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In this Issue

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SEC WHISTLEBLOWER INCENTIVES UNDER THE DODD-FRANK WALL STREET REFORM ACT

Scott L. Silver[1] and Janine D. Garlitz[2]

On August 12, 2011, in the wake of the 2008 Wall Street driven financial crisis and securities regulators' failure to detect Madoff and other Ponzi schemes, the Securities and Exchange Commission (the "SEC") implemented whistleblower regulations, which were promulgated at the direction of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). Along with its regulations, the SEC has also implemented its "Office of the Whistleblower."[3]

The SEC's efforts were in response to the Dodd-Frank legislation, which is arguably the most significant financial securities-related legislation in modern history. The stated purpose of this comprehensive legislation is to

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3. More information about the Office of the Whistleblower can be found on the SEC's website at: http://www.sec.gov/whistleblower.

"promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect consumers from abusive financial services practices, and for other purposes."[4]

Among the 848-page Dodd-Frank legislation, there are a series of revolutionary whistleblower provisions which open the door for bounties, while providing protections for whistleblowers who report violations. Dodd-Frank added Section 21F to the Securities Exchange Act of 1934, entitled "Securities Whistleblower Incentives and Protection."[5] Pursuant to this section, the SEC is required to pay awards, subject to certain restrictions and conditions discussed in this article, to whistleblowers who provide information that leads to a successful SEC enforcement action where the SEC obtains sanctions in excess of one million dollars.[6] These awards may be as much as thirty percent of the monetary sanctions.[7] The regulations provide the SEC with the authority to divide the bounty among whistleblowers. This is in marked contrast to the False Claims Act where the general rule is the whistleblower who files first gets the entire bounty.

Dodd-Frank protects whistleblowers by providing them with a cause of action in cases where employers discharge or retaliate against them for reporting (either internally or to the government) securities law violations.[8] Relief includes reinstatement, double-back pay and attorney fees.[9] Additionally, whistleblowers may state a cause of action for retaliation even if the underlying allegations of fraud did not result in a penalty.[10]

Promulgation of the final rules was not the result of a unanimous vote by the SEC. On May 25, 2011, the SEC voted 3-2 to adopt final rules which went into effect in August.[11] On August 4, 2011, the Commodity Futures Trading Commission ("CFTC") adopted a similar rule.[12]

The SEC whistleblower program is "primarily intended to reward individuals who act early to expose violations and who provide significant

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4. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The Act also includes a general reference to "other purposes." *Id.*
5. 15 U.S.C. § 78u-6 (2010).
6. 15 U.S.C. § 78u-6(a) (2011).
7. 15 U.S.C. § 78u-6(b) (2011).
8. 15 U.S.C. § 78u-6(h)(1)(B) (2011).
9. 15 U.S.C. § 78u-6(h)(1)(C) (2011).
10. *See* 15 U.S.C. § 78u-6(h)(1)(A), (B) (2011).
11. Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act, SEC Release No. 34-64545, File No. S7-33-10 (May 25, 2011).
12. *See* 7 U.S.C. § 26 (2011).

evidence that helps the SEC bring successful cases."[13] SEC Chairman Mary Shapiro stated that the whistleblower rules "are intended to break the silence of those who see a wrong. . . I believe it is critical to be able to leverage the resources of people who may have first-hand information about potential violations."[14]

The purpose of this article is to provide a backdrop of this legislation and to provide an overview of the SEC whistleblower rules. This article should assist lawyers and others in navigating these new and complex procedures to prevent ongoing or impending fraud and collect an award.

I. HISTORY OF THE WHISTLEBLOWER

Whistleblower legislation in the United States dates back to the Civil War and was intended to address government contract fraud. The first whistleblower legislation in the United States originated during the Civil War under the False Claims of March 2, 1863 (revised in 1986).[15] As enacted, the False Claims Act was intended to prevent and punish frauds upon the government during the Civil War.[16] Whistleblowers were encouraged to report frauds and share in the penalty recovered by the United States.[17]

In the last century, there have been various laws enacted to protect whistleblowers, including the Clean Water Act of 1972,[18] the Surface Transportation Assistance Act of 1982,[19] and the Sarbanes-Oxley Act of 2002.[20] The Sarbanes-Oxley Act provided, for the first time, specific whistleblower protection against employer retaliation based on the reporting of securities-related violations and various federal crimes.[21] The Whistleblower Protection Program of the Occupational Safety and Health

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13. Release, Securities and Exchange Commission, SEC Adopts Rules to Establish Whistleblower Program (May 25, 2010) http://www.sec.gov/news/press/2011/2011-116.htm.
14. Chairman Mary L. Shapiro, Speech by SEC Chairman: Opening Statement at SEC Open Meeting: Item 2 — Whistleblower Program (May 25, 2010), http://www.sec.gov/news/speech/2011/spch052511mls-item2.htm.
15. False Claims Act, 37th Cong. Ch. 67; 12 Stat. 696 (enacted Mar. 2, 1863 and subsequently revised in 1986).
16. *Id.*
17. *Id.*
18. Pub. L. 92-500; 86 Stat. 816 (enacted Oct. 18, 1972).
19. Pub. L. 97-424; 96 Stat. 2097 (enacted Jan. 6, 1983).
20. Pub. L. 107-204; 116 Stat. 745 (enacted July 30, 2002).
21. *See id.*

Administration has administered the whistleblower protection provisions of 21 whistleblower protection statutes, including Sarbanes-Oxley.[22]

The Internal Revenue Service ("IRS") also has a whistleblower program to reward whistleblowers who report on persons who fail to pay the taxes that they owe.[23] In 2006, the IRS changed the whistleblower awards from discretionary to mandatory.[24] Now, if the taxes, penalties, interest and other amounts in dispute exceed $2 million, and a few other qualifications are met, the IRS will pay between 15 percent to 30 percent of the amount collected to the whistleblower.[25] In 2011, a Philadelphia-area accountant who tipped off the IRS that his employer was skimping on taxes has received $4.5 million in the first IRS whistleblower award.[26]

In the last decade, whistleblowers have received international media attention as a result of a number of major corporate and accounting scandals, including the infamous Enron, Tyco and WorldCom debacles. In 2002, TIME Magazine named whistleblowers Sherron Watkins of Enron, Coleen Rowley of the FBI and Cynthia Cooper of Worldcom as its "Persons of the Year" for having the "strength to stand for what's right."[27]

It should come as no surprise that many major U.S. companies and the Chamber of Commerce have attempted to derail the whistleblower program, promoting internal compliance systems or a program of self-regulation. Unfortunately, not only have these types of compliance systems failed, whistleblowers are frequently the subject of retaliation and are either forced to resign or treated as a pariah for trying to do the right thing. The new regulations offer significant protections for whistleblowers to help whistleblowers from being victimized.

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22. More information about the Office of the Whistleblower Protection Program can be found on its website: http://www.whistleblowers.gov/.
23. More information about the IRS whistleblower program can be found on the IRS website: http://www.irs.gov/compliance/article/0,,id=180171,00.html.
24. *See* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 § 406(a)(i); 120 Stat. 2922 (enacted Dec. 20, 2006).
25. IRC § 7623(b)(1) (2011).
26. MaryClaire Dale, *IRS Awards $4.5M to Whistleblower,* USA TODAY, Apr. 8, 2011, http://www.usatoday.com/money/perfi/taxes/2011-04-08-irs-whistleblower-taxes-reward.htm#.
27. TIME, Persons of the Year 2002, http://www.time.com/time/specials/packages/0,28757,2022164,00.html.

II. THE CONTROVERSY SURROUNDING THE SEC WHISTLEBLOWER LEGISLATION

On November 3, 2010, the SEC proposed rules to implement the whistleblower legislation.[28] The proposed rules defined certain terms critical to the whistleblower program and outlined procedures for reporting and for the SEC making decisions on claims. The SEC received more than 240 comment letters and approximately 950 form letters on the proposed rules.[29] Commentators included individuals, whistleblower advocacy groups, public companies, corporate compliance personnel, law firms and individual lawyers, academics, professional associations, nonprofit organizations and audit firms.

The most contentious issue raised during the SEC Whistleblower rules' comment period was whether the financial incentive for employees to complain to the SEC would undermine companies' internal compliance and reporting programs. The corporate interests that commented on the rule were unanimous in advocating for a requirement that whistleblowers report violations of securities law through their internal compliance and reporting systems before submitting the information to the SEC in order to be eligible for the award.[30] Those in-house reporting requirements were mandated by the Sarbanes-Oxley Act of 2002. Many commentators, however, responded that reporting misconduct directly to the people engaging in misconduct serves no beneficial purpose. No one realistically believes Bernard Madoff would have stopped his fraud if a junior staff member highlighted he was running Ponzi scheme.

In its final rules, the SEC did not adopt a mandatory internal reporting requirement. The SEC struck a balance of concerns from both sides and added incentives for employees to comply with internal procedures. As discussed further in detail below, the SEC rules financially incentivize

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28. Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities and Exchange Act of 1934, Release No. 34-63237 (Nov. 3, 2010) ("Proposing Release").

29. Securities and Exchange Commission, Comments on Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, http://www.sec.gov/comments/s7-33-10/s73310.shtml.

30. *See, e.g.*, Letter from David Hirschman, President and Chief Executive Officer, Center for Markets Competitiveness, U.S. Chamber of Commerce and Lisa A. Rickard, President, U.S. Chamber Institute for Legal Reform to Ms. Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (Dec. 17, 2010) (*available at* http://www.sec.gov/comments/s7-33-10/s73310-194.pdf).

whistleblowers to report violations internally first.[31] Among the SEC's criteria for determining the amount of an award, is if a whistleblower participates in internal compliance and reporting first, that is a factor that can increase the amount awarded to the whistleblower. Also, if a whistleblower reports internally to the company, and then the company reports the information to the SEC, the whistleblower will receive credit, and potentially a greater award, for any additional information generated by the company in its investigation.[32] This criterion is not black letter law in that the SEC will also look at whether reporting internally could have addressed the problem. Typically, where fraud is pervasive, there is an argument that internal compliance programs will not address the fraud. This argument was made by a number commentators including Voices for Corporate Responsibility and the Change to Win Labor Coalition.[33]

The SEC made the right decision in not requiring whistleblowers to report their concerns internally to the company before reporting them to the SEC. There is no logical basis to require a junior level employee to report corporate malfeasance when the malfeasance is being conducted by senior management. A requirement to report internally first would have created unnecessary and improper hurdles for whistleblowers, resulting in some whistleblowers deciding not to report the misconduct. Further, a requirement to report internally would have contravened an employee's right to disclose information anonymously (as discussed further herein).

III. MEETING THE REQUIREMENTS OF THE SEC WHISTLEBLOWER STATUTE

A. Definition of a Whistleblower

The SEC's Whistleblower rules define a whistleblower as an individual, who alone or jointly with others, provides the SEC with information pursuant to the procedures set forth by the SEC, and the information relates to a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur.[34] The definition clarifies that a company or entity is not

31. *See* 17 C.F.R.§ 240.21F-6(a)(4) (2011).
32. *See* 17 C.F.R. § 240.21F-4(c)(3) (2011).
33. This argument was made by a number of commentators to the proposed rules. *See, e.g.*, Letter from Reuben Guttman, Voices For Corporate Responsibility, *et al.* to Ms. Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (Dec. 17, 2010) (http://www.sec.gov/comments/s7-33-10/s73310-162.pdf).
34. 17 C.F.R. § 240.21F-2(a)(1) (2011).

eligible to be a whistleblower.[35] Only individuals will meet the requirements of a whistleblower.

As noted above, the definition includes individuals that report "possible violations" of the securities law.[36] So an individual would meet the whistleblower definition if he or she provides information about a "possible violation" that "is about to occur."[37] However, the submission must relate to a violation of the federal securities laws, or a rule or regulation promulgated by the SEC.[38] An individual who submits information that relates only to state law or foreign law violations would not meet the whistleblower requirements.

To qualify as a whistleblower eligible for an award, the individual must submit their information to the SEC in accordance with the procedures set forth in the rules.[39]

Notably, the whistleblower definition does not contain a materiality requirement. In other words, there is no requirement that that the information submitted relate to a "material" violation of the securities laws. The SEC's commentary in implementing the final rules stated that "rather than use a materiality threshold barrier that might limit the number of submissions to us, it is preferable for individuals to provide us with any information they possess about possible securities violations…and for us to evaluate whether the information warrants action."[40]

This is consistent with the SEC's goals of the program to encourage whistleblowers to come forward. It is not for the individual whistleblower to determine the materiality of the violation. They should be afforded the protections of the rules (i.e., anti-retaliation and confidentiality) if in good faith they report a securities law violation that the SEC decides not to move forward with not having found a material violation. Materiality is certainly subjective and such a requirement would have provided whistleblowers with unease in reporting violations.

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35. *Id.*
36. *Id.*
37. 17 C.F.R. § 240.21F-2(a)(1) (2011).
38. *Id.*
39. *See* 17 C.F.R. § 240.21F-9(a) (2011). The procedures for submitting a possible securities law violation are further discussed in Section V *infra*.
40. Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Exchange Act, SEC Release No. 34-64545, File No. S7-33-10 (May 25, 2011).

B. Payment of Award

The monetary threshold requirement for a whistleblower to qualify for payment of an award under the SEC whistleblower rules is a successful enforcement action by the SEC in which the SEC obtains monetary sanctions totaling more than $1,000,000.[41] Whistleblowers who meet this threshold requirement, as well as the other conditions of the rules, are entitled to receive cash awards of between 10% and 30% of the sanctions the SEC collects.[42]

i. Related Actions

In determining whether the threshold of $1,000,000 in monetary sanctions has been met, the rules provide that the SEC will also pay an award based on amounts collected in certain "related actions."[43] A "related action" is defined as a "judicial or administrative action" that is brought by the United States Attorney General, an appropriate regulatory authority, a self-regulatory organization (*e.g.*, the Financial Industry Regulatory Authority "FINRA"), or a state attorney general in a criminal case.[44] In order for the SEC to make an award in connection with a related action, the SEC must determine that the same original information that the whistleblower gave to the SEC also led to the successful enforcement of the related action.[45]

A whistleblower will not be able to recover based on a related action if the SEC itself does not make a recovery. For example, if a whistleblower reports information to the SEC, and the SEC does not bring an enforcement action, but forwards the information to the Attorney General who makes a recovery, the whistleblower is not entitled to recovery under the SEC whistleblower rules. This is because the statute expressly requires a successful SEC action before there can be a "related action" upon which a whistleblower may recover.[46]

Also, the SEC will not pay an award to a whistleblower for a related action if they "have already been granted an award by the Commodity

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41. 17 C.F.R. § 240.21F-3 (2011).
42. 15 USC § 78u-6(b) (2011).
43. *Id.*
44. 15 USC § 78u-6(a)(5) (2011).
45. *See id.*
46. *See* 15 USC § 78u-6(a)(5) (2011) (related action must be "based upon the original information…that lead to the successful enforcement of the Commission action").

Futures Trading Commission ("CFTC") for that same action pursuant to its whistleblower award program under Section 23 of the Commodity Exchange Act (7 U.S.C. 26)."[47] Similarly, if the CFTC previously denied an award to an individual in a related action, the individual "will be precluded from relitigating any issues" before the SEC that the CFTC resolved against the individual as part of the denial of the award.[48]

ii. SEC's Discretion to Determine the Amount of the Award

The range of the award paid to the whistleblower (between 10%-30% of the sanctions) is at the complete discretion of the SEC.[49] The SEC's rules provide four factors for the SEC to evaluate in determining the amount of an award: 1) the significance of the information provided by the whistleblower; 2) the degree of assistance provided by the whistleblower and the whistleblower's counsel; 3) law enforcement interest; and, 4) participation in internal compliance systems.[50]

For the first factor, the SEC "will assess the significance of the information provided by a whistleblower to the success" of the SEC's action or a related action.[51] The SEC will decide how reliable and complete the information provided to the SEC was. The SEC will also determine how helpful the information was in supporting the SEC's claims.

The second factor takes into account the "assistance provided by the whistleblower" and his/her legal counsel in the SEC action or a related action.[52] In considering this factor, the SEC looks at "whether the whistleblower provided ongoing, extensive, and timely cooperation and assistance" and the extent the whistleblower encouraged others to assist the SEC that may not have otherwise assisted. The SEC also looks at the timeliness of the whistleblower reporting the violation (to the SEC and/or to internal compliance), "the resources conserved as a result of the whistleblower's assistance," the "efforts undertaken by the whistleblower to remediate the harm caused by the violations," and "any unique hardship experienced by the whistleblower" as result of their reporting the violations.[53]

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47. 17 C.F.R. § 240.21F-3(b)(3) (2011).
48. *Id.*
49. 15 U.S.C. § 78u-6(c)(1)(A) (2011).
50. 15 USC § 78u-6(c) (2011); 17 C.F.R. § 240.21F-6 (2011).
51. 17 C.F.R. § 240.21F-6(a)(1) (2011).
52. 17 C.F.R. § 240.21F-6(a)(2) (2011).
53. *Id.*

In its third factor for determining the amount of the award (the "law enforcement interest"), the SEC evaluates its programmatic interest "in deterring securities law violations by making awards to whistleblowers who provide information that leads to the successful enforcement" of those laws.[54] This includes whether the subject matter of the action is an SEC priority, "the dangers to investors or others by the underlying violations" of the action, and "the degree to which an award enhances the [SEC]'s ability to enforce the Federal securities laws and protect investors" and "encourages the submission of high quality information from whistleblowers."[55]

The fourth factor ("participation in internal compliance systems"), was intended to incentivize whistleblowers to utilize their companies' internal compliance and reporting systems.[56] The rules provide that the SEC can increase the award if the whistleblower first reported the violations internally or assisted with any internal investigation.[57] Conversely, if a whistleblower interfered with internal compliance and reporting, that is a factor that may decrease the amount of the award.[58] Other factors that can decrease the amount of the award to the whistleblower include the culpability of the whistleblower (if they were involved with the violations or financially benefited from the violations) and whether the whistleblower unreasonably delayed reporting the securities violations.[59]

C. Voluntary Information

In order for a whistleblower to qualify for an award under the SEC rules, the whistleblower must "voluntarily" provide information to the SEC.[60] This requirement means that a whistleblower needs to come forward before being contacted by government investigators.

The rules provide that a submission of information is deemed to have been made "voluntarily" if the whistleblower makes his or her "submission before a request, inquiry, or demand that relates to the subject matter of [the] submission" is directed to the whistleblower or anyone representing the whistleblower (such as an attorney): 1) by the SEC; 2) "in connection with an investigation, inspection, or examination by the Public Company

54. 17 C.F.R. § 240.21F-6(a)(3) (2011).
55. *Id.*
56. 17 C.F.R. § 240.21F-6(a)(4) (2011).
57. 17 C.F.R. § 240.21F-6(a)(4)(ii) (2011).
58. 17 C.F.R. § 240.21F-6(b)(3) (2011).
59. 17 C.F.R. § 240.21F-6(b)(1)-(2) (2011).
60. 15 USC § 78u-6(b)(1) (2011).

