court merely focuses on the distinct word choice. The court finds the difference of word choice between §10(b) and Rule 10b-5(b) to be vital in its interpretation.[61] Since the codes

55. *Tambone,* 597 F.3d at 7. [R. 10.9].

56. *Id.* [R. 10.9].

57. *Id.* [R. 10.9].

58. *Id.* at 19 (Lipez, J., dissenting). [R. 10.9 (b)(i)] .

59. *Id.* [R. 10.9].

60. *Id.* at 7 (majority opinion). [R. 10.9 (b)(i)].

61. *Id.* [R. 10.9].

utilize different words throughout the section, the court believes it attaches significant meaning to any changes in word selection.[62] The SEC argues that the scope of §10(b) remains coextensive with the coverage in Rule 10b-5(b).[63] The dissent agrees and states that the wording "to make" a statement must be read in conjunction with the wording of §10(b) and the words "use" and "employ".[64] This meaning helps avoid the perverse interpretation found in *Tambone* that allows the main purpose of §10 to disappear simply due to a change in word options.

B. REASONABLE ALTERNATIVE

The holding in *Tambone* leaves underwriters with minimal liability for their vital role in the securities market. The *Tambone* court denies the SEC's definition of an "unprecedented duty" on underwriters and merely holds that these professionals simply have a duty to investigate the "nature and circumstances" of their offerings.[65] After declaring that underwriters are entrusted with such a duty, the *Tambone* court does not elaborate further. In his concurring opinion, Justice Boudin states that securities professionals cannot be expected to represent the "entire content" of their prospectuses.[66] The concurring opinion also worries that declaring such a duty on these professionals will open the floodgates[67] and "virtually anyone" involved in the underwriting process may be held liable. [68]

The statements by the majority and concurring justices of *Tambone* ignore the unique and pervasive role that underwriters play in the securities market. Underwriters play an "essential role" in the sale and marketing of

62. *Id.* at 8. [R. 10.9].

63. *Id.* [R. 10.9].

64. *Id.* at 18 (Lipez, J., dissenting). [R. 10.9 (b)(i)].

65. *Id.* at 11 (majority opinion). [R. 10.9 (b)(i)].

66. *Id.* at 13. (Boudin, J., concurring) [R. 10.9 (b)(i)].

67. *Id.* at 14. The dissent vehemently disagrees with the notion that such a finding would open the litigation floodgates and believes that private litigants will be filtered through the strict requirements of Federal Rule 9(b) and the additional steps required for private plaintiffs, which include reliance, economic loss, and causation. *Id.* at 23 (Lipez, J., dissenting). [R. 10.9 (b)(i)].

68. *Id.* at 14 (Boudin, J., concurring). [R. 10.9 (b)(i)].

mutual funds to public investors.[69] These underwriters have a "unique" position that enables them to "discover…essential facts" about the offerings they put forth.[70] Congress has even mandated that underwriters "exercise diligence" in their roles.[71] Investors rely on underwriters to represent these investigations and seek their "reputation…and expertise."[72] The dissent holds that underwriters have a "unique statutory duty" to provide their investors with such information.[73] Based on these findings, the SEC believes that the duty of underwriters includes a representation to investors that the statements within the prospectuses are "truthful and complete."[74] The dissent likens underwriters as playing the role of "trail guides" and not "mere hiking companions," implying their "primary" and vital role in the securities market.[75]

Based on the unique duty of underwriters in the securities market, the courts should impose a bright-line rule holding underwriters responsible for the truthfulness of their prospectuses. At present, it is commonly stated that underwriters have a duty in the confirmation of the "accuracy and completeness" of the prospectuses.[76] If the majority ruling in *Tambone* remains precedent, underwriters could remain aware of the faulty representations in their prospectuses and yet not be held liable.[77] By holding underwriters to a higher level of scrutiny, Rule 10b-5(b) is also clarified. If underwriters must represent the truthfulness of their prospectuses, any false statements within that prospectus can either be held as a false statement "made" or "omitted" by an underwriter.

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69. *Id.* at 20 (Lipez, J., dissenting). [R. 10.9 (b)(i)].

70. *Id.* [R. 10.9].

71. *Id.* [R. 10.9].

72. *Id.* at 21. [R. 10.9].

73. *Id.* at 14. [R. 10.9].

74. *Id.* at 11 (majority opinion). [R. 10.9 (b)(i)].

75. *Id.* at 21 (Lipez, J., dissenting). [R. 10.9 (b)(i)].

76. *Id.* at 15. [R. 10.9].

77. *Id.* at 19. The dissent specifically struggles with a scenario in which an underwriter escapes liability even after he or she is aware the representations in a prospectus are false while the actual author of such a prospectus does not known of such alleged fraud. [R. 10.9].

III. DISTINGUISHING *CENTRAL BANK*

Tambone's final justification for its holding deals with alleged tension with the Supreme Court holding in *Central Bank.* The *Tambone* majority believes that the SEC definition of "make" remains incompatible with the Court's holding in *Central Bank.*[78] The holding in *Central Bank* revolves around primary and secondary liability, claiming that private plaintiffs are permitted only to bring suit under Rule 10b-5(b) for primary violations. The *Tambone* court believes that in holding underwriters liable for "making" false statements under Rule 10b-5(b), the SEC demands that those aiding and abetting be held to a standard of primary, rather than secondary liability.[79] Although this is not a matter of concern for the *Tambone* case,[80] the court stresses concern for the precedent of future private litigants. However, cases like *Mutual Funds Litigation* prove that alleging truthfulness of prospectuses is not always characteristic of secondary actor liability.[81] Due to the vital profession of underwriters in the securities market, their actions will often be viewed as "primary" rather than "secondary" in nature. As *Central Bank* notes, conduct can often determine whether an action may be labeled "primary" and there can always be multiple primary violators.[82]

After *Central Bank,* various circuits looked to effective means for finding liability of secondary actors in private securities litigation. Many circuits have subsequently settled on either the "substantial participation" or "bright line tests".[83] These tests have been utilized by courts to distinguish between primary and secondary violations of Rule 10b-5(b) for private plaintiffs.[84] The “substantial participation test” evaluates a person’s substantial participation or strong involvement in a fraudulent securities matter.[85] Arguably, much of the litigation involving underwriters will be

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78. *Id.* at 9 (majority opinion) (citing *Cent. Bank of Denver v. First Interstate Bank of Denver,* 511 U.S. 164 (1994)). [R. 10.9 (b)(i), 10.6.3].

79. *Id.* [R. 10.9].

80. *Id.* at 17 (Lipez, J., dissenting). “I agree that there is no need to choose between [the bright line or substantial participation test]…”. [R. 10.9 (b)(i)].

81. *Mutual Funds,* 566 F.3d at 27. [R. 10.9].

82. *Tambone,* 597 F.3d at 15 (citing *Cent. Bank of Denver v. First Interstate Bank of Denver,* 511 U.S. 164 (1994)). [R. 10.9, 10.6.2].

83. *Id.* at 17. [R. 10.9].

84. *Id.* at 10 (majority opinion). [R. 10.9 (b)(i)].

85. Colombo, *Securities Fraud*, 61 ALA. L. REV. at 46. [R. 16.7].

labeled "primary" under a substantial participation test due to the integral role underwriters play in the securities market.

The "bright line test" on the other hand, requires proof of a defendant's false statement.[86] This false statement must also be attributable to the defendant at the time of public dissemination.[87] This difficult approach remains popular in the tenth, second, and eleventh circuits.[88] Despite its popularity, commentators often criticize the bright line test for its perverse results.[89] The test can allow secondary actors to escape liability for fraudulent statements they know are false as long as such fraud is not directly communicated to the public.[90] Under this test, it remains unlikely that underwriters will face liability as their "false statements" may not be communicated to any public entity. However, despite the distinct results under the two primary tests, holding underwriters to a high standard for their prospectuses will not destroy the objective behind *Central Bank* and the vital line between primary and secondary liability will not be destroyed.

CONCLUSION

The holding of the *Securities & Exchange Commission v. Tambone* will result in the drastic reduction of liability for underwriters in securities fraud litigation. The decision erroneously interprets Rule 10b-5(b) against the main objectives of the code regarding the eradication of fraud in securities deals. By holding underwriters to a duty of truthfulness in their prospectuses, the court will address the primary and vital role of underwriters in securities fraud litigation. Finally, a heightened liability for underwriters will not disturb the holding in *Central Bank* as the line between primary and secondary liability will remain dependent upon the tests utilized by each circuit court.

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86. *Tambone,* 597 F.3d at 10. [R. 10.9].

87. *Id.* [R. 10.9].

88. Colombo, *Securities Fraud*, 61 ALA. L. REV. at 46. [R. 16.7].

89. *Id.* at 49. [R. 16.7].

90. *Id.* [R. 16.7].

Notes & Observations

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Bill Allen, et al. v. J. Roe Burton, Harbor Financial Services, LLC, Mona Kilgore Wooten, Morgan Stanley DW, Inc., Prudential Equity Group, LLC, and Wachovia Securities, LLC

FINRA Case No. 07-01716

Claimants hired Respondents to assist them in planning for retirement. Respondents recommended a strategy by which Claimants were convinced to take early retirement from Chevron, and to take distributions from their retirement plans under §72t. Claimants each had worked for Chevron for a period of anywhere between 25 and 35 years. All were high school educated, non professional hourly workers who had saved throughout their lives and were now making approximately $50,000 per year and had anywhere from $350,000 to $750,000 in their pension plans. The broker promised Claimants that 10% returns were easily generated with no risk to their principal and. She was also found to have "sold away" and made unauthorized transactions, as well as mismarking tickets as unsolicited.

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.

Prior to the arbitration hearing, Claimants dismissed their claims against Harbor Financial Services, LLC, Morgan Stanley DW, Inc. The Panel also granted Respondents' Motion to Dismiss three Claimants as to their claims against Respondents

Prudential Equity Group, LLC and Wachovia Securities; however, denied the Motion to Dismiss these claims against Respondent Mona Wooten. Respondent Wooten later filed bankruptcy and, accordingly, the claims against her were stayed. Later, the remaining Claimants dismissed their claims against Respondent J. Roe Burton. During the proceedings, the Panel granted a Motion to Dismiss Claimants’ claims of churning filed by

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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.

Respondent Prudential and Wachovia; however, denied the Respondents' Motion to Dismiss Claimants' failure to supervise claims. During the proceedings, the Chairperson's status also changed from Public to Non-Public. As such, the award was rendered by a Panel consisting of two Non-Public arbitrators and one Public arbitrator.

Claimants asserted the following causes of action: (1) unauthorized transactions; (2) unsuitable recommendations; (3) grossly negligent failures to supervise; (4) selling away; (5) selling unregistered securities; (6) gross misrepresentations and omissions; (7) churning; and, (8) self-dealing. Claimants requested rescission of all unauthorized transactions that produced a loss in their accounts and of every transaction of an unregistered or "private security" in their IRA accounts, plus 8% simple interest, exemplary damages, attorneys' fees, costs, and any other relief the arbitrators deemed appropriate.