Accounting Oversight Board or any self regulatory organization;" or 3) "in connection with an investigation by Congress, any other authority of the Federal government, or a state Attorney General or securities regulatory authority."[61]

The rule only precludes the submission of "voluntary" information if the request, inquiry or demand was directed to the whistleblower. In other words, an inquiry to a company would not automatically foreclose whistleblower submissions related to the subject matter of the inquiry from all employees of the company. However, if a particular employee was questioned, that employee could not make a "voluntary" submission related to the subject matter of the inquiry.

The rules also provide that a submission will not be considered "voluntary" if the whistleblower is under a pre-existing legal or contractual duty to report the information to the SEC or to any other authorities designated in the rule, or subject to a duty that "arises out of a judicial or administrative order."[62] Accordingly, if the whistleblower had previously entered into an agreement to assist the SEC, or has entered into a cooperation agreement with another authority, such as the Department of Justice, the individual's disclosures to the SEC regarding that information would not be deemed voluntary because they had a contractual duty to report the information the SEC. However, an agreement with a third party (for example an employer) to report securities violations would not obviate an individual from meeting the voluntary information requirement.

D. Original Information

The whistleblower must provide "original information" to the SEC to be eligible for an award. To be "original," the reported information must: 1) be derived from the whistleblower's independent knowledge or independent analysis; 2) "not already be known to the [SEC] from any other source;" and 3) "not exclusively derived from an allegation made in a judicial or administrative hearing," from the government or the news media, unless the whistleblower is the source of the information.[63] Also, the information must be provided to the SEC for the first time after July 21, 2010 (the date of enactment of Dodd-Frank).[64]

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61. 17 C.F.R. § 240.21F-4(a) (2011).
62. 17 C.F.R. § 240.21F-4(a)(3) (2011).
63. 17 C.F.R. § 240.21F-4(b)(1) (2011).
64. 17 C.F.R. § 240.21F-4(b)(1)(iv) (2011).

i. "Independent Knowledge" and "Independent Analysis"

"Independent knowledge" and "independent analysis" are constituent elements of "original information." The SEC defines independent knowledge as "factual information in [the whistleblower's] possession that is not derived from publicly available sources."[65] The whistleblower "may gain independent knowledge from [his or her] experiences, communications and observations in [his or her] business or social interactions."[66]

Independent analysis is defined as the whistleblower's "own analysis, whether done alone or in combination with others."[67] The SEC defines "analysis" as the whistleblower's "examination and evaluation of information that may be publicly available, but which reveals information that is not generally known or available to the public."[68] This definition allows a whistleblower to utilize publicly available information and through their further evaluation and analysis of that information, provide substantial assistance and insight to the SEC in recognizing and understanding securities violations.

The SEC explicitly excludes information gathered by certain individuals from meeting the independent knowledge or independent analysis requirement, making them ineligible for whistleblower awards. These include:

- attorneys (including in-house counsel) who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules);[69]
- officers, directors, trustees or partners of an entity who are informed by another person (such as by an employee) of allegations of misconduct, or who learn "the information in connection with the entity's processes for identifying, reporting and addressing possible violations of law" (such as through the company hotline);[70]
- employees "whose principal duties involve compliance or internal audit responsibilities," or were retained by the company "to perform compliance or internal audit functions" or to perform "investigation into possible violations of law;"[71]

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65. 17 C.F.R. § 240.21F-4(b)(2) (2011).
66. *Id.*
67. 17 C.F.R. § 240.21F-4(b)(3) (2011).
68. *Id.*
69. 17 C.F.R. § 240.21F-4(b)(4)(i)-(ii) (2011).
70. 17 C.F.R. § 240.21F-4(b)(4)(iii)(A) (2011).
71. 17 C.F.R. § 240.21F-4(b)(4)(iii)(B)-(C) (2011).

- public accountants who learn the information through an SEC engagements, if the information relates to violations by the engagement client;[72] or
- individuals who obtain the information by violating U.S. or state criminal law.[73]

However, in certain excluded circumstances, the officer, directors, trustee or partners and compliance and internal audit personnel, as well as public accountants could become whistleblowers.[74]

The first excluded circumstance is when the whistleblower has "a reasonable basis to believe that disclosure of the information to the [SEC] is necessary to prevent the relevant entity from engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors."[75] A second exception allows these excluded individuals to become a whistleblower if they "have a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct."[76] Finally, the individual may be a whistleblower if at least 120 days elapsed since the whistleblower reported the information to certain compliance individuals specified by the rule, or 120 days elapsed since the whistleblowers received the information if these compliance individuals are already aware of the information.[77]

IV. PROTECTING THE WHISTLEBLOWER

A. Anonymity

Whistleblowers may anonymously report information to the SEC if an attorney represents the whistleblower in connection with the submission of the information and the claim for an award, and follows the procedures for anonymous submissions.[78] Anonymity is one of the added benefits of a whistleblower retaining an attorney to represent them in the matter. An attorney experienced in securities laws issues can also help maximize the recovery for the whistleblower by using their expertise in assisting the SEC in building its case. As discussed earlier, the SEC has the sole discretion in

72. 17 C.F.R. § 240.21F-4(b)(4)(iii)(D) (2011).
73. 17 C.F.R. § 240.21F-4(b)(4)(iv) (2011).
74. *See* 17 C.F.R. § 240.21F-4(b)(4)(v) (2011).
75. 17 C.F.R. § 240.21F-4(b)(4)(v)(A) (2011).
76. 17 C.F.R. § 240.21F-4(b)(4)(v)(B) (2011).
77. 17 C.F.R. § 240.21F-4(b)(4)(v)(C) (2011).
78. 17 C.F.R. § 240.21F-7(b) (2011).

determining the percentage of recovery the whistleblower is entitled to receive (between 10-30% of the monetary sanctions). The participation of the whistleblower and his or her attorney is taken into consideration in determining the amount of the award.[79]

However, if the whistleblower retains an attorney and chooses to remain anonymous when reporting the information to the SEC, the whistleblower must disclose their identity to the SEC before an award is paid.[80] In other words, if the SEC completes a successful action recovering over $1 million as a result of the tips of the anonymous whistleblower, the whistleblower must then disclose their identity to the SEC before he or she can be paid an award. The ability of a whistleblower to remain anonymous up until this point is should encourage whistleblowers to come forward. This is important, as often times, even with anti-retaliation protections, whistleblowers fear losing business and personal relationships, as well as the risk of media exposure, if they come forward.

B. Anti-Retaliation

Dodd-Frank and the SEC rules promulgated thereunder expressly prohibits retaliation by employers against individuals who become whistleblowers under SEC rules, even if the whistleblower does not recover an award.[81] It provides the whistleblower with a cause of action in the event that they are discharged or discriminated against in any manner by their employers in violation of the act.[82] A whistleblower successful in his or her retaliation cause of action is entitled to "reinstatement with the same seniority status that the individual would have had," plus "2 times the amount of back pay otherwise owed to the individual, with interest" and "compensation for litigation costs, expert witness fees, and reasonable attorneys' fees."[83]

The rules provide, that for purposes of the anti-retaliation protections, an individual is a whistleblower if he or she has a "reasonable belief that the information [they] are providing relates to a possible securities law violation" and he or she reports the violation in accordance with Section 21F(h)(1)(A)

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79. *See supra* Section III(B)(ii).
80. 17 C.F.R. § 240.21F-7(b)(3) (2011).
81. 17 C.F.R. § 240.21F-2(b) (2011); 15 U.S.C § 78u-6(h) (2011). For a list of retaliation protections afforded to whistleblowers under other whistleblower/retaliation statutes, *see* "Whistleblower Protections" *at* http://www.whistleblowerlaws.com.
82. 15 USC § 78u-6(h)(1)(B)(i) (2011).
83. 15 USC § 78u-6(h)(1)(C)(i)-(iii) (2011).

of the Securities Exchange Act of 1934.[84] The rules also clarify that "the anti-retaliation protections apply whether or not [the whistleblower satisfies] the requirements, procedures and conditions to qualify for an award."[85]

The "reasonable belief" standard requires "that the information demonstrates a possible violation, and that this belief is one that a similarly situated employee might reasonably possess."[86] The SEC stated that the reasonable belief standard for anti-retaliation protection "strikes the appropriate balance between encouraging individuals to provide us with high-quality tips without fear of retaliation, on the one hand, while not encouraging bad faith or frivolous reports, or permitting abuse of the anti-retaliation protections, on the other."[87]

V. PROCEDURE FOR FILING A WHISTLEBLOWER CLAIM WITH THE SEC AND MAKING A CLAIM FOR AN AWARD

In order to be considered a whistleblower under the rules, the whistleblower must submit their original information one of two ways: 1) online through the SEC's website;[88] or (2) by completing a Tip, Complaint or Referral Form (referred to as a "Form TCR")[89] and submitting the form to the SEC by mail or fax.[90] The Form TCR is a relatively straight forward 6-page form. Accompanying sworn certifications by the whistleblower and counsel are required, declaring that under penalty of perjury the information is true and correct to the best of their knowledge and belief.[91]

In instances where information is provided to the SEC by an anonymous whistleblower, their attorney is to submit the information on the whistleblower's behalf to the SEC. Prior to the attorney's submission, the whistleblower is required to provide their attorney with a completed Form TCR that is signed under penalty of perjury.

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84. 17 C.F.R. § 240.21F-2(b)(i)-(ii) (2011).
85. 17 C.F.R. § 240.21F-2(b)(iii) (2011).
86. SEC Release No. 34-64545 (citing *Livingston v. Wyeth, Inc.*, 520 F. 3d 344, 352 (4th Cir. 2008); *Clover v. Total Sys. Servs., Inc.*, 176 F.3d 1346, 1351 (11th Cir. 1999)).
87. *See* SEC Release No. 34-64545 (internal citations omitted).
88. *See* http://www.sec.gov/whistleblower.
89. Form TCR is a relatively straight forward 6-page form and is available on the SEC's website at: http://www.sec.gov/about/forms/formtcr.pdf.
90. 17 C.F.R. § 240.21F-9(a) (2011).
91. 17 C.F.R. § 240.21F-9(b) (2011).

In making the submission on the whistleblower's behalf, the whistleblower's attorney is required to certify that he or she: 1) has verified the whistleblower's identity; 2) has reviewed the completed and signed TCR for completeness and accuracy and that the information is true, correct, and complete to the best of the *attorney's* knowledge, information and belief;" 3) has obtained the whistleblower's non-waivable consent to provide the SEC with the whistleblower's Form TCR in event that the SEC requests it due to concerned of false or fraudulent statements; and 4) "consents to be legally obligated to provide the signed Form TCR within seven calendar days from request by the SEC."[92]

The rules also outline certain procedures a whistleblower must follow for applying for a whistleblower award. This process begins with the SEC providing notice whenever an SEC action results in monetary sanctions totaling more than $1,000,000.[93] This notice is referred to as a "Notice of Covered Action", and will be published on the SEC's website after a judgment or order is entered.[94] The whistleblower has "**ninety (90) calendar days** from the date of the Notice of Covered Action to file a claim for award based on that action, or the claim will be barred."[95]

To file a claim for a whistleblower award, the whistleblower must file a two-page Form WB-APP (Application for Award for Original Information).[96] The Form WB-APP requires the whistleblower's signature under penalty of perjury that the information contained in the form is accurate. If the whistleblower reported the information anonymously to the SEC through an attorney, the whistleblower is now required to disclose their identity on the Form WB-APP.[97] The form is to be submitted to the SEC's office of the whistleblower by fax or mail and must be received by the Office of the Whistleblower within 90 calendar days of the date Notice of Covered Action in order for the whistleblower to remain eligible for an award.[98]

The SEC's claims staff then evaluates the claim form.[99] The SEC may request additional information from the whistleblower during this time.[100] Following the evaluation, the SEC will provide the whistleblower with "a

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92. 17 C.F.R. § 240.21F-9(c)(1)-(4) (2011).
93. 17 C.F.R. § 240.21F-10(a) (2011) (emphasis added).
94. *Id.*
95. *Id.* (emphasis added).
96. 17 C.F.R. § 240.21F-10(b) (2011). This form is available on the SEC's website at http://sec.gov/about/forms/formwb-app.pdf.
97. 17 C.F.R. § 240.12F-10(c) (2011).
98. 17 C.F.R. § 240.12F-10(b) (2011).
99. 17 C.F.R. § 240.12F-10(d) (2011).
100. *Id.*

Preliminary Determination setting a forth a preliminary assessment as to whether the claim" was accepted and the percentage of the award amount.[101]

The whistleblower has 30 days from the Preliminary Determination to request a review certain source documents the SEC perused in its review and to request a meeting with the Office of the Whistleblower (however, these are not mandatory meetings).[102]

The whistleblower has 60 days from the Preliminary Determination (or from the date of receipt of the materials requested for review, if applicable) to submit a response to the Preliminary Determination.[103] If no response is filed, the Preliminary Determination becomes a final order of the SEC.[104] However, if the whistleblower files a timely response, the SEC will review the issues and grounds in the response, as well as any accompanying documents, and will make its Proposed Final Determination for review by an SEC Commissioner.[105] A final order will be then be made by the SEC.[106]

VI. CONCLUSION

Whistleblowers are vital to exposing corporate frauds and other financial misconduct. The SEC's failure to investigate Madoff after Harry Markopolos reported his findings to the SEC strongly demonstrates why the SEC whistleblower office is a necessity. Past government whistleblower offices for the IRS, Medicare and others have helped the government timely detect gross malfeasance, which has saved U.S. taxpayers millions of dollars and prevented further financial crimes.

The SEC whistleblower rules serve an important public interest. This Act provides duality in purpose, providing an environment where a whistleblower is not likely to be adversely affected and thus providing the SEC a powerful enforcement tool. The financial incentives should help the SEC uncover and investigate fraud more efficiently. Investors and counsel are frequently driven by their need to protect other innocent investors from being victims of financial fraud and from protecting investors from a never ending list of corporate fraud, securities malfeasance and a parade of con artists. The SEC whistleblower office gives the SEC the resources to listen

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101. *Id.*
102. 17 C.F.R. § 240.12F-10(e)(1)(i)-(ii) (2011).
103. 17 C.F.R. § 240.21F-10(e)(2) (2011).
104. 17 C.F.R. § 240.12F-10(f) (2011).
105. 17 C.F.R. § 240.21F-10(g) (2011).
106. 17 C.F.R. § 240.12F-10(h), (i) (2011).

to investors or others with firsthand knowledge of misconduct. The SEC will be better equipped to halt ongoing misconduct before further damage is done for the benefit of the investing public.

DISCOVERY OF REGULATORY DOCUMENTS: DEBUNKING THE MYTH OF AN "SEC PRIVILEGE" IN SECURITIES ARBITRATION

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I. INTRODUCTION

Defective securities product cases have invited increased regulatory scrutiny by the U.S. Securities and Exchange Commission (SEC) and other financial regulatory agencies such as the Financial Industry Regulatory Authority (FINRA), formerly known as the National Association of Securities Dealers (NASD).[2] The increase in regulatory scrutiny has raised the level of awareness of civil litigants about the authority and power of regulatory bodies to order broker-dealers and/or issuers to produce documents related to product failures. Thus, it is common today for civil litigants to seek discovery of documents broker-dealers and/or issuers produce to regulators in court cases and securities arbitration.

Companies under investigation by the SEC often object to producing regulatory correspondence and documents submitted to the SEC and other regulatory agencies based on an alleged "SEC privilege." In short, there is no such privilege. Specifically, there is no support for the proposition that relevant, otherwise nonprivileged documents, submitted by a party in a civil action to any regulatory agency are not discoverable from the producing party by the other litigant in a civil action.

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

II. THERE IS NO PRIVILEGE IN CIVIL LITIGATION SHIELDING DISCOVERY OF RELEVANT NONPRIVILEGED DOCUMENTS SUBMITTED TO THE SEC

1. Courts Reject an "SEC Privilege"

In 2002, the court in *Kirkland v. Superior Court* held that there is no public policy treating SEC testimony and documents provided to the agency during an inquiry or investigation as private or confidential.[3] On appeal, the court upheld the trial court's order compelling defendant to produce copies of documents and transcripts of testimony given in proceedings before the SEC in a separate investigation of that defendant. Specifically, the court found that the documents and transcripts in question were "relevant to [plaintiff's] claim that [defendant], Kirkland, orchestrated . . . transactions in an effort to enhance PLB's financial appearance."[4] Kirkland argued that "documents and transcripts related to a private and confidential SEC investigation are not subject to discovery,"[5] relying on an SEC regulation that provides "information or documents obtained by the SEC in the course of any investigation or examination, unless made a matter of public record, shall be deemed nonpublic."[6]

The court of appeals rejected Kirkland's arguments for several reasons. First, "California's pretrial discovery procedures are designed to minimize the opportunities for fabrication and forgetfulness, and to eliminate the need for guesswork about the other side's evidence, with all doubts about discoverability resolved in favor of disclosure."[7] Second, the testimony and documents were reasonably calculated to lead to the discovery of admissible evidence.[8] Third, "ample good cause" regarding the relevancy of the

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3. Kirkland v. Superior Court (Guess? Inc.), 115 Cal. Rptr. 2d 279 (Ct. App. 2002).

4. *Id.* at 284 ("Specifically, the documents and transcripts evidencing other transactions involving PLB, Western, and Pacific were relevant to show motive, intent, knowledge, plan, and absence of mistake.") (citing Evid. Code § 1101, subd. (b); Morris Stulsaft Foundation v. Superior Court (Shultsaft), 54 Cal. Rptr. 12 (Ct. App. 1966)(explaining that evidence of other transactions is admissible to show motive, intent, knowledge, plan, and absence of mistake)).

5. *Kirkland,* 115 Cal. Rptr. 2d at 283.

6. 17 C.F.R. § 203.2 (2001).

7. *Kirkland* at 283 (citing Glenfed Dev. Corp. v. Sup. Ct., 62 Cal. Rptr. 2d 195 (Ct. App. 1997).

8. *Id.* at 283-284.

documents and testimony had been shown.[9] Fourth, Kirkland never produced any evidence that "he or any witness actually believed the SEC investigation was private or confidential."[10] In fact, the court determined that even if a request for confidential treatment was made prior to disclosure "it would mean only that Kirkland asked (and not that the SEC agreed) that the documents would 'be deemed nonpublic;'" this would not mean disclosure to the SEC would be protected from discovery in a subsequent civil proceeding.[11] Fifth, the court found there is "no law to support Kirkland's claim that the SEC testimony and documents should be as a matter of public policy treated as private or confidential, and the law that does exist supports the opposite conclusion."[12] The *Kirkland* court also found significant that:

> . . . the federal courts have uniformly rejected Kirkland's claim that, in the absence of judicial protection for the SEC's confidential investigatory process, witnesses will not be as forthcoming as they otherwise might be, and equally significant that the federal courts have refused to imbue such

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9. *Id.* at 284.