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 Prudential and Wachovia liable, as follows:

- As to Claimant Bill Allen, the Panel ordered Respondents to pay compensatory damages in the sum of $154,000.00, plus punitive damages in the sum of $15,400.00 and attorneys' fees in the sum of $51,000.00.
- As to Claimant Raymond Boyd Beckham, the Panel ordered Respondents to pay compensatory damages in the sum of $144,000.00, plus punitive damages in the sum of $14,400.00 and attorneys' fees in the sum of $48,000.00.
- As to Claimant Reed A. Bond, the Panel ordered Respondents to pay compensatory damages in the sum of $144,000.00, plus punitive damages in the sum of $14,400.00 and attorneys' fees in the sum of $48,000.00.
- As to Claimant Richard E. Bosarge, Sr., the Panel ordered Respondents to pay compensatory damages in the sum of $158,000.00, plus punitive damages in the sum of $15,800.00 and attorneys' fees in the sum of $52,000.00.
- As to Claimant James Franovich, the Panel ordered Respondents to pay compensatory damages in the sum of $168,000.00, plus punitive damages in the sum of $16,800.00 and attorneys' fees in the sum of $55,000.00.
- As to Claimant Jimmie J. Gammage, the Panel ordered Respondents to pay compensatory damages in the sum of $116,000.00, plus

punitive damages in the sum of $11,600.00 and attorneys' fees in the sum of $38,000.00.

- As to Claimant Chester E. Golf, the Panel ordered Respondents to pay compensatory damages in the sum of $102,000.00, plus punitive damages in the sum of $10,200.00 and attorneys' fees in the sum of $34,000.00.
- As to Claimant James B. Gully, the Panel ordered Respondents to pay compensatory damages in the sum of $77,000.00, plus punitive damages in the sum of $7,700.00 and attorneys' fees in the sum of $25,000.00.
- As to Claimant Larry D. Hammonds, the Panel ordered Respondents to pay compensatory damages in the sum of $166,000.00, plus punitive damages in the sum of $16,600.00 and attorneys' fees in the sum of $55,000.00.
- As to Claimant Wilson T. Miller, the Panel ordered Respondents to pay compensatory damages in the sum of $39,000.00, plus punitive damages in the sum of $3,900.00 and attorneys' fees in the sum of $13,000.00.
- As to Claimant Clyde E. Moseley, the Panel ordered Respondents to pay compensatory damages in the sum of $87,000.00, plus punitive damages in the sum of $8,700.00 and attorneys' fees in the sum of $29,000.00.
- As to Claimant John E. Rogers, Sr., the Panel ordered Respondents to pay compensatory damages in the sum of $63,000.00, plus punitive damages in the sum of $6,300.00 and attorneys' fees in the sum of $21,000.00.
- As to Claimant Jimmie G. Schafer, the Panel ordered Respondents to pay compensatory damages in the sum of $35,000.00, plus punitive damages in the sum of $3,500.00 and attorneys' fees in the sum of $12,000.00.

The Panel stated that its award award of punitive damages was 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) and that its award of attorneys' fees was 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:

- Respondent J. Roe Burton: Robert B. McGinley, Jr., Esq., McDowell Knight Roedder & Sledge, L.L.C, Mobile, AL;

- Respondent Harbor Financial Services, LLC ("Harbor"): Sidney W. Jackson, III, Esq., Jackson, Foster & Graham, LLC, Mobile, AL;
- Respondent Morgan Stanley DW, Inc. ("Morgan"): Bruce Lewitas, Esq, Morgan Stanley DW, Inc., Chicago, IL;
- Respondents Prudential Equity Group, LLC ("Prudential"), Wachovia Securities, LLC ("Wachovia") and Mona Kilgore Wooten ("Wooten"): Retta Miller, Esq., Jackson Walker, L.L.P., Dallas, TX; however, during the evidentiary hearing, Respondent Wooten was represented by John N. Bolus, Esq., Maynard Cooper & Gale PC, Birmingham, AL.

Claimant's Expert: Bob Grosnoff, Grosnoff Litigation Consultants, LLC; Jon Lyman (excluded pursuant to Motion filed by Respondents Prudential and Wachovia)

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

Arbitrators: Cynthia Lee Traina (Non-Public Chairperson); Mark A. Myers (Public); George A. Sawyer (Non-Public)

This case is significant because it is an award of approximately $2.1 million in total relief, including more than $145,000 in attorneys' fees and $481,000 in punitive damages in a 72(t) case. The award is also noteworthy because at the time it was rendered, the Panel consisted of two Non-Public arbitrators and one Public arbitrator. Claimants also successfully demonstrated that netting losses was not allowed pursuant to *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

Ame Wauters, Camilla Rogers, and the Suzanne Rogers Special Needs Trust v. White Pacific Securities, Inc., et al.
FINRA Case No. 08-04499

Claimants were three sisters whose father had passed away and left them an inheritance that was shared equally by each of them. One of the sisters was classified as a dependent adult under the California Statutes. The respondent broker took all of their inheritance and invested the funds in various TICs and other Regulation D limited partnerships. The broker had the sisters sign paperwork that indicated that they were accredited investors when he knew that they were not. The dependent adult's funds were held in a trust fund. For a trust to be accredited it must have a net worth of $5,000,000 (not the same $1,000,000, as required for an individual) or the trustee had to be accredited. The trustee was not an accredited investor.

The broker also marked order tickets as unsolicited and tried to claim that the investments were diversified since they were in many different partnerships. Respondents also tried to net out the income that the claimants

had gotten in the form of distributions. The causes of action relate to the purchase of real estate investments in Southfork & Company; Orchard Hills, a division of Southfork & Company; DBSI; Woodlark Capital; and Evergreen REIT (the "Securities")

Claimants asserted the following causes of action: (1) misrepresentations of material facts and/or omissions of material facts; (2) breach of fiduciary duty; (3) negligence; (4) unsuitable investments; (5) financial abuse as defined by Welf & I.C. §15610.30; (6) violations of federal securities laws; and (7) failure to supervise under the principles of *respondeat superior.* In the Statement of Claim, Claimants requested (1) Rescission of the purchase of the Securities; (2) Restitution of the amounts paid for the Securities; (3) Compensatory damages according to proof but at a minimum, $606,400.00 in principal, plus accrued interest and well-managed portfolio profits that would have been earned had the investments been properly managed; (4) Punitive or exemplary damages; (5) Pre- and post-award interest; (6) Costs including attorneys' fees; (7) Treble damages; and, (8) Other and further relief as this Panel may deem just and proper. Prior to the arbitration hearing, Claimants dismissed Respondents McCandless and Groth.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses.

Award: The Panel denied Claimants' claims against Respondent Liu; however, found that Respondents White Pacific Securities, Inc., Patrick S. Nelson, Robert T. Angle, and Arthur M. Quintero were jointly and severally liable and ordered these Respondents ("Respondents") to pay Claimants as follows:

- As to Claimant Ame Wauters, the Panel ordered Respondents to pay Claimant $130,000 in compensatory damages, plus post-judgment interest at 10% per annum.
- As to Claimant Camilla Rogers, the Panel ordered Respondents to pay Claimant $200,000 in compensatory damages, plus post-judgment interest at 10% per annum.
- As to Claimant Suzanne Rogers Special Needs Trust, the Panel ordered Respondents to pay Claimant compensatory damages in the sum of $660,000.00, which represented an award of treble damages, plus post-judgment interest at 10% per annum and attorneys' fees in the amount of $55,800 pursuant to Welfare & Civil Institutions Code § 15657.
- Respondents were further ordered to pay Claimants' costs of $7,127.00; Claimants' legal retainer fees of $1,500.00, Claimants' expert witness fees of $37,482.00, and Claimants' non-refundable filing fee of $600.00.

Claimants' Counsel: Val D. Hornstein, Esq., Hornstein Law Offices, P.C., San Francisco, California.

Respondent's Counsel: Respondents, White Pacific Securities, Inc. ("WPS"), Patrick S. Nelson ("Nelson"), Robert T. Angle ("Angle"), Peilee Liu ("Liu"), and Arthur M. Quintero ("Quintero"), were represented by: Kevin L. Wheeler, Esq., Duckor Spradling Metzger & Wynne, San Diego, California; Respondents M. Sean McCandless and Eric W. Groth appeared *pro se*.

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

Respondent's Expert: Alan Rockler

Arbitrators: Fred. D. Butler, J.D. (Public Chairperson); Mary Margaret Bush (Public); Paul J. Dubow (Public)

This case is significant because the award represents a full award of losses to Claimants Ame Wauters and Camilla Rogers, as well as an award of treble damages for Claimant Suzanne Rogers, a dependent adult, plus attorneys' fees and costs. Claimants also successfully demonstrated that netting losses was not allowed pursuant to *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

Frank L. Flautt Revocable Trust, et al. v. Morgan Keegan & Company Inc.
FINRA Case No. 09-02853

Claimants were sold various Morgan Keegan bond funds, including Regions Morgan Keegan Select High Income Class-A Fund, the Regions Morgan Keegan Advantage Income Fund, the Regions Morgan Keegan Multi-Sector High Income Fund, the Regions Morgan Keegan Select High Income Class-C Fund, and the Regions Morgan Keegan Select High Income Class—C Fund. In their Statement of Claim, Claimants requested compensatory damages of $1,250,000.

Claimant asserted the following causes of action: (1) misrepresentations and omissions, common law fraud; (2) breach of fiduciary duty; (3) unsuitable investments; (4) negligence; (5) failure to supervise; (6) breach of contract; (7) vicarious liability; and, (8) violation of FINRA rules.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses.

Award: The panel found Respondent liable, and ordered them to pay Claimant: (1) compensatory damages in the amount of $1,825,517.00; (2) pre-judgment interest at the rate of 11% for the year 2008, 8% for the year 2009, and 6% for the year 2010; and, (3) reimbursement of the $600.00 non-refundable portion of the claim filing fee paid by Claimants.

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

Respondent's Counsel: John Golwen, Esq., Michael Brady, Esq., and Ricardo Gonzalez, Esq., Bass, Berry & Sims PLC, Memphis, Tennessee.

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

Respondent's Experts: Kjell Ekdahl and John West, West Consulting, LLC.

Arbitrators: Richard W. Epstein (Public Chairperson); Martin P. Bergman (Public); James E. Edwards (Non-Public)

This case is significant because it represented a nearly full award of capital losses plus pre-judgment interest in Claimants' accounts in a case in which Morgan Keegan never offered a pre-hearing settlement. In addition, Claimant's counsel noted that their use of regulatory documents in the arbitration made a significant difference.

Alvin Kling and Pearl Kling, individually and as trustees of the Alvin Kling Revocable Trust U/A 9/1/93 and the Howard Gary Kling Revocable Trust v. Sanford C. Bernstein & Co., LLC

FINRA Case No. 09-04900

Claimants were an elderly couple in their 80's who entrusted their life savings of approximately $800,000 to Respondent – on a discretionary basis – after Mr. Kling had several strokes and was diagnosed with cancer. The Klings expressed an investment objective of income, and the last thing that they could afford was a significant risk to their principal. Respondent, however, failed to recommend and ensure suitable asset allocations for the Klings, exposing over 75% of the Klings' life savings to highly volatile equities markets in 2007 and 2008, despite its clients' elderly status, failing health, and financial needs.