10. *Id.* ("Generously construed, the record shows only that Kirkland's lawyer made a timely request that any information submitted to the Commission . . . be given 'confidential treatment' pursuant to 17 C.F.R. 203.83. Assuming that such a request was made (we are not told when or to whom it was made or whether it was in writing or oral), it would mean only that Kirkland asked (and not that the SEC agreed) that the documents "be deemed non-public.").

11. *Kirkland* at 284 (citing *In re Leslie Fay Companies, Inc. v. Sec. Litig.*, 152 F.R.D. 42, 45-46 (S.D.N.Y. 1993)(explaining that in the absence of a confidentiality agreement, the mere request that the SEC keep submissions confidential is insufficient to protect the submissions from disclosure to third parties)).

12. *Kirkland* at 284 ("Witnesses who testify or produce documents to the SEC usually have the right to obtain copies of the transcripts of their testimony and documents (17 C.F.R. § 203.6 (2001), and where they have done so (as has Kirkland) there is no cognizable claim of confidentiality or privacy in those documents or transcripts) (citing *LaMorte v. Mansfield*, 438 F.2d 448, 451 (2d Cir. 1971) (explaining that to the extent there is any privilege, it belongs to the SEC, not the witness); *see also White v. Jaegerman*, 51 F.R.D. 161, 163 (S.D.N.Y. 1970)(". . . the decision by the Securities and Exchange Commission to furnish White a copy of his testimony without any injunction against disclosure to a third party made the testimony public at least for the purposes of discovery by defendant; the secrecy provisions were for the benefit of the Commission and not plaintiff.).

> transcripts and documents with a patina of confidentiality that would trigger an exemption from normal discovery.[13]

Last, "the trial court's order was not unduly burdensome."[14]

Likewise, in *D'Addario v. Geller*,[15] the Fourth Circuit Court of Appeals rejected the defendant's claim that nonprivileged documents involuntarily submitted to the SEC were protected by an "SEC privilege."[16] On appeal from the District Court for the Eastern District of Virginia, D'Addario challenged the lower court's various discovery rulings as well as the grant of summary judgment for defendants.[17] The Fourth Circuit vacated summary judgment and reversed the district court's discovery ruling denying D'Addario access to documents and materials submitted by defendants to the SEC.[18] Defendants argued that because SEC investigations are nonpublic they should be protected from disclosure in subsequent civil litigation.[19] Rejecting that argument, the Fourth Circuit held that "the district court erred because there is no such thing as an SEC privilege."[20] Moreover, the Fourth Circuit rejected an 'SEC privilege' based on reliance of 17 C.F.R. § 203.2 holding that the regulation:

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13. *Kirkland*, 115 Cal. Rptr. 2d at 285 (emphasis added); *see also* Zients v. LaMorte, 319 F. Supp. 956, 958, (S.D.N.Y. 1970) mandamus denied, sub nom. *LaMorte v. Mansfield*, 438 F.2d 448 (2d. Cir. 1971) (explaining that the confidentiality provisions that do exist are to permit the SEC to enjoy confidentiality where it is necessary to complete its investigation); In re Air Passenger Comp. Res. Sys. Antitrust Lit., 116 F.R.D. 390, 393 (C.D.Cal. 1986); In re Woolworth Corp. Sec. Class Action Lit., 166 F.R.D. 311, 312-313 (S.D.N.Y. 1996); Herbst v. Able, 63 F.R.D. 135, 138 (S.D.N.Y. 1972); In re Steinhardt Partners, L.P., 9 F.3d 230 (2d Cir. 1993); Westinghouse v. Republic of the Philippines, 951 F.2d 1414 (3d Cir. 1991).

14. *Id.* at 285.

15. 129 Fed. App'x 1 (4th Cir. 2005); although *D'Addario* is unpublished, authoritative use is permitted pursuant to the Fourth Circuit local rule 32.1 which states in pertinent part: "If a party believes, nevertheless, that an unpublished disposition of this Court issued prior to January 1, 2007, has precedential value in relation to a material issue in a case and that there is no published opinion that would serve as well, such disposition may be cited . . . ."

16. *Id.* at 7.

17. *Id.*

18. *Id.* at 2.

19. *Id.* at 7.

20. *Id.*

> . . . [P]rovides only that information and documents obtained by the SEC in the course of an investigation are deemed nonpublic. The regulation does not provide that documents and materials submitted to the SEC are not discoverable in a later civil proceeding. Because there is no SEC privilege, the district court erred in refusing to compel discovery of the documents and materials submitted by RMST to the SEC.[21]

No court has rejected the holdings in *Kirkland* and *D'Addario*.

2. The Financial Industry Regulatory Agency (FINRA) Provides for the Discovery of Documents Sent to Regulatory Agencies

The holdings in *Kirkland* and *D'Addario* are consistent with guidelines set forth by the Financial Industry Regulatory Authority (FINRA), which provide for the discovery of correspondence and documents sent to regulators. Specifically, the Arbitrator's Manual[22] "provides to parties in arbitrations guidance on which documents they should exchange without arbitrator or staff intervention, and guidance to arbitrators in determining which documents customers and member firms or associated persons *are presumptively required to produce* in customer arbitrations including "correspondence with regulators."[23]

Furthermore, List 5, Item 4 of the FINRA Discovery Guide[24] states that the following documents are discoverable in failure to supervise cases:

> Those portions of examination reports or similar reports following an examination or an inspection conducted by a state or federal agency or a self-regulatory organization that focused on the Associated Person(s) or the transactions at issue or that discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the statement of claim.

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21. *D'Addario,* 129 Fed. App'x at 7.

22. *See* Fin. Industry Reg. Authority (FINRA), *The Arbitrator's Manual*, at 13, August 2007, *available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p009668.pdf.

23. *Id.* at 14 (emphasis added).

24. *See* Fin. Industry Reg. Authority (FINRA), *The Discovery Guide*, April 2007, *available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbrul/documents/arbmed/p018922.pdf.

In addition, List 1, Item 12 of the Discovery Guide also calls for the production of similar regulatory documents to be produced by the firm/associated person(s) in all customer cases, stating that: "Records of disciplinary action taken against the Associated Person(s) by any regulator or employer for all sales practices or conduct similar to the conduct alleged to be at issue." In fact, the Discovery Guide expressly states that "[t]he arbitrators and the parties should consider the documents described in Document Production Lists 1 and 2 *presumptively discoverable*;"[25] and "[a]rbitrators can order the production of documents not provided for by the Document Production Lists. . . ." Consistent with this notion is the fact that FINRA Rule 12507 allows parties to make additional discovery requests not covered by the Discovery Guide's Production Lists.

Thus, FINRA guidelines governing securities arbitration support settled case law that nonprivileged documents submitted to regulatory authorities are discoverable.

3. Securities Arbitration Panels Reject an "SEC Privilege"

Numerous arbitration panels reject the "SEC privilege" argument and have ordered the production of documents exchanged between broker-dealers and regulators. In a claim against a major broker-dealer alleging breach of fiduciary duty and failure to supervise regarding the sale of "Principal Protected Notes," Claimants sought from Respondent the production of correspondence and documents sent to any regulatory agency regarding the fund(s) at issue. The requests were as follows:

> All documents received by Respondent from any federal or state regulatory authority and/or self-regulatory authority concerning [the Funds at issue] during the relevant time period; and All documents received from, or sent to any state, federal, SRO regulatory or securities agency pursuant to any investigation by any such agency of the Funds as recently disclosed in [Respondent's] Form 10Q.

Respondent refused to produce regulatory documents claiming such production to the SEC was privileged. Claimants then filed a Motion to Compel production of regulatory correspondence and documents.

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25. *Id.* (emphasis added).

In their moving papers, Respondent's cited to 17 C.F.R. 203.2, *Stanley v. Safekin Corp.*,[26] and *SEC v. Rogers*,[27] claiming documents exchanged between Respondent and a regulatory agency are protected from public disclosure. Claimants rebutted Respondent's interpretation of 17 C.F.R. 203.2 by relying on the holding in *D'Addario* as follows:

> In D'Addario, the court held that there is no "SEC privilege," and further clarified that 17 Code of Federal Regulations section 203.2 does not prevent the production of the documents produced to the SEC when subpoenaed by one party to a civil suit from the other party which submitted the documents to the SEC during an investigation.

In addition, Claimants challenged Respondent's argument that Claimants' request would "subvert public policy and would potentially undermine pending regulatory inquiries" stating:

> Respondent's policy argument contradicts the law of privilege, both generally and specifically. In general: "The privileges set out in the Evidence Code are legislative creations; the courts of this state have no power to expand them or to recognize implied exceptions."[28] Moreover, none of the privileges were set forth in Respondent's Responses to Claimants' First Request for Production of Documents and therefore cannot be properly raised here. Finally, Respondent cites few authorities to support its policy argument, none of which govern this dispute. Respondent's policy argument that the documents responsive to Claimants' requests should not be discoverable is also without merit: "California's pretrial discovery procedures are designed to minimize the opportunities for fabrication and forgetfulness, and to eliminate the need for guesswork about the other side's evidence, with all doubts about discoverability resolved in favor of disclosure."[29]

Moreover, as presented in Claimants' reply brief, Respondent's public policy argument was rejected by the *Kirkland* court. Specifically, that "there

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26. Stanley v. Safekin Corp., No. Civ.99CV454-BTM(LSP), 2001 WL 1870859 (S.D.Cal. July 11, 2001).

27. Sec. Exch. Comm'n *v*. Rogers*,* 283 Fed. App'x. 242 (5th Cir. 2008).

28. Wells Fargo Bank v. Superior Court (Boltwood), 990 P.2d 591, 594 (Cal. 2000).

29. *See* Glenfed Dev. Corp. v. Superior Court (Nat'l Union Fire Ins. Co. of Pittsburgh, PA), 62 Cal. Rptr. 2d 195, 199 (Ct. App. 1997).

is no law to support [defendant's] claim that the SEC testimony and documents should as a matter of policy be treated as private or confidential, and the law that does exist supports the opposite conclusion."[30]

Furthermore, Respondent's reliance on *Stanley v. Safeskin Corp*[31] to support the creation of a regulatory privilege was inapposite to the case at bar. Claimants set forth why *Stanley* does not support a per se denial of requests for documents provided to regulatory agencies as follows:

> In an order denying a motion to compel, the District Court for the Southern District of California in *Stanley v. Safeskin Corp*.[32] denied Plaintiffs motion to compel "all documents relating to any communication to/from the Securities Exchange Commission or other regulatory authorities."[33] The court denied the motion finding that there was insufficient nexus between the documents requested and matters at issue in the case (i.e., lack of relevance) because it was not limited to the relevant time period in issue.[34] Stanley does not stand for a per se denial of requests for documents provided to regulatory agencies. Rather, the court in Stanley applied a factual analysis to determine if the documents sought by the plaintiff were relevant and therefore discoverable.

Thus, because the request in *Safeskin* was unlimited as to time and scope, discovery was denied.

Likewise, *Sec. Exch. Comm'n v. Rogers*[35] concerned a document request which sought from the SEC "every document pertaining to every investigation, prosecution, or enforcement action against [plaintiff] by any federal agency since 1960."[36] There, plaintiff's request sought almost 50 years of documents from the SEC. In the arbitration at bar, Claimants

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30. *Kirkland*, 115 Cal. Rptr. 2d at 284.

31. Stanley v. Safeskin Corp., No. Civ.99CV454-BTM(LSP), 2001 WL 1870859 (S.D.Cal. July 11, 2001).

32. *Id.*

33. *Id.* at 1.

34. *Id.*

35. *Sec. Exch. Comm'n v. Rogers,* No. 07-10885, 2008 U.S. App. LEXIS 13259 (5th Cir. June 20, 2008).

36. *Id.* at 243.

limited the time period for the production of the requested documents to less than six years of the relevant time period. Consequently, Respondent's reliance on *Sec. Exch. Comm'n v. Rogers* was inapposite because Claimants' document request was limited to the relevant time period in issue.

Last, Respondent presented a privacy argument which was rebutted in Claimants' reply brief as follows:

> Claims of right of privacy do not shield the production of relevant documents. Specifically, the constitutional right of privacy does not provide absolute protection against disclosure of personal information; rather it must be balanced against the countervailing public interests in disclosure.[37] Thus, it may be abridged to accommodate a compelling public interest.[38] A general public interest exists in "facilitating the ascertainment of truth in connection with legal proceedings,"[39] and in obtaining just results in litigation.[40]
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> Moreover, "relevant bank customer information should not be wholly privileged and insulated from scrutiny by civil litigants."[41] In *Valley Bank of Nevada*,[42] the court stated that: "In order to facilitate the ascertainment of truth and the just resolution of legal claims, the state clearly exerts a justifiable interest in requiring a businessman to *disclose communications, confidential or otherwise, relevant to pending litigation*."[43]

Following oral argument on the motion, the Chairperson rejected Respondent's privilege argument and ordered production of all documents that were submitted by Respondent pursuant to any "regulatory agency's (including Self-Regulating Organizations ["SRO's"]) requests for documents

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37. *See* Vinson v. Superior Court (Peralta Cmty Coll. Dist.), 740 P.2d 404, 410 (Cal. 1987).

38. *See* City of Santa Barbara v. Adamson, 610 P. 2d 436, 439 (Cal. 1980).

39. Moskowitz v. Superior Court (Zerner, Sims & Cibener), 187 Cal. Rptr. 4 (Ct. App. 1982)(quoting Britt v. Superior Court, 574 P.2d 766,774 (Cal. 1978)).

40. *See* Valley Bank of Nevada v. Superior Court (Barkett), 542 P.2d 977, 979 (Cal. 1975).

41. *Valley Bank*, 542 P.2d at 980.

42. *Id.*

43. *Id.* (emphasis added).

. . . and Respondent's replies and responses . . . specific to the broker-dealer or the PPN or both," within forty-five days. Respondent filed a Motion to Reconsider before the whole panel which was rejected after a second hearing.

In yet another case involving a municipal arbitrage product, a FINRA panel expressly rejected an 'SEC privilege' after Respondent refused to produce regulatory correspondence and documents. Claimants alleged breach of fiduciary duty, breach of contract, unsuitability and failure to supervise the municipal arbitrage fund that was marketed as a safe, low-risk investment, whereby subscribers lost all or a substantial portion of their principal investment(s). Claimants sought the production of correspondence and documents sent to regulatory agencies regarding the fund. Specifically, Claimants requested:

> All documents received by Respondent from any federal or state regulatory authority and/or law enforcement authority and/or self-regulatory authority concerning [hedge] Funds during the relevant period. And, all documents received from, or sent to any state, federal, SRO regulatory or securities agency pursuant to any investigation by any such agency of the Funds as recently disclosed in Respondent's Form 10Q.

Again, Respondent refused to produce regulatory documents claiming such production to the SEC was privileged. Claimants then filed a Motion to Compel production of regulatory correspondence and documents.

After a telephonic hearing on the Motion to Compel, the Chairperson ordered Claimants and Respondent to submit written briefs as follows:

> As to Claimants' Document Request Nos. 51 and 56, counsel for the Claimants shall submit a brief in support of their requests, by no later than October 23, 2009, and counsel for the Respondent shall submit a brief in support of their opposition to these requests, by no later than October 28, 2009. As discussed, to the extent that the Respondent has previously agreed to produce, to any counsel for any other customers, the documents that the Respondent has produced to the U.S. Securities & Exchange Commission in connection with its investigation of the [hedge] funds, then the Respondent, in its brief, shall provide the following: (1) a description of the documents and audio recordings that have been produced to such other counsel; (2) copies of all agreements between the Respondent and such other counsel that memorializes their agreements with respect to such

> documents; and (3) any documents which reflect and/or pertain to the Respondent having requested the permission and/or consent of the SEC prior to the production of such documents to any counsel for any other customers. Upon receipt and review of these submissions, the Chairman of the Panel shall issue a supplemental ruling.

In their responding brief, Respondent conceded no 'SEC privilege' exists then shifted to a public policy argument against disclosure stating: "While [Respondent] recognizes that there is no per se "SEC privilege," the production of documents provided to the regulators in this case would operate as an "end run" around federal law and would restrict the ability of a party to fully and candidly participate in a regulatory investigation." In support of their public policy assertion, Respondent cited to 17 C.F.R. § 203.2 which deems material acquired during an inquiry "nonpublic." [44] However, the fallacy in Respondent's argument is the assumption that if the SEC can refuse production of the requested documents so can Respondent, a proposition rejected by most courts.[45]

Respondent next argued that the requested documents were irrelevant to the case at bar, while repeating their concession that no "SEC privilege" exists. Specifically:

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44. Specifically, Respondent argued: "17 C.F.R. § 203.2 explicitly provides that "[i]nformation or documents obtained by the Commission in the course of any investigation or examination, unless made a matter of public record, shall be deemed non-public. . ." Thus, Claimants cannot obtain documents provided by [Respondent] to the Securities and Exchange Commission from the SEC (which is why Claimants have attempted to obtain the documents from [Respondent] through a document request, rather than a subpoena to the SEC)."

45. *See* In re Penn Cent. Commercial Paper Litig., 61 F.R.D. 453, 462 n.20 (S.D.N.Y. 1973)(rejecting defendant's reliance on SEC regulations that insure privacy in nonpublic SEC investigation, and stating that "these regulations are for the benefit of the [SEC] and not for witnesses who may appear before it."; *see also* Maryville Academy v. Loeb Rhoades & Co., 1978 U.S. Dist. LEXIS 14008 ("Any privilege attaching to non-public SEC testimony belongs to and is waivable by the Commission."); La Morte v Mansfield, 438 F.2d 448, 451 (2d. Cir. 1971)("To the extent that a privilege exists, it is the agency's, not the witness'."); Herbst v. Able 63 F.R.D. 135, 137 (S.D.N.Y. 1972)("It is clear . . . [the] SEC has no objection to making available to Donald Douglas, Jr., a copy of the transcript of his testimony. More significantly, [the] SEC expressed no desire to keep any portion of Mr. Douglas' testimony secret or confidential. Mr. Douglas' claim here of confidentiality is, therefore, without merit.").

> [Respondent] acknowledges that producing relevant documents to the SEC does not make them privileged. However, Claimants should not be allowed to do an "end run" around 17 C.F.R. § 203.2 by requesting documents from a party (as opposed to the SEC) that are not relevant to the private arbitration. Thus, while relevant documents that would have to be produced otherwise in a private arbitration remain discoverable, 17 C.F.R. § 203.2 establishes that documents cannot be obtained from a private party merely because they are part of a regulatory inquiry. Rather, the requesting party must establish an independent basis for the relevancy of documents

Lastly, Respondent argued that compelling production in this case would be too burdensome,[46] even though the same Respondent had been ordered to produce the same documents, and had produced such documents in other arbitration proceedings.

The arbitration panel rejected Respondent's arguments that compelling production would offend public policy; the requested production was irrelevant to the instant matter; and compliance would be too costly and burdensome. The order issued by the arbitration panel compelling production of regulatory documents and correspondence stated:

> 1) There is no privilege based upon the request and response for information from the Securities and Exchange Commission or any self-regulatory agency; 2) Because the claim raises issues of the design and management of the funds by respondent, the requests to the extent they relate to products sold to Claimants are relevant for discovery purposes even though the information sought does not directly relate to the Claimants; 3) To the extent respondent is required to provide such documents in any other arbitration the requests are not unduly burdensome.

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46. "Claimants' requests here are simply unduly burdensome, harassing and oppressive in scope. The cost to [Respondent] to produce regulatory documents to Claimants in this case will be enormous, and does not include the time required for [Respondent]'s attorneys to review the documents to identify and protect privileged documents. Unless the Chairperson orders that Claimants pay for the cost of producing these documents, the cost to respond to these requests alone could be staggering. This limited arbitration proceeding and the particular issues presented by Claimants in this case do not warrant such an intrusive and expensive production."

In another securities arbitration, Claimant alleged breach of fiduciary duty, breach of contract, constructive fraud, fraud by misrepresentation and omission as well as negligence against a single broker-dealer regarding the failure of a yield fund that was marketed as a safe, low-risk investment. During discovery, Claimant requested and Respondent objected to, production of documents sent to regulators regarding the product failure at issue. Briefs were submitted by both parties and a telephonic hearing on Claimant's Motion to Compel took place.

Respondent argued that documents sent to regulators were a) not supported by the Arbitrator's Manual; b) not supported by the Discovery Guide; c) beyond the scope of discovery in arbitration; d) not relevant and; e) confidential and burdensome to produce.

In response, Claimant argued their request was within the scope of FINRA arbitration guidelines, was relevant to the claims alleged, and not burdensome to Respondent. Specifically, Claimant cited the Discovery Guide as well as the Arbitrator's Manual in support of Claimant's document requests as follows:

> Respondent's argument that The Arbitrator's Manual does not support Claimant's request is without merit. Specifically, the Arbitrator's Manual, pgs. 13-14, item 6 states that "correspondence with regulators" are frequently ordered to be produced by the firm in customer cases. Although Respondent recognizes and concedes this point, Respondent argues that the Arbitrator's Manual compels production of correspondence with regulators "where those documents are *relevant* to the issue in the case." As noted above, Claimant has already established that correspondence with regulators is not only directly relevant to his case but that state and federal law support the production of such documents.[47]
>
> Furthermore, List 5, Item 4 of the Discovery Guide states that the following documents are discoverable in failure to supervise cases:

47. *See D'Addario*, 129 Fed. App'x 1 (4th Cir. 2005); accord, *Kirkland*, 115 Cal. Rptr. 2d at 284 (holding that documents subpoenaed by one party to a civil suit from the other party which submitted the documents to the SEC during an investigation *are relevant, not subject to any privilege and must be produced* because there is no SEC privilege or other regulatory privilege barring such production.) (emphasis added).

> Those portions of examination reports or similar reports following an examination or an inspection conducted by a state or federal agency or a self-regulatory organization that focused on the Associated Person(s) or the transactions at issue *or that discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the statement of claim.*
>
> Therefore, as evidenced by the language in the Discovery Guide set forth above, documents to be produced are not limited to Claimant or Claimant's account in issue. Rather, documents to be produced are those that either "focused on the Associated Person(s) . . . *or that discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the statement of claim."*

Citing List 5, Item 4 of the Discovery Guide, Respondent argued that documents and correspondence produced to regulators were not relevant to Claimant's arbitration claim because the documents sought also related to transactions other than Claimant's, and as such, was overbroad and not discoverable. Specifically, that ". . . like other documents contemplated by the Discovery Guide, 'correspondence with regulators' should be produced only if the correspondence relates to the *specific relationship* between the complaining customer and this broker, and *transactions specific* to the complaining customer."

However, Claimant countered that because it knew from other cases that individuals other than the Claimant in this action had brought *similar complaints* about the product against Respondent, documents relating to those complaints were discoverable pursuant to the Discovery Guide. The arbitration panel agreed.

The Chairperson ordered production of "[a]ll documents received by [Respondent] from any federal or state regulatory authority and/or law enforcement authority and/or self-regulatory authority concerning the Fund during the period from January 1, 2006 through the present, and [Respondent's] responses thereto;" and "[d]ocuments sufficient to show information provided by [Respondent] to any federal or state regulatory authority and/or law enforcement authority concerning the Fund during the period from January 1, 2006 through the present." To protect privacy or confidentiality interests of customers other than Claimant, the order provided that "[Respondent] may redact customer names and customer information on documents responsive to this request."

Respondent contended that compelling production of regulatory correspondence and documents was too burdensome and thus, Claimant should bear the cost of production- an argument broker-dealers often set forth once production of regulatory documents is ordered and which is often rejected by courts and securities arbitration panels.

4. Cost-Shifting is Inapplicable When Documents are Readily Accessible

Many broker-dealer firms allege that compelling production of regulatory correspondence and documents is too burdensome and if so ordered, Claimant should bear the cost of production. However, a cost-shifting argument is without merit when the documents are readily accessible, especially in the modern world of electronic discovery, where the cost of producing documents is inexpensive.

Accordingly, the United States Supreme Court has set forth the presumption "that the responding party must bear the expense of complying with discovery requests . . . ."[48] And a federal court in the Southern District of New York opined in *Zubulake v. UBS*[49] that when the information sought is readily accessible on the responding party's computer system, "the usual rules of discovery apply: the responding party should pay the costs of producing responsive data."[50]

Therefore, because cost-shifting does not apply to accessible documents, "a court should consider cost-shifting *only* when electronic data is relatively inaccessible, such as in backup tapes."[51] And even when cost-shifting is appropriate, "only the costs of restoration and searching should be shifted. Restoration, of course, is the act of making inaccessible material accessible."[52] Therefore, "the responding party should *always* bear the cost

48. *See* Oppenheimer Fund, Inc. v. Sanders, 437 U.S. 340, 358 (1978).

49. *See* Zubulake v. UBS Warburg LLC ("Zubulake I"), 217 F.R.D. 309, 324 (S.D.N.Y 2003).

50. *Id.*

51. *Id.*(emphasis in original); *see* Toshiba v. Superior Court (Lexar Media), 21 Cal. Rptr. 3d 532, 539 (Ct. App. 2004)(explaining that where requested information must be translated to render it intelligible or accessible, the requesting party bears the burden of the translation expense).

52. *See* Zubulake v. UBS Warburg, LLC ("Zubulake II"), 216 F.R.D. 280, 290 (S.D.N.Y. 2003).

of reviewing and producing electronic data once it has been converted to an accessible form."[53]

Further, according to *Zubulake*, "whether electronic data is accessible or inaccessible turns largely on the media on which it is stored."[54] Thus, "*in the world of electronic data, thanks to search engines, any data that is retained in a machine readable format is typically accessible.*"[55] In fact, the court noted how "electronic evidence is frequently cheaper and easier to produce than paper evidence because it can be searched automatically, key words can be run for privilege checks, and the production can be made in electronic form obviating the need for mass photocopying."[56] Therefore, the *Zubulake* court reached the conclusion that "it would be wholly inappropriate to even consider cost-shifting" to the data the defendant maintained in an "accessible and usable format."[57] In addition, *Zubulake* explained that:

> Courts must remember that *cost-shifting may effectively end discovery, especially when private parties are engaged in litigation with large corporations.* As large companies increasingly move to entirely paper-free environments, the frequent use of cost-shifting will have the effect of *crippling discovery* in discrimination and retaliation cases. *This will both undermine the "strong public policy favoring resolving disputes on their merits," and may ultimately deter the filing of potentially meritorious claims*.[58]

In California, the presumption is that all electronically stored information is accessible.[59] Therefore, when a party raises a burdensome objection to producing electronically stored information on the basis that the data is inaccessible, the burden to prove inaccessibility remains with the responding party.[60] *In meeting this burden, the responding party must provide detailed*

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53. *Id.* (emphasis in original); *see also* OpenTV v. Liberate Techs., 219 F.R.D. 474, 479 (N.D. Cal. 2003).

54. Zubulake v UBS Warburg, LLC ("Zubulake I"), 217 F.R.D. 309, 318 (S.D.N.Y. 2003).

55. *Id.* (emphasis added).

56. *Zubulake I,* 217 F.R.D. at 318.

57. *Id.* at 320.

58. *Id.* at 317-18 (quoting Pecarsky v. Galaxiworld.com, Inc., 249 F.3d 167, 172 (2d Cir. 2001) (emphasis added).

59. *See* CAL. CIV. PROC. CODE § 2031.060(c) (West 2010).

60. *See* CAL. CIV. PROC. CODE § 2031.310(d) (West 2010).

objections explaining why the electronically stored information is not reasonably accessible.[61]

Securities arbitration panels also reject cost-shifting once production of regulatory correspondence and documents has been ordered. For example, in a securities arbitration claim against a major broker-dealer whereby Claimant alleged breach of fiduciary duty and failure to supervise regarding the sale of "Principal Protected Notes," the Chairperson rejected Respondent's arguments in their moving papers that Claimant should bear the cost of production if Respondent was ordered to produce regulatory documents.

In their brief, Respondent cited *Schweinfurth v. Motorola*,[62] a product liability case from Ohio as an example when a court ordered 50% of costs of producing over 1 million documents shifted to plaintiffs. Claimant asserted that Respondent's use of this case was misplaced. In *Schweinfurth*, the plaintiffs sought production of documents relating to "*all* [of defendants] cellular telephones using an allegedly defective CE connector."[63] The defendant argued that the request was broad, and thus, should be "limited to the cellular telephones purchased by the named plaintiffs."[64] The court agreed with the defendants "because [plaintiff's request] did not pertain to phones used by named plaintiffs."[65] In addition, defendants had already produced over 200,000 pages, and the plaintiffs had delayed in moving for discovery.[66] Claimant argued that here, unlike *Schweinfurth*, Claimant was not seeking documents regarding all types of investment products that Respondent sold. Rather, all of Claimant's requests were limited to documents regarding "Principal Protected Notes," which was the only security in issue in that case. In addition, Claimant had neither delayed in moving for discovery nor had Respondent produced over 200,000 pages of documents.

Respondent also cited another product liability case from the Southern District of New York[67] for the proposition that "shifting some of the cost is

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61. *See* CAL. CIV. PROC. CODE § 2031.210(d) (West 2010) (emphasis added).

62. Schweinfurth v. Motorola, 2008 U.S. Dist LEXIS 82772, at *6-7 (N.D. Ohio Sept. 30, 2008).

63. *Id.* at *2 (emphasis added).

64. *Id.*

65. *Id.* at *7.

66. *Id.* at *6-7.

67. In re Fosamax Prods. Liab. Litig., 2008 US. Dist. Lexis 44323, *31 (S.D.N.Y. June 5, 2008).

intended to create an incentive for plaintiffs to narrow their requests to focus on the documents they really want."[68] Again, Claimant argued that Respondent's reliance on this case was misplaced because there, Respondent ignored the fact that the defendants had already produced the "[O]fficial Investigational New Drug ("IND") and New Drug Application ("NDA") files . . . which contained documents relating to [defendant's] *communications with the FDA* about the development, approval, and post-marketing surveillance of [the drug]."[69] In fact, those documents accounted for "856,992 of the roughly 1.4 million pages produced by [the defendants] so far."[70] More importantly, Respondent ignored the primary reason why the court shifted some of the cost to the plaintiffs:

> An *overarching reason for limitation is plaintiffs' delay in bringing this issue to the Court's attention*. Plaintiffs learned of [the defendants] intended date limitation in January 2007. [The defendant] reaffirmed its position in its April 27, 2007 letter. *Plaintiffs nevertheless waited until April 18, 2008, about a year later* and less than four months before the scheduled conclusion of fact discovery in the early trial pool cases, to file this motion. *Some restrictions appear necessary to keep proceedings in this MDL moving apace*.[71]

Those facts were not present in the securities arbitration. Specifically, Claimant highlighted that Respondent had not produced "roughly 1.4 million documents." Second, Claimant argued that the defendants in *Fosamax* had already provided plaintiffs with over 850,000 pages of documents pertaining to communications with the FDA, which were the same type of documents Claimant sought from Respondent in the instant securities arbitration – communications with regulators. Third, Claimant contended there was no need to "incentivize" Claimant to narrow the scope of the requested documents because Claimant already narrowed the requests during pre-hearing discovery conference. And finally, Claimant had not abused the discovery process by delaying over a year before filing the motion to compel. Thus, there was no need for the Chairperson to grant Respondent's requested cost-sharing restrictions to keep proceedings moving along.

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68. *Id.*

69. *Id.* at *5 (emphasis added).

70. *Id.*

71. *Id.* at *30.

Moreover, Respondent cited to *Blue Chip Stamps v. Manor Drug Stores*[72] to support their proposition that "courts have recognized the costs associated with document productions in securities cases *can* impose an unfair burden on defendants." Respondent quotes from *Blue Chip* that:

> [T]o the extent that it [discovery] permits a *plaintiff with a largely groundless claim* to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a *reasonably founded hope that the process will reveal relevant evidence,* it is a social cost rather than a benefit.[73]

Therefore, the *Blue Chip* court recognized that production costs will impose an unfair burden on defendants *only when* a plaintiff has a "largely groundless claim" with little hope of finding relevant evidence from the production.[74] Claimant argued that the production of documents did not impose an unfair burden on Respondent since Claimant had already established that he not only had a valid claim against Respondent, but that the documents he sought were relevant.

III. PRACTICE POINTERS

In any "product" case, it is an essential part of the attorney's due diligence in determining whether or not to accept the case, to discover whether any regulatory actions have been initiated against the broker-dealer who sold the product to your potential client. With respect to investigations commenced by a state regulatory agency, such as a state's securities commissioner, it is common that a state regulatory agency issues a press release announcing the commencement of an investigation against a broker-dealer involving the specific product purchased by your potential client. Often times the press release will not only report the commencement of an investigation but may also report at the same time a consent order whereby the broker-dealer has agreed to findings of fact and a remedy. In addition, the North American Securities Administrators Association ("NASAA") has a website (www.NASAA.org) which should be searched to discover any states that have commenced any such investigations. Finally, a check of the broker-dealer and the product in issue should be searched through Google or

72. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975).

73. *Id.* (emphasis added).

74. *Id.* (emphasis added).

some other search engine. Investigations commenced by the SEC, either against the broker-dealer or against the individual broker, may also be discovered by searching for press releases or at the SEC's website, www.SEC.gov.

Once the regulatory complaint has been discovered, they often contain exhibits in the form of internal emails, marketing materials, excerpts of interviews with individual brokers or supervisors about the products in issue. It is our firm's practice to attach a copy of any relevant investigatory complaint and/or consent order, with exhibits to the statements of claim. Attaching such a regulatory complaint and/or consent action is designed to demonstrate to the panel, that the wrongful conduct engaged in by the broker-dealer in selling the product was not isolated, but rather was part of a broad sales practice abuse engaged in by the firm.

Next, it is essential that one of the demands in your initial document request seeks discovery of all documents submitted by the broker-dealer to any state or federal regulator, or SRO.[75] Invariably, broker-dealers will object to such a request setting up an initial meet and confer letter which almost always is followed by a motion to compel citing the cases and authorities discussed previously in this article.

At the hearing, it is likely that notwithstanding the fact that the chairperson or the entire panel, granted the motion to compel production of the regulatory documents by the broker-dealer, the broker-dealer will object to their introduction into evidence or any reference to the investigation and/or consent. The objections by the broker-dealer often claim that because the investigation is not over, any reference to it is premature and therefore irrelevant. Alternatively, if the investigation is complete, and there is a consent order to findings of fact, the broker-dealer may cite to a portion of the consent order that sometimes states that by entering into the consent order the broker-dealer is not consenting or admitting to any liability. Alternatively, some consent orders may contain a statement that nothing in the consent order creates a private right of action.

It is our practice, regardless of whether or not the investigation is completed and regardless of the specific language in the consent order, to call the broker-dealer's corporate representative who is attending the hearing and ask him whether or not he is aware of the investigation of his firm by this

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75. For example, "All documents received from, or sent to any state, federal, SRO regulatory or securities agency pursuant to any investigation by any such agency of the investment(s) at issue" and "All documents received from, or sent to any federal or state regulatory authority and/or law enforcement authority and/or self-regulatory authority concerning the investment(s) at issue."

specific state that has initiated the investigation. In addition, it is good practice to ask the corporate representative whether he agrees that the allegations in the state regulatory complaint are similar to the allegations in the statement of claim filed by your client in this particular arbitration. In practice, the allegations should be similar since you have discovered the existence of the state regulatory complaint prior to filing the statement of claim.

Sometimes, the corporate representative will be the local branch manager who may claim that he has no knowledge of the existence of the state or federal regulatory action. In such cases, it is our practice to then show the local branch manager the state regulatory complaint and walk him through the similarities between the state regulatory complaint and the statement of claim. Such examination of the local broker-dealer is not designed to prove the truth or untruth of the state regulatory allegations but rather to show the similarities between the state regulatory allegations and those set forth in your statement of claim, in a further effort to prove that the sales practice abuses in both are not isolated but rather are wide spread.

IV. CONCLUSION

There is no case law to support the argument that nonprivileged relevant documents and correspondence submitted to the SEC are protected from discovery in subsequent civil litigation between private litigants. Instead, case law supports the conclusion that SEC regulations deeming nonpublic certain disclosures to the agency, are for the benefit of the SEC and not for the party responding to the inquiry. Accordingly, courts and securities arbitration panels have rejected the "SEC privilege" argument, ordering the production of correspondence and documents submitted to the SEC.

BROKER-DEALER LICENSING – UNDERSTANDING THE ROLE AND LIMITATIONS OF THE SERIES 6 LICENSE

Adam Gana[1]

INTRODUCTION

Broker registration is the "keystone" of broker-dealer regulation.[2] The registration requirements are designed to ensure that "securities are [only] sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells."[3] Despite the importance of registration, it is a subject that causes confusion among investors and even some financial advisors. Further, the securities law surrounding broker registration is confusing and in some ways contradictory.

Brokers are only permitted to conduct business and sell securities covered by the licenses the broker maintains. This article explores the conflicts in the licensing system, and whether or not the system achieves its primary goal – to instill public confidence that brokers are properly trained and qualified to recommend securities to investors.

THE REGISTRATION REQUIREMENT

The Securities Exchange Act of 1934 ("Exchange Act") creates an expansive broker dealer registration requirement that requires all persons who interact with the public regarding securities to register, not just persons

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2. Frank W. Leonesio, Exchange Act Release No. 23,524, 36 SEC Docket 457, 464 (Aug. 11, 1986).
3. Persons Deemed Not to be Brokers, Exchange Act Release No. 20,943 (May 9, 1984), 49 Fed.Reg. 20,512, 20,515 (1984).

who actually recommend securities transactions.[4] Accordingly, the registration requirement ensures that all persons who deal with the public concerning the sale of securities meet minimum competency requirements.