Respondent contended that the Claimants signed letters authorizing asset-allocation changes to increase equity holdings. But none of those letters contained any statement by Respondent that the new allocations were more risky than the previous allocations, or that the Claimants were making the changes against the advice of Respondent. But the documents produced by Respondent do make clear one extremely important point: the Claimants reached out to Respondent on numerous occasions in 2007 and 2008 to express concern about the safety of their life savings. Had Respondent's financial advisors been more experienced, they would have understood that the Claimants, in fact, were pleading for help in protecting their life savings.

But, because both of the advisors were mere “rookies” – having only recently passed their respective Series 7 examinations in 2006 and 2007, having never experienced a down market, and (as reflected by their respective Performance Reviews) “still developing knowledge and expertise of the business and technical expertise” – neither one of them understood how to interpret those pleas. Thus, rather than reduce the Claimants’ risks, Respondent’s novice brokers in fact exacerbated the risks by exposing ever-increasing amounts of the Claimants’ life savings to highly volatile equities markets.

Claimants ultimately lost nearly $300,000 of their life savings. Based upon a “well-managed” portfolio theory, their damages totaled $225,000, which is the amount that the Claimants requested the Panel award them.

Claimant asserted the following causes of action: (1) failure to treat Claimants in a just and equitable manner; (2) breach of contract; (3) breach of fiduciary duty; (4) common law fraud; (5) fraudulent misrepresentation; (6) negligence; (7) negligent supervision; (8) negligent misrepresentation; and, (9) gross negligence. The causes of action relate to the purchase of various, unspecified equity stocks in Claimants' accounts. In the Statement of Claim, Claimants requested compensatory damages of $300,000.00, plus pre-judgment interest, punitive damages, and such other and additional relief as the Panel deemed appropriate. At the close of the hearing, Claimants requested compensatory damages in the amount of $228,000.00.

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

Award: The panel found Respondent liable for the causes of action of breach of contract and breach of fiduciary duty, and ordered Respondent to pay Claimants $183,000.00 in compensatory damages.

Claimants' Counsel: Jared A. Levy, Esq., Dimond Kaplan & Rothstein, P.A., West Palm Beach, Florida

Respondent’s Counsel: Andrew W. Robertson, Esq., Milbank, Tweed, Hadley & McCoy, LLP, New York, New York

Claimant’s Expert: Sean Kelly, Kelly & Associates (testified regarding suitability and damages)

Respondent’s Expert: None

Arbitrators: Michael J. Quarequio (Public Chairperson) and Philip L. Manczak (Public). The Non-Public arbitrator recused himself 20 days prior to the arbitration hearing due to a conflict and the parties agreed to proceed with two public arbitrators only.

This case is significant because it represents an award of approximately 80% of damages in an asset allocation case. It is also significant to note that

this award was rendered by a panel consisting of two public arbitrators (no non-public arbitrator) and that Respondents' counsel rebuffed settlement discussions because he had previously won three similar cases.

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 Peter J. Mougey, pjm@levinlaw.com, Ryan Bakhtiari, rbakhtiari@aol.com or Robin S. Ringo, rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *Release No. 34-63223/SR-FINRA-2010-054- Proposed Rule Change to Extend the Operational Date of SR-FINRA-2009-065* was submitted to the Financial Industry Regulatory Authority by Peter J. Mougey on December 27, 2010.

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 10-54, Disclosure of Services, Conflicts and Duties

Dear Ms. Asquith:

On behalf of the Public Investors Arbitration Bar Association ("PIABA")[1], I thank FINRA for the opportunity to comment on the concept proposal advanced in Regulatory Notice 10-54. The concept proposal would require member firms, at or prior to commencing a business relationship with a retail customer, to provide a written statement to the customer describing the types of accounts and services it provides, as well as conflicts associated with such services and any limitations on the duties the firm otherwise owes to retail customers.

We support the concept of the proposal in that it would require firms to set forth in plain English a firm's accounts and services as well as associated conflicts of interest. However, in this electronic age where we are all bombarded with a deluge of information, FINRA must remain ever vigilant to assure that written disclosures are not used to avoid liability for misrepresentations and omissions by member firms. FINRA has long taken the firm stance that oral misrepresentations which contradict written disclosures may nullify the effect of the written disclosures and make the member liable for rule violation and civil damages.[2] This position is

1. PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, both former and current, who devote a significant portion of their practice to the representation of public investors in securities arbitrations.

2. *See* NASD Notices to Members 94-16, 04-30 and 05-59.

consistent with the long established SEC policy that broker dealers owe a special duty of fair dealing with their customers and the making of misrepresentations is directly contrary to those duties.[3] This initiative must not be used to erode existing policy.

We oppose the proposal to the extent it invites limitations on a firm's duties to an investor, as those duties are often determined by laws and regulations which are subject to anti-waiver provisions as well as the circumstances of the ongoing interactions between the firm and investor.

We do not believe such a disclosure should contain a section regarding the duties of the firm and broker. Such a section would appear to be nothing more than an attempt at a disclaimer of liability should a broker not live up to the expectations set through his or her actions and words. Rather than attempt to set forth the potential limitations on a broker's duties that may exist and the various circumstances that may give rise to those limitations, a uniform fiduciary duty should be established.

In general, PIABA supports disclosure of the types of accounts and services a firm offers, as well as conflicts associated with such services. PIABA opposes the inclusion of a disclaimer of duties owed by a broker and firm to an investor as well as any effort to undermine long standing FINRA policy regarding verbal misrepresentations and omissions. Pursuant to section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC is currently studying the effectiveness of the standards of care applicable to firms and brokers. Enacting disclosures should in no way alleviate the need to harmonize the duties owed by firms and brokers to investors. We urge FINRA to support the current initiative to adopt uniform fiduciary standards for broker dealers and their registered representatives.

Respectfully submitted,
Peter J. Mougey
President

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3. *See In Re Robert Foster*, 51 SEC 1211, Release No. 7077 (July 20, 1994), and *SEC v. Hasho*, 784 Fed. Supp. 1059, 1107 S.D.N.Y. 1992.

The following PIABA Comment Letter regarding *Release No. IA-3118/S7-23-07 – Temporary Rule Regarding Principal Trades with Certain Advisory Clients* was submitted to the Securities and Exchange Commission by Peter J. Mougey on December 20, 2010.

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

Re: File Number S7-23-07 Release No. IA – 3118 Temporary Rule Regarding Principal Trades with Certain Advisory Clients

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 temporary rule regarding principal trades with certain advisory clients. PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. Accordingly, our organization, its members, and their clients have a vested interest in the rules regarding investor protection and advisory regulatory compliance.

The temporary rule seeks to accommodate the interests of advisers to permit principal trading by advisers without the need to comply with the transaction-by-transaction disclosure and consent requirements for nondiscretionary accounts. The discussion of the proposed temporary rule notes that the Commission is required under section 913 of the Dodd-Frank Act to deliver its report to Congress no later than January 2011. Initially, the extension of the need to comply with the *Financial Planning Association v. SEC* decision, formerly known as the 'Merrill Lynch Rule*'* granted by the Commission, was for a oneyear extension to the rule's sunset period. Similarly, PIABA believes a one-year extension, rather than two years, is appropriate in this instance. One year will allow advisers and their firms to adapt to any uncertainty surrounding the Dodd- Frank study findings presented to Congress next month. There simply is no need to provide a two-year extension.

A one-year extension of the exemption strikes the proper balance between the concerns of investor protection and the burden of revised regulations. PIABA recommends that a one-year extension of the exemption be enacted. Thank you for your consideration.

Respectfully submitted,
Peter J. Mougey
President

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; Correction* was submitted to the Securities and Exchange Commission by Peter J. Mougey on December 14, 2010.

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

Re: SR-FINRA-2010-039 Amendment 1 to Proposed Rule Change to Adopt Rules 2090 (Know Your Customer) and 2111 (Suitability)

Dear Ms. Murphy:

Thank you for the opportunity to comment on Amendment1 to the Proposed Rule Change filed by the Financial Industry Regulatory Authority ("FINRA") to adopt FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). The rule proposal was initially filed with the Commission on July 30, 2010, and at that time, PIABA submitted a comment letter in general support of the rule proposal with the request that further attention be given to certain aspects of the proposal.

PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, both former and current, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. As stated previously, we believe the proposed rules are a step in the right direction to codify the suitability and know-yourcustomer standards for FINRA members. Additionally, we are pleased that the amendment which FINRA has filed now explicitly includes recommendations to hold within the purview of the suitability rule. However, we do believe that there remain concerns which were previously raised in our comment letter which remain unaddressed.

Proposed Rule 2090

PIABA supports the inclusion of the NYSE's "Know Your Customer" rule as part of proposed Rule 2090. This inclusion will provide better protection to investors, as it requires the firms to use diligence to know and to retain essential facts concerning every customer. However, PIABA remains concerned that the proposed rule does not require the firms or the brokers to do anything more than learn this information. This lack of necessary proactive action is especially troubling if a customer transfers an account from one firm to another, but there are no recommendations ever made at the new firm. A customer may believe, rightly so, that if a firm is gathering all of this information when the customer is opening the account, that the firm is using the information for some purpose, such as reviewing the appropriateness of the portfolio that was transferred into the firm. 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 to 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. However, as the proposed rules are currently written, a broker may not have a duty absent an explicit recommendation.

Proposed Rule 2111

PIABA continues to support proposed Rule 2111 regarding suitability. Current NASD Rule 2310 applies to recommendations of a "purchase, sale or exchange of any security." As we have previously stated, 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. PIABA also supports the inclusion of the factors that are considered to be part of a customer's investment profile and the specification that a broker should consider these factors when making a recommendation.

We are also pleased with inclusion of the supplementary materials to proposed Rule 2111 for the most part, as they clarify the purpose of the rule. We welcome the inclusion, through the amendment, of Supplementary

Material .02, which prevents a member or associated person from disclaiming responsibility under the rule. Additionally, Supplementary Material .03 has been amended so that the phrase "investment strategy" includes "an explicit recommendation to hold a security or securities." Recommendations to hold are important components of investment strategies and are properly included within the definition of the term. We are puzzled as to why the term "explicit" is used before recommendation in this context when it is not used in other parts of the rule. We believe this phrasing may lead to confusion in the application of the rule and to attempts to make unintended distinctions.

Supplementary Material .04 has also been added with the amendment, requiring that an associated person have sufficient information about a customer before making a recommendation. This section makes it clear that there is an obligation on part of the broker to obtain and analyze the customer's investment profile as specifically delineated in the rule when a recommendation is being made.

As discussed in our previous comment letter, we support the inclusion of Supplementary Material .05, which identifies three suitability analyses that firms and brokers should consider when making a recommendation. Supplementary Material .06 seems that it should be intuitive, as brokers should not make a recommendation that is inconsistent with the customer's ability to meet such a financial commitment.

PIABA does not support the inclusion of the part of Supplementary Material .03, which specifically excludes a number of communications from Rule 2111's coverage if the communication does not include the recommendation of a particular security or securities. Brokers and firms often use asset allocation models, particularly when recommending a particular, overall portfolio strategy. The mere fact that the asset allocation model is not accompanied by a specific recommendation should not relieve a broker of his obligations under the rule. The broker should have an obligation to believe that the asset allocation model he is presenting to a customer is suitable for that customer. Moreover, general financial and investment information which includes an assessment of a customer's investment profile is specifically excluded. It seems counterintuitive to exclude from the coverage of the rule communications which are specifically tailored to customers and which those customers are clearly meant to rely upon.