Courts examining the registration requirement under the Exchange Act have cited strong policy considerations for requiring broker registration. In Eastside Church of Christ v. National Plan, Inc., the Fifth Circuit explained,

> that the requirements that brokers and dealers register is of the utmost importance in effecting the purposes of the [Exchange] Act. It is through the registration requirement that some discipline may be exercised over those who may engage in the securities business and by which necessary standards may be established with respect to training, experience, and records.[5]

In addition, courts have stated that even minimum and ancillary contacts with the investing public require registration. For example, in Exchange Services, Inc. v. Securities and Exchange Commission, the Fourth Circuit upheld a Securities and Exchange Commission's ("SEC") order and an NASD[6] decision that required discount brokerage employees to register. The Court found that any employee interactions with the public for securities order taking required registration even though those interactions represented only a small fraction of the employees' responsibilities.[7] The Fourth Circuit explained,

> The regular and continuous contact order takers have with the public is reasonable rationale for the policy. These personnel may stray from their limited duties during public contact, resulting in harm to investors. Such risk and the overriding concern for protection of public interest are sound bases for the SEC's reliance on the policy denying exemption status for the order takers.[8]

It is clear the Exchange Act broadly requires persons to register when communicating with the public and conducting brokerage activity.

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4. Section 15(a)(1) of the Exchange Act states that, "It shall be unlawful for any broker or dealer…to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security…unless such broker or dealer is registered..." 15 U.S.C.A. § 78o(a)(1).
5. Eastside Church of Christ v. National Plan, Inc., 391 F.2d 357, 362 (5th Cir. 1968).
6. Now known as The Financial Regulatory Authority ("FINRA").
7. 797 F.2d 188 (4th Cir. 1986).
8. *Id.* at 190.

However, as the remainder of this paper will cover, the creation of various registration license types, each covering only certain products, complicates regulatory and compliance requirements and creates conflicts between limiting broker qualifications by product type and ensuring that brokers are minimally competent to deal with the public.

REGISTRATION LIMITATIONS

Congress delegated authority to the Self-Regulatory Agencies ("SRO") under the auspices of the SEC to develop the criteria for broker-dealer registration.[9] FINRA has created and continues to update the licensing requirements for all registered representatives, compliance officers, and securities principles.

The most common and encompassing license is a general securities registered representative, or the Series 7 license, which allows a broker to sell nearly all types of securities[10] such as stocks, bonds, mutual funds, and private placements.[11] In contrast to a Series 7 broker's broad license, a Series 6 broker is qualified to sell only two types of products.[12]

A Series 6 licensed broker can recommend certain investment companies, more commonly known as mutual funds, and variable contract products, such as annuities.[13] More specifically, a Series 6 can offer and sell

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9. FINRA is the current SRO with authority to implement securities related registration requirements.

10. A Series 7 cannot sell commodities and futures.

11. FINRA, CONTENT OUTLINE FOR THE GENERAL SECURITIES REGISTERED REPRESENTATIVE EXAMINATION: SERIES 7 (2011).

12. FINRA, INVESTMENT COMPANY PRODUCTS/VARIABLE CONTRACTS LIMITED REPRESENTATIVE QUALIFICATIONS EXAMINATION: SERIES 6 (2005).

13. Under FINRA Rule 1022(d)(1) a registered representatives who holds a Series 6 is permitted to:

> transact a member's business in redeemable securities of companies registered pursuant to the Investment Company Act of 1940, securities of closed-end companies registered pursuant to the Investment Company Act of 1940 during the period of original distribution only, and variable contracts and insurance premium funding programs and other contracts issued by an insurance company except contracts that are exempt securities pursuant to Section 3(a)(8) of the Securities Act of 1933.

open-end mutual funds, and closed-end mutual funds during the initial offering period only – a significant limitation.[14]

SERIES 6: THE "LIMITED" REPRESENTATIVE LICENSE

A Series 6 licensed broker faces several unique challenges in attempting to adhere to FINRA rules and regulations, while also abiding by the Series 6 licensing limitations. First, a Series 6 broker can only discuss two types of securities, but will invariably be asked about securities outside the scope of the broker's qualifications. FINRA's only guidance to Series 6 brokers is not to function outside the scope the limited license.[15] Consequently, the responsibility to create communication guidelines for Series 6 brokers falls upon brokerage firms and the brokers themselves. Brokerage firms often create internal compliance rules to prevent Series 6 brokers from attempting to sell or even discuss securities products outside the scope of the broker's license with clients. Yet, even with these procedures in place, the line between what a Series 6 holder can and cannot discuss with their clients is blurred at best.

Second, the limited nature of the Series 6 license raises the issue of whether a Series 6 broker can adequately meet FINRA's suitability rule. FINRA Rule 2111, the updated rule governing a broker's suitability obligations, requires all brokers to understand the client's "other

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14. Closed-end funds differ from open-end funds because they raise money only once in a single offering period, similar to they way a stock issue raises money for the company only once, at its initial public offering. After the shares are initially sold, a closed-end fund uses the money to buy a portfolio of underlying investments, and any further growth in the size of the fund depends on the return on the closed-end fund investments, not new investment dollars. Open-end mutual funds, on the other hand, can buy and sell shares at any time. The open-end fund can sell new shares to meet increased demands. FINRA, Mutual Funds, http://www.finra.org/ Investors/SmartInvesting/ ChoosingInvestments/MutualFunds/ (last visited Jun. 27, 2011).

15. FINRA Rule 1032(b)(1)(A) only states that a Series 6 broker's "investment banking or securities business are limited solely to those activities enumerated in Rule 1022(d)(1)." Further, under Rule 1032(b)(2) a Series 6 broker "shall not be qualified to function as a representative in any area not described in paragraph (b)(1)(A)."

investments" as well as the client's "financial situation and needs."[16] However, the FINRA rules state that a Series 6 broker is not qualified to function as a representative for products outside the scope of the license.[17] Consequently, a conflict exists between a Series 6 broker's ability to satisfy the suitability requirements under the FINRA Rules and the limited scope of the broker's license. Even though a Series 6 broker's ability to perform a complete suitability analysis appears questionable given the limitations of the license, FINRA does not require Series 6 brokers to disclose their limitations to clients.

Third, a potential compliance issues exist when a Series 6 broker recommends closed-end mutual funds during the offering period and then continues to service the client's account holding the closed-end mutual funds. Since a Series 6 broker can only make a recommendation at the initial offering the Series 6 broker cannot recommend that a client sell or hold the closed-end fund after the initial recommendation because any further communication or discussion of the merits of the closed-end mutual fund would violate the Exchange Act. It is difficult to understand the reasoning behind allowing a broker to recommend the purchase of a product that they could not later recommend the client sell or hold. FINRA has not provided guidance to Series 6 brokers that would assist the representatives in trading closed-end mutual funds in client accounts.

Finally, an argument can be made that a Series 6 broker is not fully qualified to sell the products that the Series 6 license allows the representative to sell. A limited representative is expected to understand the underlining products contained in the mutual funds they recommend to clients. For example, Notice to Members ("NTM") 04-30 requires that brokers understand the characteristics, risks, and rewards of bonds and bond mutual funds before the broker recommends the product to investors.[18] While a Series 6 representative cannot sell bonds, the Series 6 broker can sell bond mutual funds. Since a mutual fund can hold almost any type of investment product, none of which a Series 6 broker is otherwise qualified to offer and sell, it is difficult to understand how the Series 6 is qualified to describe the risks associated with mutual funds.

Presumably, FINRA allows Series 6 brokers to sell mutual funds because the funds are managed by a fund manager and are usually diversified through investments in many asset types and sectors. While diversification and a

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16. Formally FINRA Rule 2310. Rule 2310 also required brokers to take into account an investors holdings and financial needs.
17. *See supra* note 15.
18. FINRA NTM 04-30, pg. 4 (Apr. 2004).

separate management structure reduces some risk, they have never been found to negate a broker's obligation to understand the nature and qualities of the mutual fund's properties. Further, many mutual funds hold concentrated positions in complex products such as embedded swaps, structured assets, and various hedging instruments. The presence of complex products in a mutual fund can dramatically impact the funds volatility and risk profile depending upon prevailing market conditions. A Series 6 broker is not licensed to explain to their clients the nuanced risks of the specific underlining products and specialized instruments contained in some mutual funds.

As discussed above, there are at least four areas in which a Series 6 broker's responsibilities are unclear and come into conflict with the broader purposes of broker dealer registration. Because Series 6 representatives are limited in the types of securities they can sell, there is substantial doubt whether the Series 6 holder can meet all of its obligations to its clients.

FINRA DISCIPLINARY ACTIONS AGAINST SERIES 6 BROKERS

FINRA has disciplined brokers for conducting securities business beyond the scope of their Series 6 license qualifications. For example, the NASD, now FINRA, brought a disciplinary proceeding against Majied Alzid for placing equity trades outside the scope of his Series 6 license and in violation of Rule 1032(b).[19] Mr. Alzid's "activities in the investment banking and securities business were limited" and did not allow for equity trading.[20] As a result of his violation of Rule 1032 and other violations, FINRA barred Mr. Alzid from association with any member firm in any capacity.

In another example, FINRA brought an action against Brookstone Securities, Inc. and David W. Locy for failing to supervise the activities of Series 6 brokers at the firm.[21] Brookstone and Locy conducted a private placement offering through Series 6 licensed brokers without proper due diligence. Brookstone allegedly allowed Series 6 brokers to conduct the due diligence on the private placement offering and recommend the investments to clients, even though the brokers were not qualified to perform either duty.

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19. Department of Enforcement v. Majied Alzid, NASD Disciplinary Proceeding No. C8A050041 (Apr. 18, 2006).
20. *Id.* at 6.
21. Dep't of Enforcement v. Brookstone Secs., Inc., FINRA AWC No. 2009019837303 (May 20, 2011).

CONCLUSION

The registration requirements are designed to ensure that a broker who recommends and sells securities understands both the properties of the securities being sold and the broker's responsibilities to the investor. Despite the importance of registration, the current system fails to allow limited license holder's to properly serve their clients and to abide by the letter of the FINRA rules.

The first step FINRA could take to rectify the issues discussed is to provide greater guidance and standards in order to prevent a Series 6 broker from performing broker duties outside the scope of the broker's qualifications. FINRA can better protect investors by requiring customers to be informed as to the qualifications of their broker. A more informed investing public will ultimately lead to a better investor decision-making process and more efficient markets, an important economic objective. To this end, FINRA should require brokers to provide clear disclosures concerning a Series 6 broker's limitations and their ability to provide complete investing services and advice.

Unfortunately, broker dealer licensing types was not a topic included in the recent Dodd-Frank Act. As a consequence, the SEC is not currently studying the potential impact on investors in maintaining securities qualification distinctions amongst brokers. However, on June 28, 2011, FINRA published a notice that the organization is seeking input to update the Series 6 license, among other listed licenses.[22] The information gathered by FINRA will be used to update the qualification exams.

In the notice, "FINRA encourages survey recipients to participate to help ensure that examination content accurately reflects the jobs they perform."[23] While FINRA is not examining major changes to the Series 6 license, the organization should take this opportunity to examine the role and obligations of the Series 6 broker and update the training requirements and exam accordingly.

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22. Information Notice: FINRA Surveys to Update the Series 6, 16, 24 and 26 Exams (Jun. 28, 2011).
23. *Id.*

ETHICAL ISSUES THAT MAY ARISE IN SETTLEMENT NEGOTIATIONS IN MASS ARBITRATION REPRESENTATION

Professor Lisa A. Catalano[1]

INTRODUCTION[2]

Lawyers have a duty to represent their clients zealously. Lawyers must, however, balance zealous representation and their ethical duties as members of the bar. There are numerous ethical rules governing an attorney's conduct. The area of settlement negotiations is fraught with ethical issues and is fertile ground for potential violations. This paper discusses ethical issues that may arise when negotiating on behalf of numerous clients in a single arbitration case with a focus on the New York Rules of Professional Conduct ("NYRPC"). Representing a single client in settlement discussions has its difficulties (i.e., managing client expectations, trying to avoid the client second guessing or having "buyer's remorse" after accepting an offer, zealous representation and abiding by a client's wishes concerning case strategy,) but other issues, particularly ethical issues are amplified when representation involves more than one individual. The paper will address ethical issues that may arise in settlement negotiations when a lawyer engages in multi-party representation in a single arbitration case.

I. Representation of Multiple Parties[3]

A. Handling Divergent Client Interests

Assuming during the course of representing two parties in a case, their strategies for handling the case significantly diverge. Can the lawyer continue in the joint representation? The New York State Bar Association

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2. Professor Catalano extends a warm appreciation and well-deserved thank you to Jacquelyn Mascetti ('11), a former Securities Arbitration Clinic intern and a third year student at St. John's University School of Law, for her excellent research assistance with this paper.

3. This paper assumes that joint representation is appropriate pursuant to Rule 1.7 of NYRPC.

"NYSBA" Committee on Professional Ethics addressed this issue in the following context:[4] A law firm represented co-owners of a business which they had sold. The purchasers sued the co-owners, who then asserted a counterclaim against the purchaser. The co-owners' interests were consistent at the outset of the litigation. The plaintiff purchasers did not vigorously pursue the litigation. One of the co-owners wanted to aggressively pursue the counterclaim, while the other wanted to let sleeping dogs lie and instructed the lawyer to do nothing. The Committee's opinion was sought as to whether the lawyer could continue to engage in the joint representation or, alternatively, whether the lawyer could continue to represent one of the joint clients after the conflict arises and, if so, under what circumstances.

With respect to the issue of joint representation in the same or related matters, the Committee concluded that where properly advised joint clients determine to pursue divergent strategies, both of which are legal and consistent with the lawyer's ethical duties, a conflict arises which cannot be waived. "[B]ecause the firm cannot simultaneously pursue both client's objectives – a disinterested lawyer could not conclude that the lawyer could competently represent the interests of each client. Therefore, the firm cannot continue to represent both clients in the matter."[5]

With regard to the issue of whether the firm may continue to represent one of the clients, the Committee explained that the continued representation of the client who wanted to aggressively pursue the counterclaim could be materially adverse to the interests of the client who did not want to pursue the counterclaim. Additionally, pursuit of one of the client's goals may require the attorney to take action inconsistent with the other client's goals. "In either case, unless the clients validly consented in advance to continuing representation of one of them in the event of a conflict emerging, the firm needs to obtain the informed consent of the former client after full disclosure. Insofar as necessary to avoid misunderstanding, the firm should explain that the former client is under no obligation to consent to allow the firm to

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4. NYSBA Comm. on Prof'l Ethics, Op. 823 (2008).

5. NYSBA Comm. on Prof'l Ethics, Op. 823 (2008). The Committee cited to DR 5-105 which was the effective rule at the time the opinion was rendered. DR 5-105 (B) provides that "[a] lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client . . .." (Note that current Rule 1.7(b)(1) of the NYRPC now provides that the lawyer him/herself, and not a "disinterested lawyer", must reasonably believe that they can provide competent representation.).

represent the other client and 'that no negative consequences will attend [a] denial of consent.'"[6]

The Committee considered former New York DR 5-108(a)(2) in its decision. Rule 1.9 of the NYRPC ("Duty to Former Clients") would now apply. Rule 1.9(a) provides:

> [a] lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.[7]

Rule 1.9(c) provides:

> [a] lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:
> (1) use confidential information of the former client protected by Rule 1.6 to the disadvantage of the former client, except as these Rules would permit or require with respect to a current client or when the information has become generally known; or
> (2) reveal confidential information of the former client protected by Rule 1.6 except as these Rules would permit or require with respect to a current client.[8] [9]

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6. NYSBA Comm. on Prof'l Ethics, Op. 823 (2008).

7. The Committee discusses former New York DR 5-108(a) which was in effect at the time the opinion was rendered. New Rule 1.9(a) is almost identical in substance to former New York DR 5-108(a)(1), but Rule 1.9(a) omits the exception for "current or former government lawyers" (though the exception appears to remain, by inference, in Rule 1.11), and Rule 1.9(a) requires that the former client's consent be "confirmed in writing."

8. New Rule 1.9(c) is similar in substance to former New York DR 5-108(a)(2), but new Rule 1.9(c)'s lead-in language applies not only to a lawyer who personally represented a client in a matter, but also to "a lawyer whose present or former firm" represented a client. Rule 1.9 (c) (1) applies only when information is used "to the disadvantage of the former client." Also, in addition to prohibiting the "use" of a former client's confidential
information, Rule 1.9(c)(2) adds a parallel provision providing that a lawyer shall not "reveal" a former client's confidential information.

9. With respect to continuing representation of a jointly represented party when a conflict arises, ABA Model Rule 1.9(a) is identical to NYRPC Rule 1.9(a). ABA Model Rule 1.9(c) is substantially similar to NYRC Rule 1.9(c), providing:

> [a] lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

With respect to protecting client confidences, the Committee explained:

> while there generally are no confidences between co-clients [citations omitted], to the extent that the lawyer has acquired, under an understanding of confidentiality, information not known to the proposed continuing client, '[t]he former client must also be informed that she has the right to insist that all of her confidences and secrets or specific confidences and secrets be held inviolate.' [Citations omitted.] In that circumstance, the firm must also consider whether it can competently represent the interests of the continuing client while keeping the former client's confidence. Any restriction placed on the firm by the former client to preserve certain information protected as a confidence or secret may present a compromising influence that may prevent the firm from representing the current client competently and zealously. [Citation omitted.]

In *DeLorenz v. Keyes*, the court held that disqualification of a lawyer from the continued representation of one of two formerly jointly represented parties was not necessary where the moving party failed to demonstrate that

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> (1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or
> (2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

Florida's Rules of Professional Conduct (FRPC) Rule 4-1.9(a) is also substantially similar to NYRPC Rule 1.9(a), except Florida's rule does not state that informed consent must be in writing. FRPC 4-1.9 further provides that a lawyer who previously represented a client shall not subsequently:

> (a) use information relating to the representation to the disadvantage of the former client except as these rules would permit or require with respect to a client or when the information has become generally known; or
> (b) reveal information relating to the representation except as these rules would permit or require with respect to a client.

California's Rules of Professional Conduct (CRPC) Rule 3-310(E) provides:

> [a] member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment.

there was any information obtained by the lawyer during the joint representation that might be used against the former client to the benefit of the current client. "This concern for maintaining client confidences is cited as a key reason for disqualification for adverse interests."[10]

B. Settlement of Multi-Party Claims

1. Settlements Generally

Can a lawyer ethically represent multiple clients in settlement negotiations in a mass arbitration and collectively settle their claims? In New York, a lawyer may represent multiple clients in settlement negotiations and settle their claims collectively if the clients give written informed consent which sets forth the existence and nature of all claims involved and the participation of each person in the settlement.

In New York, two ethical rules are implicated. Rule 1.7 of the NYRPC ("Conflict of Interest: Current Clients"), and Rule 1.8 (g) of the NYRPC ("Current Clients: Specific Conflict of Interest Rules").

Rule 1.7 provides:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:
  (1) the representation will involve the lawyer in representing differing interests; or[11]
  (2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other interests.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
  (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  (2) the representation is not prohibited by law;

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10. 24 Misc. 3d 1218(A), 2009 WL 2045623 *4, 2009 N.Y. Slip Op. 51519(U) (Sup. Ct. Nassau Cty. 2009) (citation omitted.)

11. Similar in substance to former New York rule, DR 5-105(A)-(B), but Rule 1.7 deletes from both DR 5-105(A) and (B) the phrase "if the exercise of independent professional judgment in behalf of a client will be or is likely to be adversely affected by the lawyer's representation of another client," leaving only the reference only to "representing differing interests."

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
(4) each affected client gives informed consent, confirmed in writing.[12]

Rule 1.8 (g) provides that:

> [a] lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, absent court approval, unless each client gives informed consent in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims involved and of the participation of each person in the settlement.[13]

(This is commonly referred to as the "aggregate settlement" rule.)

Although not addressed in an arbitration context, the courts have considered this rule's predecessor in the litigation context. The *Matter of New York Diet Drug Litig.*, 15 Misc. 3d 1114(A), 839 N.Y.S.2d 434, 2007 WL 969426 (N.Y. Sup. N.Y. Cty. 2007) (slip op.), was a personal injury case involving the "fen-phen" diet drug and was brought on behalf of numerous plaintiffs. The matter had been settled with defendant American Home

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12. Partly similar in substance to the consent provisions in former New York rules, DRs 5-101 and 5-105(C), but Rule 1.7(b) adds additional criteria for consentability and specifies two forms of nonconsentable conflicts. *See* Rule 1.7(b)(2) and(3).

13. ABA Model Rule 1.8(g) provides:

> [a] lawyer who represents 2 or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

FRPC Rule 4-1.8(g) provide:

> [a] lawyer who represents 2 or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregated agreement as to guilty or nolo contendere pleas, unless each client consents after consultation, including disclosure of the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

CRPC Rule 3-310(D) provides:

> [a] member who represents two or more clients shall not enter into an aggregate settlement of the claims of or against the clients without the informed written consent of each client.

Products ("AHP") whereby it agreed to pay a lump sum settlement. Some of the plaintiffs moved to challenge the settlement which had been approved by a predecessor court. The movants alleged that settling counsel offered larger and disproportionate settlements to its clients (versus clients that were referred to that law firm by other law firms,) to increase its firms fees; the offers extended to the plaintiffs were not individually negotiated, but rather were based on settling counsel's evaluation of each claim based on a lump sum offer; contrary to settling counsel's representation, the Special Master did not made individual evaluations of each settlement offer; and, the ethics opinion offered in support of the settlement was based on incomplete information and, thus, was flawed. The initial question addressed by the court was whether the settlement was aggregate or collective, thereby triggering the conflict of interest disclosures prescribed by (then effective) DR 5-106. The court noted that the professional conduct rules do not define "aggregate settlement" and adopted the following definition:

> in terms of what makes a settlement meaningfully collective, there is no bright line between all-or-nothing settlements and walk-away settlements. All of them involve collective conditions and thus present the lawyer-client and client-client conflicts of interest. A settlement with a walk-away provision set at ninety-nine percent, for example, functions almost identically to an all-or-nothing settlement in that the lawyer has a strong self-interest in ensuring that virtually every client accepts the deal, and clients who favor the settlement are pitted against those who do not. The higher the proportion permitted to decline the settlement, the larger the safety value, but the meaningful line is between settlements with collective conditions and those without.

Quoting, Howard M. Erichson, *A Typology of Aggregate Settlements*, 80 Notre Dame L. Rev. 1769, May 2005.

The court reviewed the sealed settlement agreement and determined that the settlement was a "lump sum collective or aggregate settlement." 2007 WL 969426 at *4 -*5. The agreement provided that AHP would pay a lump sum to settling counsel representing "the sum of the individual settlement amounts listed in Exhibit 3." *Id.* at *5. In determining that the settlement was aggregate, the court noted that Exhibit 3 which contained individual settlement amounts did not exist at the time the settlement agreement was entered into and, thus, the individual settlement amounts were not known at that time. The process by which settling counsel determined the individual settlement amounts was at issue. The movants alleged that settling counsel divided the lump sum among the clients without disclosure to the clients and

subsequently sought client approval for individual settlements. Settling counsel argued that an aggregate settlement is not just one that is collective, but includes one that requires all plaintiffs to agree. The court held that, regardless of the particular definition of "aggregate settlement", settling counsel had a duty to fully disclose conflicts, not only as required by the aggregate settlement rule, but as required by the rule that client consent must be informed consent. "The firm had a duty to disclose to its clients what the conflicting interests were. In this mass settlement, the conflict was that all claimants were vying for a share of what was a lump sum offer. They were in competition with each other." *Id.* at *6. "[I]f it is likely that a conflict exists, as here where the recovery of one client is at the expense of the recovery of another, full disclosure must be made. The aggregate settlement rule can be understood as a particular application of the rule on concurrent conflicts of interest [DR 5-105]. Both prevent lawyers from trading off client interests against each other without the client's consent." *Id.* at *7.

The court concluded that settling counsel was required to make full disclosure to the clients and fully explain the nature of the settlement, particularly:

(1) if the settlement offers were not offers by AHP, then who was offering them these settlement amounts;
(2) if the offers were . . . [settling counsel's] evaluation of the relative merits of each client's case, then what were the details and the basis for their offer; and
(3) if it was true that all clients were to be paid out of one lump sum.

Id. at *8.[14]

2. Advance General Consent to Settlement

Assume that for purposes of ease, a lawyer requests the clients' advance general consent to accept any terms of an aggregate settlement? Is this ethical? In New York a lawyer is required to receive informed written consent after the proposed settlement is negotiated, otherwise the clients will not be bound to the aggregate settlement.

Although New York courts have not yet squarely addressed the issue of whether consent in advance of knowledge of the terms of a settlement[15] or

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14. The final determination of the motion to vacate or modify the settlement remained open until conclusion of the trial on plaintiffs' allegations of misrepresentations and manipulation of the settlement. *Id.* at *11-12.

15. Although it would appear from the *Matter of New York Diet Drug Litig.* decision (*see* pp. 18-19 herein,) that New York courts would not countenance such a practice.

majority client approval of a settlement in multi-party representation is permissible, the New York City bar's ethics committee has advised that in the joint representation context, lawyers may not ask clients to waive their right to approve a proposed aggregate settlement or bind themselves to a settlement if it is approved by a certain percentage of the other clients.[16] The committee indicated that no client can be bound to an aggregate settlement without individual informed written consent after the proposed settlement is negotiated. The committee explained that the informed consent requirement is meant to protect clients against inadequate settlements and unfair allocations and this protection outweighs any burden to lawyers in obtaining individual informed consent. The committee further explained that because of the settlement process and the dynamics of litigation "'informed consent' to an advance waiver is virtually a contradiction in terms." At the time when an advance waiver would be sought, the lawyer generally does not have enough information to permit the client to understand the risks and ramifications of waiving their individual right to approve a settlement.

Rule 1.2(a) of the NYRPC also appears to render such arrangements impermissible. Rule 1.2(a) provides that: "[s]ubject to the provisions herein, a lawyer shall abide by a client's decisions concerning the objectives of the representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to settle a matter."[17] [18] Comment 13 of Rule 1.8(g) of the NYRPC provides:

See also, Rejohn v. Serpe, 125 Misc.2d 148, 150, 478 N.Y.S.2d 799, 801 (D.Ct. N.Y. Suffolk Cty. 1984) ("[w]ith respect to settlement of a case, an attorney representing multiple clients may not settle unless each client consents to the settlement 'after being advised of the existence and nature of all of the claims involved in the proposed settlement, of the total amount of the settlement, and of the participation of each person in the settlement' (DR 5-106 (A))")

16. New York City Bar Ass'n Comm. on Professional and Judicial Ethics, Op. 2009-6.

17. For a general discussion by New York state courts and the Second Circuit of a lawyer's authority to bind a client to a settlement, *see Hallock v. Power Authority of New York State*, 64 N.Y.2d 224, 231-32, 485 N.Y.S.2d 510 (Ct. App. N.Y. 1984) (enforcing settlement stipulation made in open court where the attorney had apparent authority to enter into settlement even where the lawyer exceeds actual authority); *Winston v. Mediafare Entertainment Corp.*, 777 F.2d 78, 83 (2d Cir. 1986) (holding that a written settlement agreement that had not been fully executed was not binding where a party communicated intent not to be bound until the agreement was fully executed); *Fennell v. TLB Kent Co.*, 865 F.2d 498, 502 (2d Cir. 1988) (holding that only a principal's actions to a third party, and not the agent's, may cloth the attorney with apparent authority; distinguishes *Hallock* on the grounds that *Hallock* involved

> [d]ifferences in willingness to make or accept an offer of settlement are among the risks of common representation of multiple clients by a single lawyer. Under Rule 1.7, this is one of the risks that should be addressed before undertaking the

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a stipulation in open court and not a purported settlement reached by the lawyers over the telephone.); *Artha Management, Inc. v. Sonia Holdings, Ltd.*, 91 F.3d 326, 329 (2d Cir. 1996) (relying on federal precedent and distinguishing New York case law, held that the presumption is that the attorney of record has authority to enter into and bind a client to a settlement agreement); *Stormer v. County of Oneida*, 66 A.D.3d 1449, 1450, 886 N.Y.S.2d 298 (4th Dep't 2009) (involved joint representation of parties and contract providing that the attorney was to "[p]rovide all legal representation necessary to properly substantiate and administratively process such 620/621 [Medicaid] claims . . . [and n]egotiate with any appropriate agencies and offices . . . [and that the clients] shall pay [the lawyer] for such services at a rate of 25% [of clients'] share of all recoveries, reimbursements or offsets received by [clients]." Held that attorney was entitled to 25% of the recovery clients received in settlement. The court did not address the validity of the broad grant of discretion of settlement authority by the clients to the lawyer in the contract.); *Wil Can (USA) Group, Inc. v. Zhang*, 73 A.D.3d 1166, 1167, 903 N.Y.S.2d 429 (2d Dep't 2010) (relying on *Hallock*, held that a settlement agreement signed by the attorneys memorializing a settlement reached at mediation was enforceable against the complaining party where the complaining party's attorney had apparent authority to enter into the settlement agreement.) Interestingly, none of these cases discusses a lawyer's ethical responsibilities with respect to settlement negotiations.

18. ABA Model Rule 1.2(a) is identical to NYRPC Rule 1.2(a) concerning a lawyer's duty to abide by a client's decision regarding the objectives of the representation and a client's decision to settle a matter, with the exception of the additional language in the ABA Model Rules: "[a] lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation."

FRPC Rule 4-1.2(a) provides:

> [a] lawyer shall abide by a client's decisions concerning the objectives of representation, subject to subdivisions (c), (d), and (e), and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to make or accept an offer of settlement of a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial, and whether the client will testify.

CRPC Rule 3-510(A) provides:

> [a] member shall promptly communicate to the member's client: (1) All terms and conditions of any offer made to the client in a criminal matter; and (2) All amounts, terms, and conditions of any written offer of settlement made to the client in all other matters.

> representation, as part of the process of obtaining the clients' informed consents. In addition, Rule 1.2(a) protects each client's right to have the final say in deciding whether to accept or reject an offer of settlement. Paragraph (g) [of Rule 1.8] is a corollary of both these Rules, and provides that, before any settlement offer is made or accepted on behalf of multiple clients, the lawyer must inform each of them about all the material terms of the settlement, including what the other clients will receive or pay if the settlement is accepted.

Other jurisdictions have found general advance consent agreements to an aggregate settlement unacceptable. In *In re Hoffman*, 883 So. 2d 425 (S. Ct. La. 2004), for example, attorney, Donald Hoffman, represented three family members in a will contest. Two of the family members (client *A* and client *B*) provided the attorney with an affidavit which stated,

> To whom it may concern: I am represented by attorney Donald A. Hoffman with respect to a contest of Milton Lorning's will. Donald A. Hoffman is, furthermore, my representative with respect to any settlement negotiations which may take place with respect to such contest. Mr. Hoffman is authorized to accept, on my behalf, any amount in settlement of my claim as to the will of Milton Lorning, which is in excess of the amount of the legacy to me contained in such will.

The case was mediated without the presence of the two family members (clients *A* and *B*) that signed the above affidavit. The third family member (client *C*) was also not present at the mediation, but his two children were. A lump sum settlement of $225,000 was reached at the mediation and one of the children present accepted the settlement offer on her father's (client *C*) behalf. Client *C* determined how the settlement would be divided. He communicated to clients *A* and *B* that they had received $10,000 more than had been bequeathed to them in the will and did not disclose any further details of the settlement (i.e., the total settlement amount or that client *C* would be receiving the balance thereof). Attorney Hoffman did not discuss the settlement negotiations with clients *A* and *B*, nor did he discuss the division of the lump sum settlement with them. Clients *A* and *B* filed a complaint with the Louisiana Office of Disciplinary Counsel ("ODC"), alleging that Hoffman did not consult with them regarding division of the settlement proceeds and did not get their consent. The ODC held a disciplinary hearing and Hoffman was found to have violated Rules 1.4 (failure to communicate with a client) and 1.8(g) (the aggregate settlement rule).

The ODC recommended that Hoffman be publicly reprimanded and Hoffman filed an objection to the ODC's report and recommendation.

Upon review, the disciplinary board found that Hoffman agreed to an aggregate settlement, but the board disagreed with ODC's finding that the consent of clients *A* and *B* was required in order to settle in the aggregate. The board reasoned that "[b]ecause the scope and objectives of the representation were made clear by the affidavits [signed by clients A and B] and the clients expressed their consent to accept any amount in excess of their legacies, there was no need for respondent [Hoffman] to further communicate with . . . [clients A and B]." 883 So.2d at 431. Thus, the board recommended dismissal of the formal charges against Hoffman and the ODC sought review of the board's ruling which was the issue before the Louisiana Supreme Court.

The court found first that Hoffman violated Rule 1.7(b) of the Rules of Professional Conduct permitting joint representation if each client consents after full disclosure. The court held that Hoffman failed to obtain the informed consent of clients *A* and *B* and "failed to discuss with his clients the nature of their potentially differing interests and the risks of joint representation . . . [Moreover,] respondent's failure to appreciate the potential conflict between [clients *A*, *B* and *C*] . . . and to guide his conduct accordingly, led to his violation of Rule 1.8(g) in the course of his settlement of the siblings' claims against the Succession of Milton Lorning." *Id.* at 432. With respect to aggregate settlements for multiple clients, the court held that they

> are not *per se* impermissible, but during the negotiation of the aggregate settlement, the lawyer must confer with all of his clients and fully disclose all details of the proposed settlement, including information about each client's claim and share of the proposed settlement. Rule 1.8(g) explicitly requires "consultation" before a client consents to an aggregate settlement . . . The requirement of informed consent cannot be avoided by obtaining client consent in advance of a future decision by the attorney or by a majority of the clients about the merits of an aggregate settlement.

Id. at 432-33.

3. Acceptance of Settlement by Majority Rule

Is an agreement by each jointly represented client providing that the majority rule by the clients would govern acceptance of a settlement valid

and is it ethical for a lawyer to request such an agreement? Although New York courts have not expressly ruled on this issue, some jurisdictions with rules substantially similar to New York's have held that agreements by jointly represented clients that permit acceptance of settlement by majority vote of the clients are not valid as such agreements deprive clients of the right to approve settlement; require consent before the essential terms of the settlement are known and, thus, deprive the clients of giving informed consent after full disclosure; and put the lawyer in a position where the lawyer cannot maintain a duty of loyalty to each client.

The seminal case of *Hayes v. Eagle-Picher Industries, Inc.,* 513 F.2d 892 (10th Cir. 1975) addresses precisely this issue. In *Hayes*, the lawyer represented 18 individuals in the same action. On the eve of trial, a lump settlement offer was made that was to be divided among the group. A majority of the clients voted to accept the offer, but the appellants did not. The trial court reduced the settlement to judgment. Appellants immediately protested the settlement. The trial court held a hearing and set aside the judgment. The trial court then held another hearing on appellee's motion to reinstate the judgment and the court reinstated the judgment. On appeal, appellees contended that there was consent given that the decision to accept a settlement would be governed by the vote of the majority, while appellants argued that they never agreed to be bound by the majority. The Tenth Circuit held that the trial court erred in reinstating the judgment which reflected the settlement reached by a vote of the majority of the clients. The court explained that the agreement to permit the attorney to settle the case over the express objection of his clients,

> is contrary to the plain duties owed by an attorney to a client. An agreement such as the present one which allows a case to be settled contrary to the wishes of the client and without his approving the terms of the settlement is opposed to the basic fundamentals of the attorney-client relationship. . . . One other aspect which complicates the problem is the fact that the agreement calling for the majority governing the decision to settle was entered into some time prior to the date of negotiations. It is difficult to see how this could be binding on non-consenting plaintiffs as of the time of the proposed settlement and in the light of the terms agreed on. In other words, it would seem that plaintiffs would have the right to agree or refuse to agree once the terms of the settlement were made known to him. A further difficult aspect in the enforcement of such an agreement is the ethical problem which is posed for the attorney who is bound by Rule 5-106 of the Code of Ethics

> promulgated by the Kansas Supreme Court which requires the attorney to refrain from participating in a settlement on behalf of two or more clients unless each of them consents to it.[[19]] In view of this, it was untenable for the lawyer to seek to represent both the clients who favored the settlement and those who opposed it. [513 F.2d at 894.] [The court held that] the arrangement presented allowing the majority to govern the rights of the minority is violative of the basic tenets of the attorney-client relationship in that it delegates to the attorney powers which allow him to act not only contrary to the wishes of his client, but to act in a manner disloyal to his client and to his client's interests. Because of this, it is essential that the final settlement be subject to the client's ratification particularly in a non-class action case such as the present one.

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19. *See also*, *Tax Authority, Inc. v. Jackson Hewitt, Inc.*, 187 N.J. 4, 21, 898 A.2d 512, 522 (S. Ct. N.J. 2006) (holding that New Jersey's Rules of Professional Conduct (RPC) 1.8 (g), prohibiting an aggregate settlement without each client's consent to the settlement after its terms are known, was violated by majority approval of the settlement as set forth in the client retainer agreements. "We conclude that RPC 1.8 (g) forbids an attorney from obtaining consent in advance from multiple clients that each will abide by a majority decision in respect of an aggregate settlement. Before a client may be bound by a settlement, he or she must have knowledge of the terms of the settlement and agree to them."); *Knisley v. City of Jacksonville,* 147 Ill. App. 3d 116, 122, 497 N.E.2d 883, 888 (App. Ct. Ill. 4th Dist. 1986) (The court held that majority-rule with respect to settlement in multi-party representation violated Disciplinary Rule 5-106 of Illinois' Code of Professional Responsibility which states:

> [a] lawyer who represents two or more clients shall not make or participate in the making of an aggregate settlement of the claims of or against his clients, unless each client has consented to the settlement after being advised of the existence and nature of all the claims involved in the proposed settlement, of the total amount of the settlement, and of the participation of each person in the settlement.