The most glaring omission from Rule 2111 continues to be the omission of a 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 inclusion would provide a framework for brokers and firms to understand what would constitute a recommendation.

Also, we continue to believe that the proposed rule should be broadened 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" or "financial advisers." 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 to discuss with the client the suitability of such investments. 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 harmonize the duties among brokers and other financial professionals and to decrease public confusion concerning multiple professional designations.

Conclusion

PIABA supports the proposal to adopt the two new rules but requests that the Commission further examine the Supplementary Materials and consider other ways in which the rules can further provide for investor protection. Thank you for your consideration in this matter.

Respectfully submitted,
Peter J. Mougey
President

The following PIABA Comment Letter regarding *Pre-Dispute Arbitration: Title IX Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act* was submitted to the Securities and Exchange Commission by Peter J. Mougey on December 3, 2010.

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

Re: DF Title IX - Pre-Dispute Arbitration

Dear Ms. Murphy:

On behalf of the Public Investors Bar Association ("PIABA"), I thank the Commission for this opportunity to comment on pre-dispute arbitration clauses in furtherance of its review of such clauses pursuant to section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. Accordingly, our organization, its members, and their clients have a vested interest in the rules governing arbitration agreements.

> PIABA requests that the Commission further rulemaking that would eliminate pre-dispute arbitration agreements between retail customers and broker-dealers and their associated persons, but otherwise preserve the status quo with regard to a retail customer's ability to compel arbitration pursuant to current FINRA rules. In sum, we request that customers be given the choice to pursue their claims in either court or arbitration after a dispute arises. We believe this can be done by either the Commission or FINRA enacting a rule or issuing an interpretive memo indicating that it is inconsistent with the just and equitable principles of trade for a member to include a pre-dispute arbitration clause in account opening agreements with retail customers, to condition opening or maintaining an account on behalf of a retail customer on the acceptance of a pre-dispute arbitration agreement, or to enforce any existing pre-dispute arbitration agreements between retail customers and member firms.

The History of Customer Choice

The Landscape Pre-McMahon

The Federal Arbitration Act ("FAA") provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[1] The FAA "was designed to allow parties to avoid 'the costliness and delays of litigation,' and to place arbitration agreements 'upon the same footing as other contracts.'"[2] From the enactment of the FAA in 1925 until the Supreme Court's decision in *Wilko v. Swan*[3] in 1953, pre-dispute arbitration clauses were given full effect in the securities industry.

However, *Wilko* effectively changed the face of securities arbitration. In that case, the Supreme Court held that claims brought by investors under the Securities Act of 1933 (the "'33 Act") could not be referred to arbitration through the use of pre-dispute arbitration clauses. In reaching this conclusion, the Court cited several flaws in the arbitration process, which included concern for the ability of arbitrators to decide legal issues,[4] limited judicial review of arbitral decisions,[5] and the circumvention of the anti-waiver provision in the '33 Act.[6] Following *Wilko*, arbitration of claims brought under the '33 Act was strictly voluntary.

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1. 9 U.S.C.A. § 2.

2. *Scherk v. Alberto-Culver Co.,* 417 U.S. 506, 510-11, 94 S. Ct. 2449, 2453, 41 L. Ed. 2d 270 (1974) (quoting H.R.Rep.No.96, 68th Cong., 1st Sess., 1, 2 (1924)).

3. 346 U.S. 427, 74 S. Ct. 182, 98 L. Ed. 168 (1953) overruled by *Rodriguez de Quijas v. Shearson/Am. Exp., Inc.*, 490 U.S. 477, 109 S. Ct. 1917, 104 L. Ed. 2d 526 (1989).

4. *See id.* at 436 ("As their award may be without explanation of their reasons and without a complete record of their proceedings, the arbitrators' conception of the legal meaning of such statutory requirements as 'burden of proof,' 'reasonable care' or 'material fact' . . . cannot be determined.").

5. *See id.* at 436-37 ("In unrestricted submission, such as the present margin agreements envisage, the interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in federal courts, to judicial review for error in interpretation.").

6. *See id.* at 434-35 (Section 14 of the '33 Act voids any "'stipulation' waiving compliance with any 'provision' of the Securities Act. This arrangement to arbitrate is a 'stipulation,' and we think the right to select the judicial forum is the kind of 'provision' that cannot be waived under [Section 14] of the Securities Act.").

During the years after *Wilko*, courts interpreted the Supreme Court's decision as also applicable to claims brought under the Securities Exchange Act of 1934 (the "'34 Act").[7] Moreover, in 1979, the Commission issued a release to brokerage firms advising them that "[r]equiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade."[8] In 1983, Exchange Act Rule 15c2-2, "Disclosure Regarding Recourse to the Courts Notwithstanding Arbitration Clauses in Broker-Dealer Customer Agreements" was adopted "in order to address regulatory concerns arising from the inclusion in standard form customer agreements of pre-dispute arbitration clauses (i.e., agreements requiring customers to submit to arbitration all future disputes.)."[9] Thus, two layers of protection existed after *Wilko*: pre-dispute arbitration clauses would not be enforced by the courts as to federal securities law claims, and if a firm did include a pre-dispute arbitration clause, it had the duty of fully disclosing the clause to the customer prior to the customer signing the agreement.

Because *Wilko* affected claims brought under the federal securities laws but not state law claims, an issue arose as to whether cases containing both federal and state law claims should be heard together in court or be bifurcated with the state law claim being referred to arbitration. Until 1985, courts were generally split, with some requiring the claims to be tried

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7. *See e.g. Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979) ("While *Wilko* arose under only the Securities Act of 1933, its holding and rationale are equally applicable to cases arising under the Securities Exchange Act of 1934." (citing *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823, 827-29 (10th Cir. 1978); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 834-35 (7th Cir. 1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 (3d Cir.), Cert. den. 429 U.S. 1010, 97 S.Ct. 542, 50 L.Ed.2d 619 (1976); *Newman v. Shearson, Hammill & Co.*, 383 F.Supp. 265, 268 (W.D.Tex.1974); *Maheu v. Reynolds & Co.*, 282 F.Supp. 423, 426 (S.D.N.Y.1967); *Stockwell v. Reynolds & Co.*, 252 F.Supp. 215, 220 n. 2 (S.D.N.Y.1965)).

8. "Notice to Broker-Dealers Concerning Clauses in Customer Agreements which Provide for Arbitration of Future Disputes", 1979 WL 174165 (S.E.C. Release No. 34-15984), p. 4.

9. "Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements", 1987 WL 847512 (S.E.C. Release No. 34-25034), p. 1.

together[10] and others bifurcating the claims by referring the state law claims to arbitration.[11] In 1985, the Supreme Court decided *Dean Witter Reynolds, Inc. v. Byrd*.[12] In that case, a customer brought suit in federal district court alleging violations of both state and federal securities laws by his broker-dealer.[13] The broker-dealer moved to compel arbitration of the state law claims, which was denied by the district court and subsequently affirmed on appeal. The Supreme Court granted certiorari and overturned the appellate court's decision.[14] Although the Court recognized the issue of intertwining, and the effects it could have on a case, namely "arbitration of an 'intertwined' state claim might precede the federal proceeding and the factfinding done by the arbitrator might thereby bind the federal court through collateral estoppel" and that there may be "redundant efforts to litigate the same factual questions twice," the Court held that "the Arbitration Act requires district courts to compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums."[15] Hence, *Byrd* affirmed the validity of arbitration clauses as to state law claims, and in some cases, customers were forced to either pursue their claims in two forums, or to forego certain aspects of their claims.

In 1968, FINRA (then NASD) adopted the Code of Arbitration Procedure. Section 12 of the Code was entitled "Required Submission" and provided that, upon the demand of a customer, a member and associated person was required to submit any dispute, claim, or controversy to arbitration. Today this rule exists in substantially similar form as FINRA Rule 12200. Although brokerage firms were not permitted to enforce pre-dispute arbitration agreements with respect to federal securities law claims pursuant to *Wilko*, pursuant to FINRA rules, customers were able to compel brokerage firms to arbitrate any claims. From 1968 through today, in the absence of a pre-dispute arbitration agreement, customers have had the

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10. *See e.g. Shapiro v. Jaslow*, 320 F. Supp. 598 (S.D.N.Y. 1970) (denying the motion to compel arbitration and refusing to bifurcate the state and federal securities law issues).

11. *See e.g. DeHart v. Moore*, 424 F. Supp. 55 (S.D. Fla. 1976) (granting the motion to compel arbitration and bifurcating the state and federal securities law claims).

12. 470 U.S. 213, 105 S. Ct. 1238, 84 L. Ed. 2d 158 (1985).

13. *See id*.

14. *See id.* at 223-24.

15. *See id.* at 217.

option of choosing either court or arbitration to resolve their claims, and firms have no say in the choice.

Erosion of Customer Choice with McMahon

In 1987, the Supreme Court decided *Shearson/American Express v. McMahon*[16], which revisited the issue of whether pre-dispute arbitration clauses were enforceable pursuant to investor claims under the '34 Act. The Court effectively reversed decades of precedent that prohibited the enforcement of pre-dispute arbitration clauses in claims brought under the '34 Act and cited the increasing prevalence of arbitration in the securities industry as its basis.[17] The Court also addressed the concerns set out in the *Wilko* decision and found that "there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards is necessarily limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute," thus reinforcing the legitimacy of an arbitral award.[18]

However, *McMahon* was a 5-4 decision that resulted in a most significant dissenting opinion authored by Justice Blackmun.[19] Specifically, Justice Blackmun objected to the majority's decision on two bases. First, he noted that the majority erred in reading the *Wilko* decision as being decided solely on the basis of perceived inadequacy in the arbitration process.[20] Second, he criticized the majority's blind acceptance that the problems with arbitration cited in *Wilko* no longer exist.[21] With a prescient assertion that foreshadows the current state of affairs, he criticized Commission oversight of the securities arbitration process: "[T]he Court's complacent acceptance of the Commission's oversight is alarming when almost every day brings

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16. 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed. 2d 185 (1987).

17. *See id.* at 233 ("Thus, the mistrust of arbitration that formed the basis of the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time. This is especially so in light of the intervening changes in the regulatory structure of the securities laws.").

18. *See id.* at 232.

19. *See id.* at 242 (Blackmun, J., dissenting).

20. *See id.* at 249-50.

21. *See id.*

another example of illegality on Wall Street."[22] It is difficult to argue that Wall Street's conduct has improved in the years since *McMahon.*

Shortly after *McMahon*, the Supreme Court officially overruled the *Wilko* decision in *Rodriguez de Quijas v. Shearson/American Express*.[23] As a result of *McMahon* and *Rodriguez*, brokerage firms have the unhindered ability to compel arbitration of customer claims through the inclusion of a simple pre-dispute arbitration clause in all customer brokerage account agreements. The once voluntary submission to arbitration had become an industry mandate, leaving aggrieved customers with no other choice than to arbitrate their claims.