87 Ill.2d Disc. R. 5-106. In reaching its conclusion that majority-rule votes of approval of a settlement in a multi-party representation context are impermissible, the court reasoned that "[i]n a joinder action there is no judicial review of the settlement [as there is in class action settlements] and a third party should not be bound unless he has specifically agreed to it. Fundamental fairness is violated when a settlement is allowed to bind parties who object and no safeguards have been added to protect their interests.").

Id. at 894-95. The court reversed the district court's ruling reinstating the judgment and remanded for further proceedings consistent with its decision that each client be provided the opportunity to ratify the settlement.

4. Insufficient Assets to Satisfy All Claims

Assume that a lawyer representing multiple clients against a single defendant discovers that there may not be sufficient assets to fully satisfy all claims, may the lawyer continue representation? In New York, an attorney may represent multiple clients against a single defendant where there may not be sufficient assets to satisfy all claims if the lawyer determines that all clients will be zealously represented, there are no other differing interests, and the clients agree as to allocation of recovery.

In the context of rendering an opinion on the ethical implications of a lawyer representing two plaintiffs injured in the same incident in separate actions against the same defendant where there was a likelihood that there would be insufficient assets available to fully satisfy all claims, the New York State Bar Association's Committee on Professional Ethics addressed the implications of accepting potentially adverse multiple representations, governed by (then current) DR 5-105, and settling claims of multiple clients, governed by (then current) DR 5-106.[20] The Committee stated that representing multiple plaintiffs or defendants in the same or a related matter is not prohibited *per se*. Rather, a lawyer may accept the engagement even if representing "differing interests", defined as "conflicting, inconsistent, diverse and other interests that will adversely affect the judgment or the loyalty of a lawyer to a client", if the lawyer can adequately represent each client's interest and each "consents to the representation after full disclosure of the possible effect of such representation on the exercise of the lawyer's independent professional judgment on behalf of each." (Current Rule 1.7(b)(3) of the NYRPC also provides that the representation cannot involve the assertion of a claim by one client against another and subsection (4) requires that the informed consent be confirmed in writing.) The Committee concluded that the interests of the two clients would be inconsistent and, thus, would be "differing interests" pursuant to DR 5-105, if the available assets were unlikely to satisfy both judgments that may be obtained in the aggregate by both clients.[21]

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20. NYSBA Comm. on Prof'l Ethics, Op. 639 (1992).

21. The Committee explained that the issue was one of "first impression" for the Committee and cited to an Alabama Opinion 82-591 (March 17, 1982) (BNA

The Committee explained that where the attorney determines that it is unlikely that there will be sufficient assets, the lawyer must determine if the lawyer can adequately represent both clients and each consents after full disclosure. It is only in that circumstance that the attorney may agree to the representation. Such a condition may be met, the Committee explained, if both claims will be zealously pursued, the respective interests do not differ except as to the lack of sufficient assets, and the expectation is that the plaintiffs will divide the available assets in proportion to each of their judgments or in accordance with an agreement concerning allocation of recovery. However, the lawyer may not proceed with multiple representation where it is obvious that the attorney cannot adequately represent both parties such as where one client's damages far exceed any claims that could be proven or asserted on the other client's behalf. Moreover, an attorney may not make an aggregate settlement for multiple clients unless each clients consents after being informed of "(1) the existence and nature of all the claims involved, (2) the total amount of the settlement, and (3) the participation of each person in the settlement." Multiple representation that may have appeared appropriate at the outset may later require the attorney's withdrawal from representation of either client if the circumstances change in such a way as to put the clients in "an irreconcilable conflict" (i.e., an aggregate settlement proposal.)

5. Lawyer Agreements to Forego Future Cases Against Settling Respondent(s)

Assume that a lawyer has settled a case against a broker-dealer on behalf of several clients. The dispute involved a firm proprietary product in which hundreds of investors lost money. The broker-dealer suspects that the lawyer may represent other clients against the broker-dealer involving the same product, thus, the broker-dealers asks the lawyer to agree not to pursue future cases against the broker-dealer as a condition to settlement (an arrangement

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810:1030) in support of its conclusion. In the Alabama opinion, it was concluded that a lawyer may not represent multiple plaintiffs where the assets were insufficient to satisfy all potential claims and one claimant's recovery would result in reduction of the available assets to satisfy the remaining claims. In reaching its conclusion, the Committee also cited to *Matter of Guardianship of Lauderdale*, 15 Wash. App. 321, 549 P.2d 42 (1976) (concluding that a lawyer could not act as guardian ad litem for several minors whose interests were not substantially similar and where the lawyer must recommend a larger settlement for one client to the potential detriment of another.)

known as a "buyout"), can the lawyer ethically make such an agreement? In New York, a lawyer may not offer or enter into a settlement agreement requiring a lawyer not to pursue future cases against the settling broker-dealer as such an agreement impermissibly restricts the lawyer's right to practice law.

Current Rule 5.6(a)(2) of the NYRPC provides that "[a] lawyer shall not participate in offering or making: [] an agreement in which a restriction on a lawyer's right to practice is part of the settlement of a client controversy."[22] The American Bar Association's Committee on Ethics and Professional Responsibility has addressed the impermissibility of an agreement restricting a lawyer's right to practice law. The Committee stated that:

> [a] restriction on the right of plaintiffs' counsel to represent present clients and future claimants against a defendant as part of a global settlement of some counsel's existing clients' claims against that same defendant represents an impermissible restriction on the right to practice which may not be demanded or accepted without violating Model Rule 5.6(b).[23] [24]

According to the Committee, the issue raises concerns about the interplay between Rule 1.2 governing a lawyer's duty to the lawyer's present clients and Rule 5.6. The Committee ultimately opined:

> [w]hile the Model Rules generally require that the client's interests be put first, forcing a lawyer to give up future representations may be asking too much, particularly in light of the strong countervailing policy favoring the public's unfettered choice of counsel.

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22. ABA Model Rules, FRPC and CRPC are consistent with the NYRPC Rule 5.6(a)(2) prohibition against agreements restricting an attorney's right to practice law. ABA Model Rule 5.6 is identical to Rule 5.6(a)(2) of the NYRPC. Rule 4-5.6 of the FRPC is substantially similar. Rule 1-500(A) of the CRPC provides that "[a] member shall not be a party to or participate in offering or making an agreement, whether in connection with the settlement of a lawsuit or otherwise, if the agreement restricts the right of a member to practice law . . ."

23. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 93-371 (1993). *See also*, Los Angeles County Bar Ass'n Professional Responsibility and Ethics Comm. Formal Op. 468, 8 Law. Man. Prof. Conduct 129 (Cur. Rep. [May 29, 1992]).

24. In ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 95-934 (1995), the Committee stated that the prohibition against such agreements also applies where a party is a governmental entity.

CONCLUSION

Lawyers representing multiple clients in one arbitration must be sensitive to many potential ethical issues that may arise during the course of the representation. When one or more of the clients' strategies significantly diverge from those of the remaining clients, the lawyer cannot continue with the joint representation. Additionally, unless the clients consented in advance to continuing representation of one of them should a conflict arise, the lawyer needs to obtain the consent of the client from whom the lawyer is withdrawing representation before continuing the representation of the remaining client(s). A lawyer may ethically represent multiple clients in settlement negotiations and collectively settle their claims if the clients give written informed consent which sets forth the existence and nature of all claims involved and the participation of each person in the settlement. The clients' advance general consent to accept any terms of an aggregate settlement, however, is not acceptable and the clients will not be bound to the aggregate settlement unless the lawyer received informed written consent after the proposed settlement is negotiated.

Additionally, some jurisdictions with rules substantially similar to New York's have held that agreements by the clients permitting acceptance of a settlement by majority rule of the clients are not valid. Those jurisdictions have reasoned that such agreements deprive clients of the right to approve the settlement; require consent before the essential terms of the settlement are known and, thus, deprive the clients of giving informed consent after full disclosure; and put the lawyer in a position where the lawyer cannot maintain a duty of loyalty to each client. When a lawyer represents multiple clients against a single defendant and it appears that there may be insufficient assets to satisfy all claims, the lawyer may represent the clients if the lawyer determines that all clients will be zealously represented, there are no other differing interests, and the clients agree as to allocation of recovery. Finally, buyout agreements whereby a lawyer agrees not to pursue future cases against a defendant as a condition of settlement are ethically impermissible as they restrict the lawyer's right to practice law.

THE VXX ETN AND VOLATILITY EXPOSURE

Tim Husson, PhD, and Craig McCann, PhD[1]

Exposure to the CBOE Volatility Index (VIX) has been available since 2004 in the form of futures and since 2006 in the form of options. Recently new exchange-traded products have offered retail investors an easier way to gain exposure to this popular measure of market sentiment. The most successful of these new products has been Barclays's VXX ETN, which has grown to a market cap of just under $1.5 billion. However, the VXX ETN has lost more than 90% of its value since its introduction in 2009, compared to a decline of only 60% for the VIX index. This poor relative performance is because the VXX ETN tracks an index of VIX futures contracts that can incur negative roll yield. In this paper we review the VIX index and assess the opportunities and risks associated with investing in an investment like Barclay's VXX ETN.

I. INTRODUCTION

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a measure of "the market expectation of future volatility implied by the S&P 500 stock index options prices."[2] It was originally described in a paper by Robert Whaley in 1993 as an average of the implied volatilities of eight near-the-money options contracts on the S&P 100 index. However, in 2003 the CBOE reformulated the VIX as a weighted average of S&P 500 options *prices* across a wide variety of strikes.[3] This revised calculation has been shown to be more highly correlated with the realized variance of the S&P

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2. http://www.cboe.com/micro/VIX/vixwhite.pdf.

3. See Carr and Wu (2006) for a thorough explanation of the old and new VIX calculations.

500, and shortly after the revision, futures and options contracts were introduced on the VIX.

The VIX index has earned a reputation as a 'market fear gauge'.[4] The CBOE points out that the VIX index is more properly a measure of 'uncertainty' rather than 'fear'; nonetheless, it attracts considerable attention during periods of market instability or financial uncertainty.[5] This index's reflection of expected future stock market volatility has made it attractive to investors who want to speculate on, or hedge, future stock market volatility. Moreover, the VIX index has been negatively correlated with the S&P 500 itself, which became especially evident during the 2007-8 financial crisis. Thus adding VIX exposure to an investor's portfolio has been suggested as a source of potential diversification.[6]

The VIX is a calculated index, not a directly investable asset; one way to achieve exposure to the VIX is by trading futures or options contracts written on the VIX. These futures and options contracts are not simple investments for retail investors to trade. Investors who want to invest in futures contracts need to open a margin account, find the right contracts to purchase, and "roll-over" the maturing future contracts into new contracts as they expire. In addition, futures contracts are highly leveraged, marked-to-market daily, and usually only trade in large blocks.[7]

On January 29, 2009 Barclays first issued the iPath S&P 500 VIX Short Term Futures Exchange Traded Note (VXX ETN).[8] The VXX ETN tracks the S&P VIX Short Term Futures Index Total Return (SPVXSTR),[9] which tracks changes in the value of the near-term futures contracts written on the VIX index. Changes in the level of the SPVXSTR Index are generally correlated with changes in the level of the VIX index. The VXX is an ETN and not an ETF, and as such is a senior, unsubordinated, unsecured debt security issued by Barclays. As long as Barclays does not default on its

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4. See for example Whaley (2009).
5. See the CBOE's explanation at http://www.cboe.com/micro/vix/ faq.aspx#2.
6. Brière, Burgues, and Signori (2010).
7. Futures contracts are inherently leveraged investments because each contract only requires a small fraction of the contract's notional amount as an initial investment (the initial margin requirement). Chance (2002) argues that the initial margin requirements for futures contracts are "usually less than 10% of the futures price."
8. Prospectus and original pricing supplement available at the SEC website: www.sec.gov/Archives/edgar/data/312070/000119312509 013753/d424b3.htm.
9. This index is designed to track a portfolio of VIX futures contracts with an average maturity of 1 month, and includes the cost of rebalancing that portfolio daily to maintain that average maturity. Details available at: www2.standardandpoors. com/spf/pdf/index/SP_VIX_Future_Index_Methodology_Web.pdf.

obligations, the notes pay investors a return equal to the percentage change in the level of the reference index minus management fees.[10]

The VXX ETN's reference index, SPVXSTR, calculates the return to a portfolio of 1 and 2 month futures contracts that is rebalanced daily to achieve an average maturity of 1 month.[11] While this methodology does achieve high correlation with the spot price of the VIX index, its use of futures contracts has a substantial effect on the changes in the reference index relative to changes in the VIX index. The result is a decline in value of over 90% from January 2009 until the end of 2010, compared to a decline of only 60% for the VIX index during the same time period. This difference is due to the use of a reference index that is calculated from maturing futures contracts rather than the VIX index itself.[12]

In this paper we review the risks associated with investing in the VXX ETN in order to gain exposure to the changes in the level of the VIX index. We show that the return to the VXX ETN depends in a large part on movements in the futures markets. We show that a part of the deviation between the VIX index and the VXX ETN is predictable. Our findings highlight the complexity and the risk of this futures-based investment.

II. THE VIX INDEX AND VOLATILITY EXPOSURE

The VIX index is not a tradable asset, it is a calculation that is updated by the CBOE every 15 seconds. The VIX index is designed to capture "the market expectation of future volatility implied by the S&P 500 stock index options prices."[13] It does so by computing the weighted average of S&P 500 options prices across a wide variety of strikes under the assumption that "the price of each option reflect[s] the market's expectation of future volatility."[14] Figure 1 shows the cumulative historical performance of the VIX index compared to the performance of the S&P 500.

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10. See for example Wright, Diavatopoulos, Felton (2010) for an in-depth explanation on ETNs and the differences between ETNs and ETFs.

11. The SPVXSTR index is a 'total return' index, meaning its notional value includes the interest accrual on a 3-month US Treasury bill.

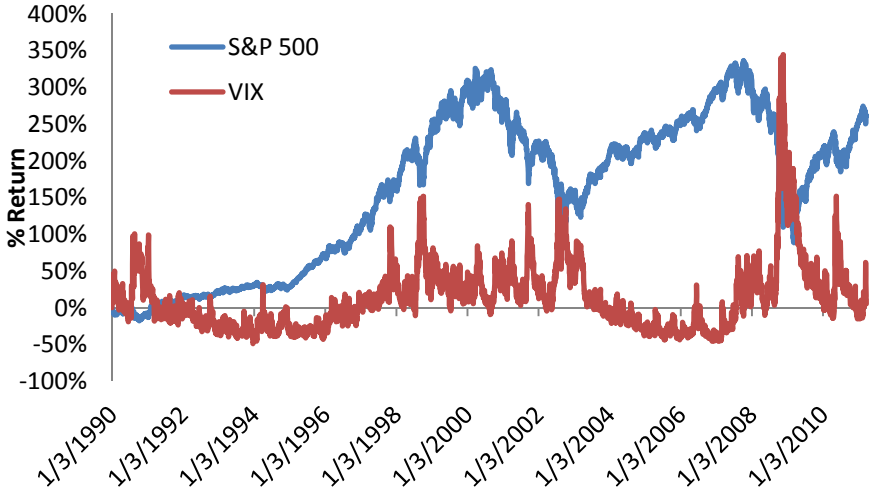
12. See for example Guedj, Li, and McCann (2011) for a description of the deviation between commodities spot price return and the return to futures-based commodities ETFs.

13. http://www.cboe.com/micro/VIX/vixwhite.pdf.

14. See http://www.cboe.com/micro/vix/vixwhite.pdf for a detailed description of the VIX calculation. Although the CBOE revised its original formula in 2003, it still

Figure 1: The VIX Index and S&P 500 Index Daily Cumulative Price Changes

Daily cumulative price changes of the VIX Index and the S&P 500 Index from January 1990 to March 2011.



The VIX index is often interpreted as a measure of stock market risk or general market sentiment[15] – some perceive the VIX index to capture an aspect of Keynes' (1936) 'animal spirits'. During periods of crisis or uncertainty, the volatility of stock markets tends to increase dramatically, which is reflected in abrupt, sharp jumps in the VIX index. For example, during the US government bailouts of banks in October 2008 the VIX index went up by 260% and during the Russian financial crisis of 1998 the VIX index increased by 155%.[16] This well-documented regularity suggests that exposure to the VIX index could be 'catastrophe insurance' (a way of hedging large negative movements in the S&P 500) or a means of betting on disruptive world events. Indeed, this interpretation of the VIX index as a 'market fear gauge' has contributed greatly to the increased attention it has attracted from investors.[17]

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reports both the previous calculation (VXO) and the updated version backfilled to 1990 (VIX).

15. See Whaley (2009) and Figuerola-Ferretti and Paraskevopoulos (2010).
16. Return observations from August 28 to October 10, 2008 and July 16 to August 27, 1998.
17. See for example reviews by Whaley (2000) and Carr and Lee (2009).

Until 2009 the only way to achieve exposure to the VIX index was through the VIX futures and options. These contracts, introduced by the CBOE in 2004 and 2006 respectively, have become some of the most heavily traded contracts on the CBOE with, for example, open interests on March 25, 2011 of 182,258 futures contracts and 4,601,688 options contracts.[18] However, due to their complexity and minimum efficient trade sizes, most retail investors are not likely to invest directly in options and futures markets.

Barclay's VXX ETN provides indirect exposure to the VIX index by tracking changes in the level of a reference index that mimics the return to a portfolio of VIX futures contracts fully collateralized with treasury securities. The VXX ETN has since become one of the most popular of all exchange-traded products with a market capitalization of as high as $1.5 billion.

III. PERFORMANCE OF THE VXX ETN

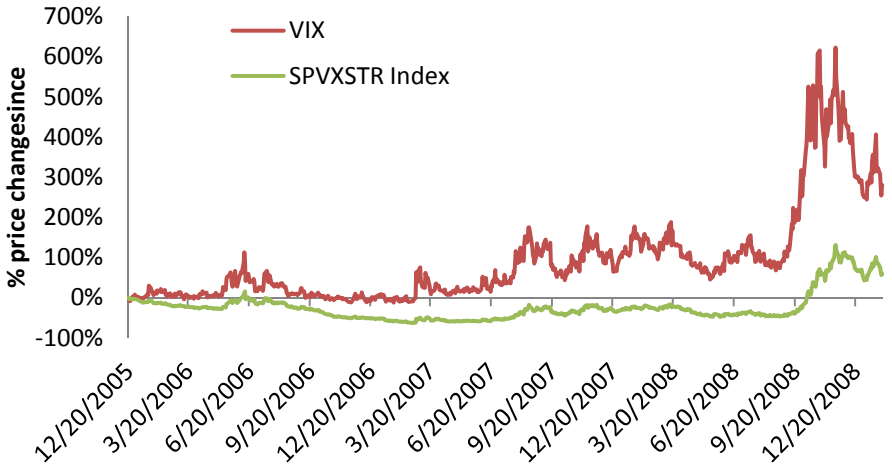
In Figure 2 Panel A, we plot the cumulative percentage change in the level of the VIX index and the SPVXSTR index from December 2005 to the introduction of the VXX ETN in 2009. In Figure 2 Panel B, we plot the cumulative return to the VXX ETN and the cumulative percentage change in the level of the SPVXSTR index from the VXX's introduction in 2009 to 2011.[19] In both time periods the futures-based methodology underlying the VXX ETN has accumulated a large negative deviation in returns relative to percentage changes in the VIX index despite having a weekly return correlation of 86% with the VIX index. The VXX ETN and SPVXSTR index align in Figure 2 Panel B because the VXX pays investors the change in the level of the SPVXSTR index minus fairly modest management fees.