The Landscape After McMahon

When *McMahon* was decided, the Commission found in a survey that "98% of the margin accounts, 95% of the options accounts and 39% of the cash accounts" were subject to pre-dispute arbitration clauses.[24] This means that at the time, over 60% of accounts were not subject to pre-dispute arbitration clauses. In every one of these accounts, because of FINRA rules, customers were free to choose between court and arbitration if a dispute arose. The survey did indicate a movement toward placing these provisions

22. *See id.* at 265.

23. 490 U.S. 477, 109 S. Ct. 1917, 104 L. Ed. 2d 526 (1989).

24. Letter from SEC Chairman David Ruder to New York Stock Exchange, July 8, 1988, in ARBITRATION REFORM: HEARINGS BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE OF THE COMMITTEE ON ENERGY AND COMMERCE, U.S. HOUSE OF REPRESENTATIVES, 100TH CONGRESS, SECOND SESSION, ON MARCH 31, JUNE 9 AND JULY 12, 1988 (U.S. G.P.O., 1989), at p. 510. Similarly, James Buck, Sr. V.P. of the New York Stock Exchange, testified in that hearing: "Most firms do not require arbitration agreements for cash accounts. Only in the case of margin accounts where the customer is borrowing money do you find overwhelming use of these clauses." Id., at p. 533. *See also* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the NYSE, NASD, and AMEX Relating to the Arbitration Process and the Use of Pre-dispute Arbitration Clauses, 54 Fed. Reg. 21144, n.51 (May 10, 1989) [hereinafter *Self-Regulatory Organizations*] (stating that, at the time of *McMahon*, only 39% of broker-dealers mandated arbitration of customer disputes involving cash accounts). It is now widely believed that all brokerage agreements contain a pre-dispute arbitration provision requiring the investor to submit any and all claims to arbitration.

in cash account agreements. Commission Chairman Ruder testified to Congress[25]:

> I expressed vocally and vociferously my opposition to that trend. I believed then, and I believe now, that customer choice is an exceedingly important aspect of this industry and the movement apparently to push these clauses on the public so that they couldn't trade at all without them was in my mind simply terrible.

The industry responded by assuring the Commission that it had no intentions of imposing arbitration clauses in cash accounts and depriving American investors of any choice.[26] In essence, firms were accepting of the fact that customers could choose the forum in which they wanted to resolve their disputes. Based on these assurances at the time, the Commission decided not to seek legislation prohibiting pre-dispute arbitration clauses, although it could have if it believed that firms intended to deprive customers of choice.

Over the years this situation dramatically changed. Notwithstanding the concerns voiced by the Commission in 1988, little has been done to curb the widespread inclusion of pre-dispute arbitration clauses in customer account agreements. Although the industry assured the Commission that it had no intention of including such clauses in customer account agreements, today virtually every brokerage firm in America includes a mandatory arbitration provision in its new account documentation for every type of account. Practically speaking, the provisions are non-negotiable. The result is that if customers want to buy a stock or a bond or seek to participate in the capital markets in America, they must give up their Constitutional right to a jury trial by an independent and impartial judiciary and agree to mandatory arbitration. Of course, most customers do not realize this when they open their accounts. Many times, they are told by brokers that the new account documents are routine and must be signed in order to open an account with the firm.

The number and types of Americans who invest have also changed since the pre-*McMahon* years. The number of households holding stocks has

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25. *Id*., p.512, Testimony of July 12, 1988. Chairman Ruder also testified on June 1, 1988: "I fail to see why one should deny access to the securities market to those people who are unwilling to waive their disputes in advance. I think it's unfair." *Id.*, at p. 524.

26. *Id*., pp. 474, 514-516.

increased more than three-fold since the early 1980s.[27] Half of all U.S. households own shares of stock or equity mutual funds. Capital markets are no longer just for the wealthy; the stock markets hold the retirement hopes and financial security for Americans from all walks of life. Investors are increasingly older; indeed, seniors are the fastest-growing segment of investing consumers.[28] Seniors are also the most vulnerable to abuse by financial advisors and to unjust and unfair outcomes in mandatory arbitration.

Customer choice has been eroded in other ways as well. Today, the only remaining SRO-sponsored forum is FINRA. Requiring arbitration before a single forum is a dramatic change from the arbitration alternatives in place when *McMahon* was decided. At the time of *McMahon* there were at least ten different arbitration forums. Most stock exchanges and the Chicago Board of Options Exchange provided arbitration forums. Many arbitration clauses, and the rules of the American Stock Exchange, gave investors the option of avoiding arbitrating in an arbitration forum associated with the securities industry altogether by allowing arbitration before the American Arbitration Association. So while customers may have had to arbitrate in response to *McMahon*, they could still choose among various arbitration forums, including at least one that was entirely independent of the securities industry. Different forums had different rules, different policies, different administrators and, most importantly, different pools of arbitrators. These options were essential in attempting to obtain fair processes and just outcomes for customers.

> Now all these choices are effectively gone for customers. Over the last decade, we have seen a consolidation of the American securities markets, which culminated in the 2007 NYSE-NASD merger. Customers with pre-dispute arbitration clauses (virtually all customers) are forced into the only game left in town, an association run by an organization made up of securities firms. FINRA now has a total monopoly on investor arbitration. There is no competition, and there is no alternative. Twenty-three years ago, a defrauded customer could pursue claims in court, or choose between numerous arbitral forums. In a relatively short time span, America's savers and investors have seen their 'choices' dwindle to one.

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27. Investment Company Institute & Securities Industry Association, "Equity Ownership in America," (Nov. 2005), p. 1.

28. *Id.*, p. 17.

CONCERNS REGARDING MAINTAINING THE STATUS QUO

Perceptions of the System

In 2005, amid concerns about the fairness of the arbitration process, the Securities Industry Conference on Arbitration ("SICA") conducted a study of perceived fairness in the arbitration process.[29] It consisted of a survey that was sent to over 30,000 participants with questions assessing perception of the arbitration process. Particular emphasis was placed on the following: fairness of the SRO arbitration process; competence of arbitrators to resolve investors' disputes with their broker-dealers; fairness of SRO arbitration as compared to their perceptions of fairness in securities litigation in similar disputes; and fairness of the outcome of arbitrations.[30] Not surprisingly, the SICA study found that the overall perception of the securities arbitration process was negative.[31] Over sixty percent of customers perceived the process as unfair,[32] with nearly half perceiving arbitral panels as being biased.[33] And, most significantly, three out of every four customers found securities arbitration to be "very unfair" or "somewhat unfair" when compared with the judicial system.[34] Moreover, over one-third of customers confronted with a pre-dispute arbitration clause in the brokerage agreement were not aware of its existence.[35]

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29. *See* Barbara Black & Jill Gross, *Perceptions of Fairness of Securities Arbitration: An Empirical Study*, Report to the Securities Industry Conference on Arbitration (2008), *available at* http://www.publicjustice.net/Repository/Files/Perceptions%20of%20Fairness.pdf.

30. *See id.* at 1.

31. *See id.* at 3.

32. *See id.* at 45 (finding that approximately 63% of investors answered "Disagree/Strongly Disagree" when responding to the statement, "As a whole, I feel the arbitration process was fair").

33. *See id.* at 50 (finding that 47% of responses disagreed with the statement that "arbitration is conducted by the arbitrators in a way that is fair to all parties" and 44% disagreed with the statement that arbitrators conduct the arbitration without bias).

34. *See id.* at 47 (finding that 75.55% of customers found arbitration to be "very unfair" or "somewhat unfair" when compared to civil litigation).

35. *See id.* at 19 (stating that 37% of customers responded that they were unaware that their customer agreement contained a pre-dispute arbitration clause).

The SICA study demonstrates that the rationale set out in *McMahon* is flawed. *McMahon* supported its decision in part on the opinion that "we are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals should inhibit the enforcement of the [FAA] in controversies based on statutes."[36] *McMahon* rejected *Wilko*'s distrust of arbitration panels, stating that "the reasons given in *Wilko* reflect a general suspicion of the desirability of arbitration and the competence of arbitral tribunals – most apply with no greater force to securities disputes than to the arbitration of legal disputes generally."[37] The *McMahon* court trusted the integrity of the arbitration process; however, the results of the SICA study prove that there are inherent problems with the system. These problems are compounded by the fact that a disturbing number of customers were not even aware that they had consented to proceed in this system and to forego their right to a jury trial.

Customer Recovery Statistics

In 2007, Edward S. O'Neal and Daniel R. Solin published a study assessing customer recoveries in the securities industry.[38] The study compiled data from arbitrations conducted in the NYSE and NASD arbitral forums between the years 1995 and 2004.[39] Perhaps the two most striking conclusions arrived at in the course of the study were: (1) the "win percentage" published by arbitration providers is not an accurate reflection of how customers actually fare in arbitration; and (2) there is an increasing trend towards customers receiving less of their requested claims when the claim is brought against a top-twenty firm. Both of these findings undermine the claim of fairness in the current securities arbitration system.

The predominant "win percentage" calculation offered by FINRA takes into consideration solely whether the investor received any amount of monetary reward for its claim. For the purposes of industry statistics, a customer receives a "win" regardless of whether the award is $1 or

36. 482 U.S. at 226 (partially quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, at 626-27(1985)).

37. *See id.*

38. *See* Edward S. O'Neal & Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare* (2007).

39. *See id.* at 5.

$1,000,000. The authors advance that the "expected recovery percentage" would be a more accurate statistic in providing guidance in terms of assessing the likely outcomes in arbitration. The expected recovery percentage is achieved by multiplying the "win percentage" by the amount of the award as a percentage of the amount requested.[40] Accordingly, published statistics from arbitration providers do not paint an accurate picture of how investors actually fare in the arbitration process, thereby masking the true likelihood of success in the forum.

There is also an increasing trend towards the customer's expected recovery percentage decreasing as the size of the respondent-brokerage firm increases and as the size of the requested damages increases.[41] For example, if a customer were to bring a claim against one of the top-twenty brokerage firms requesting damages exceeding $250,000, the expected recovery percentage would range between 10-13%, while overall it is 26%. If the same customer were to bring a claim against the same top-twenty firm requesting damages of $100,000, the expected recovery percentage would range between 18-21%, as compared to 40% overall. Finally, if the customer brought a claim for less than $10,000 against the same top-twenty firm, the expected recovery percentage would be approximately 28% as compared to 37% overall.[42] Thus, the expected recovery percentage is a product of both the size of the claim as well as the size of the respondent firm. These variances in results may be explained in part by the impact repeat players, i.e. the large brokerage firms, may have on an arbitrator's decision, as well as the inclusion of industry arbitrators on three-person panels. Arbitrators may be influenced by their desire to be chosen as an arbitrator in future cases and the fear that a large award may prevent that from happening. Industry arbitrators may have additional pulls on their independence such as the desire for future employment at a firm appearing before them.

The Arbitration Fairness Act Congressional Findings

In April 2009, the Arbitration Fairness Act ("AFA") was introduced in Congress with the purpose of amending the FAA.[43] Section two of the

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40. *See id.* at 12.

41. *See id.* at 15.

42. *See id.* at 16.

43. *See* Arbitration Fairness Act of 2009, S. 931, H.R. 1020, 111th Cong. (2009).

proposed legislation includes seven findings that support the elimination of pre-dispute arbitration agreements:[44]

(1) The [FAA] was intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power.

(2) A series of United States Supreme Court decisions have changed the meaning of the Act so that it now extends to disputes between parties of greatly disparate economic power, such as consumer disputes and employment disputes. As a result, a large and rapidly growing number of corporations are requiring millions of consumers and employees to give up their right to have disputes resolved by a judge or jury, and instead submit their claims to binding arbitration.

(3) Most consumers and employees have little or no meaningful option whether to submit their claims to arbitration. Few people realize, or understand the importance of the deliberately fine print that strips them of rights; and because entire industries are adopting these clauses, people increasingly have no choice but to accept them. They must often give up their rights as a condition of having a job, getting necessary medical care, buying a car, opening a bank account, getting a credit card, and the like. Often times, they are not even aware that they have given up their rights.

(4) Private arbitration companies are sometimes under great pressure to devise systems that favor the corporate repeat players who decide whether those companies will receive their lucrative business.

(5) Mandatory arbitration undermines the development of public law for civil rights and consumer rights, because there is no meaningful judicial review of arbitrators' decisions. With the knowledge that their rulings will not be seriously examined by a court applying current law, arbitrators enjoy near complete freedom to ignore the law and even their own rules.

(6) Mandatory arbitration is a poor system for protecting civil rights and consumer rights because it is not transparent. While the American civil justice system features publicly

44. *See id.* at § 2.

accountable decision makers who generally issue written decisions that are widely available to the public, arbitration offers none of these features.

(7) Many corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals, including provisions that strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes. While some courts have been protective of individuals, too many courts have upheld even egregiously unfair mandatory arbitration clauses in deference to a supposed Federal policy favoring arbitration over the constitutional rights of individuals.

Findings one through three illustrate the concern that pre-dispute arbitration agreements are, notwithstanding the decision in *McMahon*, contracts of adhesion. Disparity in bargaining power in the contracting stage of a relationship undermines the voluntary nature of contracts. Pre-dispute arbitration agreements are so pervasive throughout the brokerage industry that it is virtually impossible for customers to open accounts without agreeing to waive their right to a trial by jury, before they even know the nature of their dispute. Customers do not have a meaningful opportunity to object to the inclusion of a pre-dispute arbitration clause in their account documents. Moreover, as demonstrated above by the SICA study, a number of customers do not even appreciate that they have signed a pre-dispute arbitration agreement.

Findings four through seven highlight the concerns of customers being pushed into a single arbitration forum which is run by an organization made up of the same firms they are suing. The findings of the O'Neal and Solin study illustrate the fear that industry control over the process has an effect on outcome. A customer has a smaller expected recovery percentage against a top-twenty firm, which presumptively brings more repeat business to the arbitration forum than other firms.[45] More generally, there is a concern that the presence of an industry arbitrator on an arbitration panel may affect the outcome of the hearing. FINRA is attempting to address this concern by proposing a rule that would give customers the option of having an all public panel.[46] However, as demonstrated by the results of the SICA study, there is

45. *See supra* note 38, at 16.

46. *See* FINRA news release, "FINRA Proposes to Permanently Give Investors the Option of All-Public Arbitration Panels", September 28, 2010, *available at* http://www.finra.org/Newsroom/NewsReleases/2010/P122178.

a widespread perception among customers that there is bias within the arbitration process that extends beyond the presence of an industry arbitrator on the panel.

There are some protections present in the securities arbitration process that are not present in other consumer arbitration forums. The Commission has approved rules in the past that impact a firm's ability to include pre-dispute arbitration clauses in customer agreements. For example, NASD Rule 3110 sets out specific requirements that firms must follow when including a pre-dispute arbitration clause in customer agreements.[47] Firms are required to highlight the pre-dispute arbitration clause as well as precede the clause with language explaining its practical effects on the parties.[48] Similarly, pre-dispute arbitration clauses cannot attempt to circumvent certain procedural safeguards, including: providing limitations on the rules of the self-regulatory organization; imposing limitations on the investor's ability to file a claim in arbitration; and preventing or limiting an arbitrator from rendering a particular award.[49] Moreover, these rules apply regardless of whether the underlying claim arises from a federal statute or state law. As such, it is clear that the Commission and FINRA have the ability to enact rules that are all encompassing with regard to claims brought by customers.

EUROPEAN LAW SUPPORTS ELIMINATION OF PRE-DISPUTE ARBITRATION AGREEMENTS

A number of foreign jurisdictions have eliminated or limited the use of pre-dispute arbitration clauses. For example, in 1993 the European Union issued Council Directive 93/13, which addresses unfair terms in consumer contracts.[50] The pertinent language of this legislation is as follows:

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47. *See generally* NASD Rule 3110(f).

48. *See e.g.* NASD Rule 3110(f)(1)(A) ("By signing an arbitration agreement the parties agree as follows: (A) All parties to this agreement are giving up the right to sue each other in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.").

49. *See* NASD Rule 3110(f)(4).

50 See Council Directive 93/13 (1993), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31993L0013:EN:HTML. "The Directive is horizontal and covers all business-to-consumer transactions including retail financial services, unless more specific legislation is applicable." "Commission Staff Working Document on the Follow Up in Retail Financial Services to the Consumer

> Article 2(b): 'consumer' means any natural person who, in contracts covered by this Directive, is acting for purposes which are outside of his trade, business or profession.
> Article 3(1): A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.
> Article 3(2): A term shall always be regarded as not individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of a pre-formulated standard contract.
> Article 3(3): The Annex shall contain an indicative and non-exhaustive list of the terms which may be regarded as unfair.
> Annex (q): excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions . . .

EU member states were required to achieve the purpose of the Directive, which is to "ensure that contracts concluded with consumers do not contain unfair terms."[51] The United Kingdom adopted the terms of EC 93/13 verbatim in the UK Unfair Terms in Consumer Contracts Regulations of 1999.[52] France implemented the directive of EC 93/13 in Section L, Article 132-1 of the French Consumer Code. The language used varies slightly from the language of the EC directive, stating that "unfair terms are deemed to be null and void" and defines as an unfair term: "canceling or impeding the institution of legal proceedings or means of redress by the consumer, in particular, by obliging the consumer to exclusively refer the case to an arbitration panel not covered by legal provisions…".[53] Germany has interpreted EC 93/13 more as a requirement of good faith and, thus, requires

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Markets Scoreboard", Report for the European Commission, n.76, September 22, 2009, *available at* http://ec.europa.eu/consumers/rights/docs/swd_retail_fin_services_en.pdf.

51. *See id.*

52. *See* The Unfair Terms in Consumer Contracts Regulations, Schedule 2(1)(q), *available at* http://www.opsi.gov.uk/si/si1999/19992083.htm.

53. *See* French Consumer Code, Section L, Article 132-1, *available at* http://195.83.177.9/upl/pdf/code_29.pdf.

that certain safeguards be utilized to protect parties entering into the typical standard form contract.[54]

Thus, there is support for elimination of pre-dispute arbitration agreements throughout Europe. Elimination of these agreements would put the US on even footing with other parts of the financial world, and should not restrict the ability of brokerage firms to compete effectively in the global marketplace.

TWO-WAY CHOICE IS UNFAIR TO CUSTOMERS

Despite its shortcomings, FINRA arbitration should be maintained as an option for customers. Indeed, if customers are allowed to choose between court and arbitration, thereby encouraging FINRA to address the perceived inadequacies with the forum, FINRA arbitration has the potential to be the fair and neutral forum which is necessary to comply with due process and ensure investor protection.

However, if two-way choice is adopted, i.e. if FINRA Rule 12200 is eliminated in its entirety, the default forum will be court. When the customer expresses an interest in arbitrating a claim, the industry defendant will have the ability to determine whether or not it should agree to arbitrate. The end result is that the industry will have the opportunity to assess its best interests in deciding whether a case should be arbitrated. However, there are cases that, from the customer's perspective, are appropriate for arbitration. Indeed, it is possible that, should investor choice be adopted, the vast majority of cases will still be submitted to FINRA arbitration instead of court. There are a number of reasons for this.

Cost

Arbitration has always been touted as an efficient, cost-effective way to resolve disputes. While the hearing fees, fees which would not attach in a court proceeding, can be fairly substantial for larger cases, arbitration allows the parties to avoid the time and expense associated with court discovery procedures. Interrogatories, a time-consuming endeavor in court, are not permitted in FINRA arbitration.[55] Absent a compelling reason, depositions are also not permitted.[56] A customer should be permitted to weigh the cost of

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54. *See* German Civil Code (BGB), Division 2, Section 305, *available at* http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html.

court discovery against the benefits of substantially lower court fees and court supervision, once the dispute arises.

Similarly, thanks in large measure to recent reforms, motions are strictly limited in arbitration. Pre-hearing motions to dismiss are discouraged and may be granted only for tightly circumscribed reasons; an improper motion to dismiss subjects the industry defendant to potential sanctions.[57] This ramification makes sense, as the customer is not entitled to the same discovery rights and procedural safeguards as he would get in court.

> In view of the streamlined nature of arbitration, a customer is able to retain an attorney for smaller cases and to pursue those claims in an efficient manner. In most cases (though not all), the firm has greater financial resources than the investor and is able to base its decision whether or not to arbitrate on the size of its war chest. With two-way choice, industry defendants would be able to refuse arbitration in order to make it uneconomical for customers to pursue smaller claims. In short, the industry can flex its economic muscle to the detriment of its own clients. This would be an appalling result for the small public investor.

Substantive Law/Rules

Arbitration is an equitable forum in which the technicalities that generate so much of the motion practice in court are put to the side. Indeed, arbitrators can allow recoveries for violations of SRO rules which are designed for the protection of customers, such as the suitability rule. In contrast, many courts deny a private right of actions for such rules violations or, if they consider the rules as evidence of a standard of care, may require expert testimony to establish the standard and the violation thereof. It is reasonable and fair that an arbitration forum exist where customers who have been injured by deviations from securities industry standards be allowed to recover for such violation.

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55. A party may propound requests for information, but such requests are limited in scope. FINRA Customer Code section 12507(a)(1) provides, in pertinent part: "Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute; such requests should be reasonable in number and not require narrative answers or fact finding. Standard interrogatories are generally not permitted in arbitration."

56. FINRA Code of Arbitration Procedure for Customer Disputes, Rule 12510.

57. FINRA Code of Arbitration Procedure for Customer Disputes, Rule 12504.

Time

Generally, arbitration leads to a quicker result than court proceedings. According to FINRA's statistics, the average turnaround time for cases filed in its forum has been about 12 months since the beginning of 2009. Most courts are unable to match this record. Arbitration is not dependent on a judge having availability in the court calendar. In arbitration, the parties have the ability to set a schedule for their case that meets their needs. Where an elderly investor desperately needs to replace funds lost through broker misconduct, the ability to get a case heard and decided quickly may be of great significance. Additionally, in 2004, FINRA instituted procedures for expediting cases involving senior or seriously ill customers, ensuring that these cases are handled as efficiently as possible.[58]

Finality

FINRA awards are rarely subject to reversal on vacatur motions. This is closely related to the time issue. While there are advantages to having appellate rights, as a customer has in court, it is an undeniable fact that appeals add at least a year to the finality of a judgment. In contrast, customers have some comfort in knowing that if they are successful in arbitration, there are few grounds upon which an unsuccessful firm can challenge the award.

Enforcement

Article XIII, Section 1(c) of FINRA's Corporate Bylaws provides that a member or associated person may be disciplined for failure to pay an arbitration award or written settlement agreement. Article VI, Section 3 permits summary suspension upon 15 days' written notice of a member or associated person who fails to pay. Recently, FINRA limited the defenses a firm or associated person may raise to prevent the suspension: (1) that the firm or person paid the award in full; (2) the customer has agreed to installment payments or has otherwise settled the matter; (3) the firm or person has filed a timely motion to vacate or modify the arbitration award

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58. *See* FINRA Dispute Resolution Party's Reference Guide, p. 26, available at http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@party/documents/arbmed/p011178.pdf.

and such motion has not been denied; and (4) the firm or person has filed a petition in bankruptcy and the bankruptcy proceeding is pending, or the bankruptcy court has discharged the award.[59] Previously, a firm or associated person was able to claim a general inability to pay the award. As a result, it is relatively uncommon for a customer to have to resort to court enforcement procedures to ensure that the arbitration award is paid in a timely manner.

The Pro Se Claimant

Many customers choose to represent themselves in FINRA arbitration proceedings, especially in smaller cases. While pro se claimants often do not fare well, they do at least get their opportunity to attempt to resolve their grievances. FINRA offers comprehensive resources and an easy to follow Code of Arbitration Procedure to help navigate pro se claimants through the process. By contrast, a pro se plaintiff in litigation is likely to get lost in the maze of court procedures, and may not be able to get past a dispositive motion. Accordingly, customers may be more likely to pursue a smaller claim, even when they cannot retain an attorney to represent them.

Simplified Proceedings

FINRA provides a simplified procedure for cases under $25,000. Many courts only provide simplified proceedings for small claims cases, whose jurisdictional limits may be as low as $5,000. Under the simplified procedures, customers may elect to have their cases heard solely on the basis of documents submitted to the arbitrator. Besides having the potential to be cost effective, elderly customers may avoid the stress of a several day hearing, or the need to travel to the hearing location.

59. *See* FINRA Regulatory Notice 10-31 "Change to Expedited Proceedings for Failure to Comply with an Arbitration Award or Related Settlement", *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121647.pdf.

Case-Specific Issues

From a customer's standpoint, there are several cases which simply make more sense in arbitration. It is impossible to delineate all of the case-specific issues which may argue for arbitration over litigation. By way of example, however, FINRA has stated that its rules of conduct may be enforced by an arbitration panel. In such a case, a customer may decide to seek redress in arbitration, rather than through the courts.

Another consideration arises in product cases. The passage of the Securities Litigation Uniform Standards Act ("SLUSA") in 1998 has resulted in preemption of state law in cases where there are 50 or more claimants asserting the same relief.[60] Moreover, such cases are removed to federal court and subjected to federal pleadings standards and the mandatory stay of discovery. Thus, a customer with a product case which involves numerous plaintiffs may prefer to file the case in arbitration, where removal to federal court may be avoided.

Finally, there is the issue of the statute of limitations. In many states, statutes of limitations do not apply to private arbitration proceedings. Therefore, a case which may be subject to a motion for summary judgment in court may be heard on the merits in a FINRA arbitration.

A RETURN TO CUSTOMER CHOICE

It is time to reconsider the place pre-dispute arbitration clauses have in the securities arbitration process. At the time *McMahon* was decided, pre-dispute arbitration clauses were used in a limited nature – customers only encountered such clauses upon entering into more complex brokerage agreements. However, in the years since *McMahon*, firms have increasingly utilized these clauses, to the point that virtually every brokerage agreement now requires the investor to submit all claims to industry-sponsored arbitration. The requirement that customers submit to arbitration as a precondition to investing their wealth undermines the integrity of the securities arbitration process and violates the principles of contract law. Brokerage firms have the resources necessary to resolve disputes in both the judicial and arbitral settings and, thus, are more capable of adjusting their strategy than customers. Therefore, the brokerage firm, rather than the customer, should bear the burden of uncertainty in forum selection. Firms

60. *See, e.g.*, *Bell v. Ebbers (In re Worldcom, Inc. Sec. Litig.)*, 308 F.Supp. 236 (S.D.N.Y. 2004).

will not be unduly burdened if customers have the ability to choose between court or arbitration once a dispute arises.

There is support for a return to customer choice. For almost twenty years between the time FINRA first enacted its Code of Arbitration Procedure and the *McMahon* decision, customers had a choice between court and arbitration. Even following *McMahon*, until pre-dispute arbitration agreements became pervasive throughout the industry, customers retained choice in terms of forum selection. We believe it is possible to return to this standard by either the Commission or FINRA enacting a rule or issuing an interpretive memo indicating that it is inconsistent with the just and equitable principles of trade for a member to include a pre-dispute arbitration clause in account opening agreements with retail customers, to condition opening or maintaining an account on behalf of a retail customer on the acceptance of a pre-dispute arbitration agreement, or to enforce any existing pre-dispute arbitration agreements between retail customers and member firms. There is ample support for the Commission to be able to take this action. Section 921 of Dodd-Frank addresses the Commission's ability to enact legislation affecting pre-dispute arbitration agreements for disputes arising under the federal securities laws, the rules and regulations thereunder, or the rules of self-regulating organizations. However, the Commission has always had the ability to regulate firms with regard to state law claims. To the extent the Commission enacts rules limiting a firm's use of pre-dispute arbitration clauses, it should be clear that these rules affect both federal and state law claims, as have the other SRO rules governing pre-dispute arbitration clauses. We should not return to the unfortunate predicament that *Byrd* explicitly endorsed, where customers could find themselves bound to try their case in two separate forums if they chose to advance all claims they were entitled to advance. We urge the Commission to recognize, as it did in 1988, the importance of customer choice.

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,
Peter J. Mougey
President

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The following PIABA Comment Letter regarding *Release No. 34-63250/SR-FINRA-2010-053 – Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes* was submitted to the Securities and Exchange Commission by Peter J. Mougey on December 3, 2010.

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

Re: File No. SR-FINRA-2010-053
Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Relating Rules, of the Code of Arbitration Procedure for Customer Disputes

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I thank the Commission for the opportunity to comment on the proposed rule change which would give investors the choice to proceed with an all public panel of arbitrators in cases heard before FINRA Dispute Resolution ("FINRA-DR") in which the amount in controversy exceeds $100,000.[1] The FINRA rule proposal essentially proposes that the claimants in investor securities arbitration disputes be given the *choice* to decline the presence of an industry arbitrator on panels that hear and decide their cases.

PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, both former and current, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. Virtually every broker-dealer customer account agreement provides for *mandatory* arbitration before FINRA-DR of any dispute arising between the investors and the firm; our clients have no meaningful choice of judicial forums. Accordingly, our members and their clients have a strong interest in

1. See, Proposed Rule Change – Elimination of FINRA-DR Mandatory Industry Arbitrator, Commission Rulemaking Proposal 4-586, available at http://sec.gov/rules/petitions/2009/petn4-586.pdf. PIABA submitted a similar rule petition to the Commission in June of 2009 pursuant to Rule 192 (17 CFR 201.192).

FINRA's rules which govern the way in which the arbitration process is administered.

PIABA supports any changes that make the process fairer for investors, both in perception and reality. PIABA supports the current rule proposal to the extent that it provides investors with choice; however, we take contention with the fact that an investor must opt-in within 35 days from the service of the Statement of Claim to be given the opportunity to proceed with the all public panel option. We believe this should be the default choice and that an investor should given the opportunity to opt-in to proceed with the majority public panel option.

I. SYNOPSIS OF THE PROPOSED RULE CHANGE

FINRA's current arbitration rules provide that a panel of three arbitrators must hear all arbitration claims whenever the amount in controversy exceeds $100,000. FINRA Code of Arbitration Procedure, Rule 12401(c). The rules further provide that one of the panel members must be a "non-public" (i.e., industry) arbitrator. FINRA Code of Arbitration Procedure, Rule 12402(b). The rules define a "non-public" arbitrator as any individual who currently works in the securities industry, who has worked in the securities industry within the past five years, or retired individuals who have spent a substantial amount of their career employed in the securities industry. Code of Arbitration Procedure, Rule 12100(p)(1), (2). The rules also provide that any lawyer, accountant, or other professional who has devoted more than twenty percent of his or her work to the securities industry within the past two years is also deemed an industry arbitrator. Code of Arbitration Procedure, Rule 12100(p)(3). In addition, certain individuals are deemed ineligible to be public arbitrators, such as spouses of securities industry personnel, investment advisers, and professionals whose firms do a certain amount of work for the securities industry. Code of Arbitration Procedure, Rule 12100(u).

The proposed rule change provides investors with the option to *choose* whether an industry arbitrator sits on their particular case. Such a rule would be a significant improvement to the current system wherein FINRA *requires* that an industry arbitrator sit on every case where the amount of damages claimed exceeds $100,000.

II. THE NEED FOR REFORM

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

In 1987, the Supreme Court again considered the issue of whether investors could be compelled to arbitrate claims involving statutory violations of the Securities Exchange Act of 1934[2] pursuant to pre-dispute arbitration agreements in the landmark case *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). In reversing the long held position that investors could not be compelled to arbitrate these statutory claims, the Supreme Court issued a 5-4 decision ruling that pre-dispute arbitration agreements could be enforced with respect to these claims. However, the dissenting opinion in *McMahon* raised serious concerns regarding the fairness of the industry-sponsored securities arbitration process. The concerns raised in the dissenting opinion have largely proven prescient.

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

> Furthermore, there remains the danger that, at worst, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the

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

> market professional. The Uniform Code [of Arbitration] provides some safeguards, but, despite them, *and indeed because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry, and not drawn from the public* . . . The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage in a forum under its own control." *See N.Y. Times*, Mar. 29, 1987, Section 3, p. 8., col. 1 (Statement of Sheldon H. Eisen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck.").

482 U.S at 260-261 (emphasis added)(footnotes omitted). The dissenting justices were critical of the fact that the Commission had not conducted a study of the perceived inadequacy of the SRO arbitration system as it existed in 1987. *Id*., at 265. The *McMahon* dissent also suggested that studies of the mandatory arbitration system would likely reveal evidence as to the fairness (or lack thereof) of the process. *Id.* at 265 and fn. 20 (After noting the industry's use of statistics to support its claim of fairness, noting further that "[s]uch statistics, however, do not indicate the damages received by customers in relation to the damages to which they believed they were entitled. It is possible for an investor to 'prevail' in arbitration while recovering a sum considerably less than the damages he actually incurred.")

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

A. THE SICA STUDY

In 2005, The Securities Industry Conference on Arbitration ("SICA") undertook to perform an academic study of fairness in arbitration based upon empirical evidence. Specifically, the study sought to determine whether participants in securities arbitration believe that the process is conducted simply, fairly, economically, and without bias by the arbitrators. In February of 2008, SICA published the results of the study (Barbara Black, Jill I. Gross,

"*Perceptions of Fairness of Securities Arbitration: An Empirical Study*," (2008)).[3]

The SICA study found a strong perceived bias with respect to industry sponsored securities arbitration. Nearly half of responding investors believed that arbitration panels were biased. Sixty-two percent of public investors felt that the arbitration process was unfair. Seventy percent of public investors were dissatisfied with the outcome of their securities arbitration cases. Seventy-five percent of public investors found securities arbitration to be "very unfair" or "somewhat unfair" as compared to court. Of particular note, the SICA study specifically probed issues relating to the mandatory industry arbitrator. Thirty-six and one half percent of the responding public investors found the industry arbitrator to be biased in favor of the industry respondents.

After publishing the results of the SICA empirical study, the authors published a paper discussing the results of the report, wherein they set forth the following conclusion[4]:

> Accordingly, based on the findings of our Report, we urge the SEC and FINRA to give serious consideration to eliminating the requirement of an industry arbitrator on every three-person arbitration panel. Rightly or wrongly, investors are simply suspicious of a mandatory process with an opaque outcome that is sponsored by the regulatory arm of the securities industry and that includes an industry representative on every three-arbitrator panel hearing a claim greater than $25,000. The frequently-made argument – that no one can prove that the presence of an industry arbitrator harms the investor – misses the point. Given the widespread distrust of the industry arbitrator, it would seem that the presence of an industry arbitrator would have to contribute great value to the process—which no one can establish either—to justify the continuation of this practice.

Following the release of the SICA study, the North American Securities Administrators Association (NASAA), a group composed of state securities regulators from all fifty states, issued a statement calling for immediate

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3. http://www.law.pace.edu/files/finalreporttosica.pdf.

4. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. Disp. Resol. 349, 400.

reforms to the system. Karen Tyler, the president of NASAA, encouraged FINRA to take immediate action by stating[5]:

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

(Emphasis added.) Thus, NASAA recognizes the importance of eliminating the mandatory industry arbitrator from the current system.

B. THE O'NEAL-SOLIN STUDY

In 2007, an independent study was conducted to analyze investor recoveries in securities arbitration.[6] The study examined all arbitration awards rendered in NASD and NYSE arbitral forums between 1994 and 2004. In light of the *McMahon* dissent's suggestion that customer "win" rates might not be as meaningful as data showing damages awarded versus damages sustained, the study focused primarily on the amount a public investor could expect to recover in securities arbitration. The numbers were discouraging, ultimately finding that the percentage of the amount awarded to public investors compared to the amount sought significantly decreased from 68% in 1998 to 50% in 2004. Through extrapolation, it was found that investors bringing securities arbitration claims could expect to recover only 20% of the amount sought. Shockingly, the expected recovery percentage of a claim of over $250,000 (claims which would involve a three person panel and include an industry arbitrator) against one of the three largest brokerage firms was a paltry 12%.

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5. NASAA News Release, February 6, 2008, available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/8081.cfm.

6. J. O'Neal and D. Solin, "Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare," (2007). Hereinafter the "O'Neal-Solin Study," available at http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20Study.pdf.

Since the publication of the O'Neil-Solin Study, investors' chances of recovery have continued to decline. In 2006, the win rate for public investors in FINRA arbitrations declined to 42% and plummeted to 37% in 2007, before rebounding to a still dismal 42% rate in 2008 with a slight increase to 45% in 2009.[7] Moreover, the experience of our members, who routinely represent investors in arbitration cases, is that full recoveries of statutory damages such as those provided under state securities acts are usually the exception, even when liability is established.

III. THE ALL PUBLIC PANEL SHOULD BE THE NORM, THE INDUSTRY ARBITRATOR SHOULD BE THE EXCEPTION

The traditional justification for the inclusion of industry arbitrators on panels is that they provide needed expertise and guidance to the public arbitrators on matters involving the securities industry. This justification is unwarranted; the opinions of industry arbitrators should be given no greater weight than those of the public arbitrators. The significance of the "expert" role of the industry arbitrator cannot be underestimated. Not only are they one of only three votes, but at FINRA, industry arbitrators are also given a significantly disproportionate voice in the process. For years, FINRA explicitly advised arbitrators that in determining liability, "[w]hen the case is highly technical, the industry arbitrator might begin the discussion to help clarify industry terminology *or practices*."

Ironically, the undue influence of the industry arbitrator is further highlighted in the "*White Paper on Arbitration in the Securities Industry*" published in October 2007 by the Securities Industry and Financial Markets Association ("SIFMA").[8] SIFMA, which is the securities industry's trade association, describes the following as a particular *virtue* of the industry arbitrator: "'Industry' arbitrators also benefit the public panelists as they can serve to educate them about financial products and services, industry customs and practices and other legal industry-related issues." (SIFMA White Paper, at 35). The SIFMA White Paper goes so far as to suggest that because of the

7. A "win" is not always a win. If a panel were to make a small award to a public investor, then assess forum fees in excess of the amount awarded, this would still be counted as a "win" in FINRA's statistics. The statistics are available at http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm

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

presence of industry arbitrators on panels "parties need not call expert witnesses in order to educate a panel about certain products or industry practices." (SIFMA White Paper, at 35-36).

The suggestion that industry arbitrators serve as *de facto* expert witnesses should be deeply troubling for not only investors but also regulators overseeing the process. Importantly, the influence of the industry arbitrator is not counter-balanced by any requirement that one of the other arbitrators have the qualifications to offer not only a more investor friendly perspective, but also not even an objective perspective of securities industry products and practices. Furthermore, industry arbitrators who offer their opinions on these topics are not subject to cross-examination about any errors or biases that could make their opinions unreliable. As a result, investors may lose their cases on the basis of "expert opinions" that they never have an opportunity to address or even hear.

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

(a) pervasive conflicts of interest of Wall Street research and recommendations on "tech" stocks in favor of brokerage firms' investment banking clients;[9]
(b) abuses in the trading and sales of mutual funds;[10]
(c) deceptive seminars and marketing schemes aimed at the elderly and newly retired;[11]

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

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

(d) fraudulent and unsuitable sales of variable annuities, especially to seniors and for tax-deferred accounts;[12]
(e) dishonest and deceptive practices in connection with the conduct of auctions of "auction rate securities" ("ARS") and the mismarketing of such securities as money market or CD equivalents;[13] and
(f) fraudulent practices in connection with the securitization and retail sales of products backed by subprime loans.[14]

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

12. *See*, "*Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*" (June, 2004), available at http://www.sec.gov/news/studies/secnasdvip.pdf.

13. Firms that have been implicated in ARS misconduct include: TD Ameritrade; Banc of America Securities; Bear Stearns & Co., Inc.; Citigroup Global Markets; Deutsche Bank; A.G. Edwards, Inc.; E-Trade; Goldman Sachs & Co.; H&R Block; Lehman Bros. Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch Pierce Fenner & Smith, Inc.; Morgan Keegan & Company, Inc.; Morgan Stanley; Oppenheimer; Piper Jaffray & Co.; Raymond James; RBC Dain Rauscher, Inc.; SunTrust Capital Markets, Inc.; UBS; Wachovia Capital Markets, Inc.; and Wells Fargo & Co. The SEC's 2006 Consent Order against 15 firms for fraudulent practices in connection with ARS can be found at: http://www.sec.gov/litigation/admin/2006/33-8684.pdf.

14. The SEC, FINRA, Justice Department and the states have initiated dozens of investigations relating to subprime securitization and sales. *See*, *"Prosecutors Widen Probes Into Subprimes" Wall Street Journal* (Feb. 8, 2008); The Bureau of National Affairs, Inc., *In Three Dozen Subprime Investigations SEC Is Asking 'Who Knew What, When'*, 40 Securities Regulation & Law 7 (Feb. 18, 2008); David Scheer and Jesse Westbrook, *Brokers Probed by FINRA on Mortgage Securities Sales, Person Says*, Bloomberg.com (Jan. 4, 2008), available at http://www.bloomberg.com/apps/news?pid=20601087&sid=apNYRLoCVcUk&refe r=home; Edward Hayes, *FINRA Joins Mortgage Storm*, Wolters Kluwer Financial Services (Feb., 4, 2008), available at http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=02-04-08; *USA Today*, *Regulators' Subprime Mortgage Cases* (Feb. 18, 2008), available at: http://www.usatoday.com/money/economy/2008-02-18-4194118666_x.htm; "*Morgan Keegan Fraud Alleged; SEC, States Aim at $2 Billion Loss*" Memphis Commercial Appeal, (April 7, 2010); "*Banks in Talks to End Bond Probe*" Wall Street Journal (Dec. 2, 2010) (noting that after Goldman Sachs' $550 billion settlement with the SEC concerning sale of

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

In addition, the on-going consolidation of brokerage firms within the securities industry has compounded potential conflicts for industry arbitrators. In recent years, such well-known firms as Dean Witter, Prudential Securities, A.G. Edwards, PaineWebber, Bear Stearns, Wachovia, and Merrill Lynch have been taken over by other firms. Faced with this consolidation trend, industry arbitrators may be reluctant to award substantial damages against firms that could well become their future employers. The same economic considerations may influence lawyers or accountants who serve as industry arbitrators, since their clientele may include brokerage firms that could be acquired by the firm whose conduct is at issue in the case before them.[15] Against this backdrop it should not be surprising that statistically an investor's expected recovery rate (i.e., win rate times recovery rate) of substantial damages in a large claim against a major brokerage firm is far less than against smaller firms.[16] This disparity suggests, at least in part, that some arbitrators are reluctant to antagonize major firms.

CDOs, other investment banks including Deutsche Bank, J. P. Morgan, Morgan Stanley, UBS, and Citigroup were negotiating with the SEC).

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

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

While PIABA unquestionably supports the proposed rule, it should be modified so that the all public panel option is the default option applicable to all customer cases. As currently drafted, too many *pro se* claimants, and even attorneys who do not regularly practice in this area, will not comprehend the potential impact of ranking an industry arbitrator, or even worse, they may simply overlook the deadline to select the all public panel option. Similarly, adopting the all public panel option as the default option would eliminate notification deadlines for customers while simultaneously lessening the burden of the FINRA-DR case administrators with respect to following up on the application of the rule. An investor should not be deprived of the ability to exclude an industry arbitrator from a panel due to missing a deadline.[17]

In addition, the proposed rule is vague as to whether a claimant can request that the all public panel option be elected at the time of filing a Statement of Claim. The rule appears to preclude the ability of an investor to request it be applied to a case at the time of filing, forcing the claimant to wait until the Statement of Claim has actually been served. To the extent that there may be any uncertainty on the part of investors, they should be given the benefit of the doubt and be permitted to proceed with an all public panel unless they opt otherwise.

CONCLUSION

PIABA urges the Commission to adopt the rule proposed by FINRA. We request, however, that the rule be amended so that the all public panel option is the default option, and not require that investors opt-in. Thank you for your kind consideration in advancing the interests of investor protection.

Respectfully submitted,
Peter J. Mougey
President

17. It should be noted that FINRA-DR's procedures for serving notices of claim can vary slightly between regional offices. Due to deficiency letters and other procedural matters that hold up the service of a statement of claim, it is sometimes difficult to ascertain when a claim has actually been served.

Notes & Observations