18. Open interest is the total number of futures or option contracts that are open, i.e., have not been settled, and hence it reflects the size of a market.

19. On November 9, 2010 the VXX issued a 1-for-4 reverse split and we adjust the price accordingly.

Figure 2: Performance of VXX ETN and its Reference Index SPVXSTR Compared to the Performance of the VIX Index

Panel A: SPVXSTR Index compared to the VIX Index from 2006 to 2008



Panel B: VXX ETN and the SPVXSTR Index compared to the VIX Index from 2009 to 2011

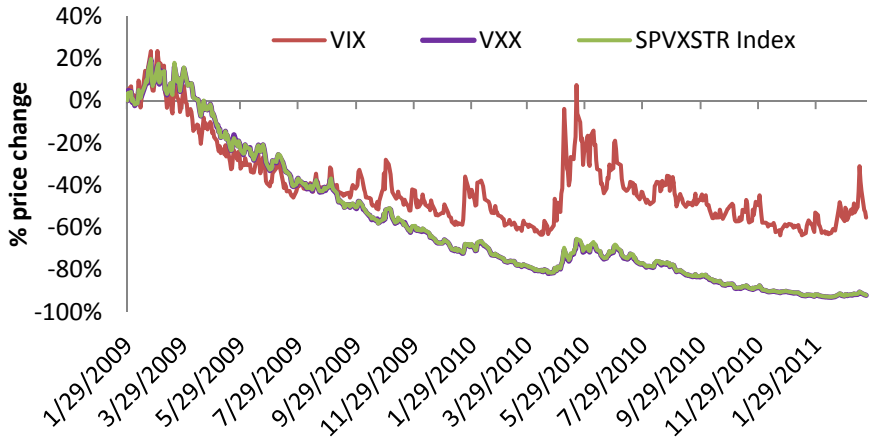


Table 1 lists the correlations and deviations between the weekly returns to the VXX ETN and the changes in the VIX index for 6 month sub-periods.

As is clear from the graphs, the deviations are more severe in some periods than in others. The deviations can also be positive, as in the second period of 2010.

Table 1: Performance of VXX ETN Compared to the VIX Index
Return deviations are the difference in the returns over the entire period. Correlations are of weekly returns.

Holding period	Return Deviation	Correlation
1/29/2009-6/30/2009	6%	88%
7/1/2009-12/31/2009	-23%	83%
1/1/2010-6/30/2010	-36%	91%
7/1/2010-12/31/2010	14%	82%
1/1/2011-3/1/2011	-3%	84%

The weekly returns to the VXX ETN differ from changes in the VIX index because the VXX ETN's returns are based on the SPVXSTR index of futures prices on the VIX index rather than spot prices of the VIX index. The SPVXSTR index calculates the return to a portfolio that holds a combination of 1- and 2- month futures contracts, and every day it sells a fraction of its holding of 1-month contracts and uses the proceeds to buy 2-month contracts. If the price of 1-month contracts is consistently lower than the price of 2-month contracts, then the daily rebalancing will incur a loss relative to the change in the VIX spot level. As this situation has been common in the VIX futures market, the SPVXSTR index and thus the VXX ETN's cumulative returns have gradually accumulated a large negative shortfall compared to cumulative changes in the VIX index.

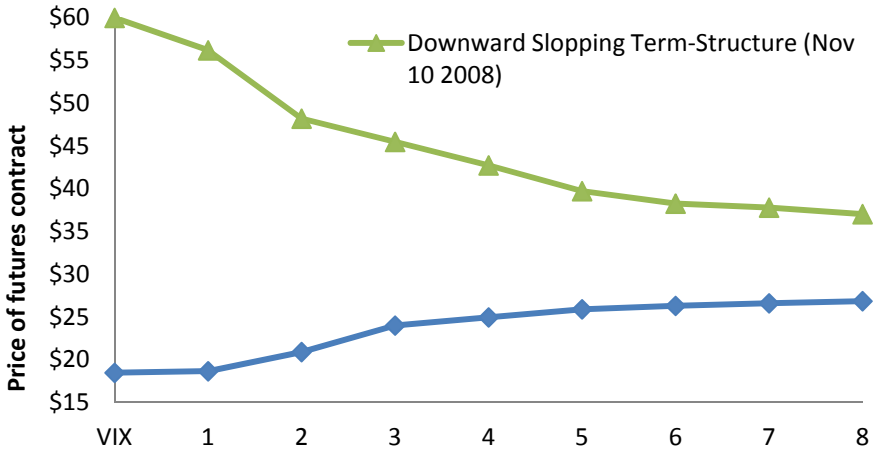
IV. VIX FUTURES TERM STRUCTURE

The term structure of a futures market is the yield curve of the prices of futures contracts ordered by their time to maturity. An upward (downward) sloping term structure refers to a market condition where the longer-term futures contract prices are higher (lower) than the nearer-term futures contract prices. The term "backwardation" is often used when referring to a "downward sloping term structure," where the near-term future price is

higher than long-term future price.[20] For clarity and tractability, we use the terms "upward sloping term structure" if the longer-term futures price is higher than the near-term futures price and "downward sloping term structure" if the longer-term futures price is lower than the near-term futures price. As an illustration we plot in Figure 3 the term-structure of the VIX future contracts on two days, one that had an upward- and one that had a downward-sloping term structure.

Figure 3: Examples of the Term-Structure of the VIX Index Futures Contracts

This graph shows examples of the term structure of the VIX index future contracts. On November 10, 2008 the term-structure was downward sloping, i.e. the price of the second month futures contract was lower than the price of the one month futures contract. On November 10, 2010 the term-structure was upward sloping.



20. The term "contango" and "backwardation" are used frequently in commodity market literatures, but Hull (2011) defines the following: "When the futures price is below the expected future spot price, the situation is known as normal backwardation; and when the futures price is above the expected future spot price, the situation is known as contango." Hull's definition of backwardation market is defined over a time series, which is a different concept from what we call "downward-sloping term structure" which is defined over a cross-section of futures contracts. He goes on to say, "however, it should be noted that sometimes these terms are used to refer to whether the futures price is below or above the current spot price, rather than the expected spot price."

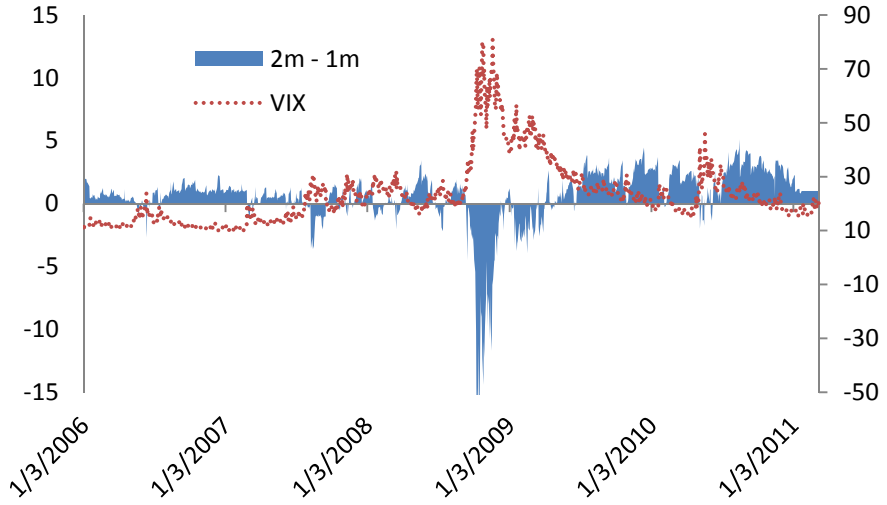
As Gorton and Rouwenhorst (2005) have shown, the term structure of futures prices contains important information for predicting the expected future spot price and therefore the roll-over return. Erb and Harvey (2006) use the slope of the term structure directly as the measure of roll-over return. However, changes in the yield curve over time, which determine the roll-over return, are different from the term structure of the yield curve, which represents the prices of futures contracts over different maturities at one specific point of time.

The dynamics of the term structure of a futures market will have a potentially important impact on any purchaser of a futures contract, including the exchange traded products that use futures contracts to track an underlying index. The return to such an investment will not only depend on the return to the spot price but also on whether the contract was purchased during a period when the term structure of the futures prices was upward- or downward-sloping.

Following Gorton and Rouwenhorst (2005) and others, Figure 4 plots the term structure of the VIX futures market as defined by the difference in price between the 1 and 2 month VIX futures contracts. Positive (negative) values of the term-structure mean that the term structure was upward-sloping (downward-sloping). The only time the slope was significantly negative was during the financial crisis of 2008-9. During this period, the VXX ETN accumulated a small daily profit compared to the VIX index; however, the majority of the time the VXX ETN incurred a steady loss of value.

Figure 4: Term Structure of VIX Futures Contracts Compared to the VIX Index Level

The term structure is defined as the difference between the prices of 2-month and 1-month futures contracts (see Gorton and Rouwenhorst (2005) for example). We report data from January 2006 through March 9, 2011 onwards due to the lack of liquid data, especially for the 2 month futures contracts, before that time[21].



The reason for the apparent persistent upward-sloping term-structure in the VIX futures market is not straightforward. In commodities markets, persistent upward-sloping term-structure can be explained by storage costs—investors must be compensated for holding a good (barrels of oil, bushels of wheat, etc.) over a period of time, and this is reflected in a higher futures price.[22] However, the VIX index is an entirely synthetic asset (it is simply a calculated number), thus it is not immediately clear why its term structure should exhibit time persistence.

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21. We use the interpolation/extrapolation methods reported by Standard & Poor's to reconstruct missing contract data whenever possible; further missing data has been generously supplied by S&P. Details of these procedures can be found in the SPVXSTR Index Methodology available at: http://www2.standardandpoors.com/spf/pdf/index/SP_VIX_Future_Index_Methodology_Web.pdf.

22. Alternative explanations for persistence in term structures based on risk premia also exist, see for example Pindyck (2001).

Recent models proposed by Zhu and Lian (2011) and Duan and Yeh (2011) offer a mean-reversion explanation for this behavior, in the sense that investors in the futures market expect volatility to revert to a long-term mean. When the VIX index is above that assumed mean, its term structure will be downward sloping, and when it is below that mean, its term structure will be upward-sloping. This interpretation is especially intuitive during periods of extremely high volatility, such as during financial crises, where it is recognized that market uncertainty will be resolved sometime in the future. In periods of sustained growth, such as the 2010 market rally, the sustained upward-sloping term structure represents an expectation of future market instability. This interpretation is supported by the historical term structure of VIX futures, but it is unclear if this relationship will continue in the future, or what the long-term mean to which the VIX index will revert should be. Since VIX futures date only from 2004 (and are liquid only from about 2006), it is difficult to fully analyze the dynamics of this market.

Table 2: Upward- and Downward-Sloping VIX Futures

Similar to Figure 3, we here report data only from Jan 1, 2006 due to illiquidity effects for earlier contracts. However, it can be noted that on all observable dates from Jan 2004-Jan 2006 the VIX futures market was upward-sloping.

	Trading days	*Days slope d up*	*Days sloped down*	*Upward %*	*Downward %*	*Average slope when positive*	*Average slope when negative*
2006	251	235	16	93.63%	6.37%	0.893	-0.527
2007	251	167	84	66.53%	33.47%	0.736	-0.776
2008	253	87	166	34.39%	65.61%	0.975	-3.750
2009	252	127	125	50.40%	49.60%	1.903	-1.539
2010	252	236	16	93.65%	6.35%	2.396	-0.650
2006 -10	1259	852	407	67.67%	32.33%	1.440	-2.120

Table 2 shows the number of days that the VIX futures market has been upward- or downward-sloping. Since 2006, the dominant regime has been an upward-sloping term structure; however, the most significant downward-slope occurred in 2008 when VIX index levels were remarkably high (see Figure 1). During this period, the slope of the term structure was not only negative, but strongly so. This implies that the roll yield is on average more

positive when the term structure is downward-sloping than it is negative when the term structure is upward-sloping.

V. RISKS

a. Term Structure Risk

As described in the previous section, a significant risk factor inherent to the VXX ETN is that its reference index, the SPVXSTR index, values a portfolio of rolling VIX futures contracts, and hence its price changes are determined by the evolving term structure of VIX futures contracts. As shown in Figure 4, the VIX futures market has had long stretches of consistently upward-sloping term structures punctuated by rapid shifts to strongly downward-sloping regimes, making any long or medium term investment involving the VXX ETN subject to a daily loss of value not due to the actual VIX index price changes. Moreover, the reasons for persistent term structure in the VIX futures market are not clearly understood. Indeed, shifts in the term structure can occur abruptly, as they are correlated with unexpected market disruptions.

To analyze the persistence of upward- and downward-sloping term structures, we analyze the VIX futures market with a two-state Markov regime switching model.[23] Such a model imposes the condition that there are two distinct states, such as upward or downward-sloping term structures, and can evaluate the likelihood of switching between those states. First, we test whether the spread (log price of second-month futures contract – log price of near-month futures contract) is a unit-root process using an Augmented Dickey-Fuller (ADF) test. The ADF test results reject the unit root process – the spread is a stationary process. The Bayesian Information Criteria (BIC) suggests an ARMA(2,0) process as the optimal number of lags in the time series process to maximize the likelihood estimation. Second, we apply the Markov Regime Switching model to our sample. The results are summarized in Table 3.

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23. See Hamilton (2008) for a description of regime-switching models. We follow a similar methodology to Fattouh (2009) who uses a Markov Regime Switching model to estimate the transition probability between two states of upward-sloping term structure and downward sloping term structure.

Table 3: Markov Regime Switching Model Results
Transition Probabilities

	From Upward-sloping	From Downward-sloping
To upward-sloping	96%	66%
To downward-sloping	4%	34%
Expected duration	26.7 weeks	1.5 weeks

Using weekly VIX futures market data from February 3, 2006 to March 4, 2011, we find that that the conditional probability of observing an upward-sloping term structure in the current time period, given an upward-sloping term structure in the prior period, is 96%. Conversely, the conditional probability of observing a downward-sloping term structure in the current period given a downward-sloping term structure in the prior period is only 34%. The expected duration of upward-sloping term structure is approximately 27 weeks, as compared to only 1.5 weeks for downward-sloping.

These results suggest that periods of upward-sloping term structure are highly persistent, whereas downward-sloping term structures tend to be short lived. In the context of the VXX ETN, these results imply that an investment in the VXX ETN will more likely lead to persistent losses relative to the VIX spot level due to due to roll yield in the reference index, and that gains from a positive roll during periods of downward-sloping term structure are not likely to persist. However, as noted above, during periods of a downward sloping term structure, the gains from the roll yield is larger on average than the losses during an upward slope. Therefore, the extent of roll costs on the value of an investment in the VXX ETN is difficult to forecast, even with specific expectations of future VIX levels.

b. VIX Index Tracking Risk

We decompose the changes in the SPVXSTR index which determines the VXX ETN payoffs into the impact of changes in the VIX and changes in the term structure of VIX futures prices in Table 4. We regress the contemporaneous daily price changes of the SPVXSTR index on the difference between the two- and one-month future contract prices, the daily

changes in the VIX index and the return to the two-month futures contract, explaining 98% of the deviation in SPVXSTR returns.

Table 4: Decomposition of SPVXSTR's Price Changes

*This table describes the decomposition of the contemporaneous monthly price changes of the VXX ETN's reference index, the SPVXSTR index, to the two components that may affect them: the term-structure and the return on the VIX futures and VIX index. T-statistics in parentheses, *** indicates significance at 1% level and ** at the 5% significance level.*

	(1)	(2)
Term Structure	-0.0673***	-0.0252***
	(9.87)	(9.58)
VIX Return		-0.143***
		(3.95)
2M Future Ret		1.199***
		(17.66)
Constant	0.0370**	-1.067**
	(2.00)	(2.00)
Observations	62	62
R-squared	0.697	0.977

c. Credit Risk

As with all ETNs, the VXX ETN is also subject to the credit risk of the underlying issuer (in this case Barclays). While often ignored in the valuation of derivatives and structured products, credit risk has been an increasingly important input to valuations and strategies since the financial crisis of 2007-8, which proved that even the most reputable and ostensibly protected firms can indeed default on their obligations. For example, the ETNs released by Lehman Brothers that were still outstanding during that firm's bankruptcy lost their entire value. In considering the VXX ETN as an investment vehicle, investors should decrease their expectation of future returns by the relative strength of the issuer's credit, reflected in its CDS swap rates or its debt rating from financial ratings services such as Moody's or Standard & Poor's.

d. Effectiveness as an Equity Hedge

One of the main reasons investors may want to add an exposure to the VIX index in their portfolio is the fact that the VIX index has a negative correlation with the S&P 500, which may contribute to a portfolio diversification. However, as noted by Shu and Zhang (2010), the VIX index appears to show a stronger negative correlation to the S&P 500 index during extraordinarily large daily movements. Since January 6, 2003, on days when the S&P 500 index has high positive or negative movement, the VIX index was more likely to change in the opposite direction. This suggests that the VIX index, and in turn the VXX ETN, functions as an effective hedge on equity returns only during *extreme* equity market movements. While this property may be consistent with a potential role as catastrophe insurance, the VXX ETN's effectiveness as a long term equity hedge is far less effective during normal market conditions.

e. Predictability

In Table 5 we test this question directly, by regressing the monthly price changes of the VXX ETN's reference index, the SPVXSTR index, price changes on observable factors in the previous month. Table 6, column 1 shows the results of regressing the deviation of the monthly price changes of the SPVXSTR with those of the VIX index on the previous month's deviation. While there is no readily apparent relationship, when we also include the lagged price changes of the VIX index and the lagged futures return (column 2), we find a strong positive relationship between the deviation and the previous month's deviation, as well as strong positive contributions from the VIX index and negative contributions from futures market returns. Interestingly, the slope of the term structure (the difference between the second and first month futures contracts) from the previous month does not appear to contribute predictive ability to the deviation (column 3). Overall, these three variables can predict approximately 52% of the variance in the deviation between the VXX ETN's reference index and VIX index price changes.

Table 5: Predictive Regression on Deviation in Price Changes

*T-statistics in parentheses, *** indicates significance at 1% level, ** significance at 5% level, and * significance at 10% level.*

	Deviation SPVXSTR Index		
	(1)	(2)	(3)
Lagged Deviation	-0.119	1.434***	1.523***
	(0.146)	(0.259)	(0.465)
Lagged VIX Return		1.869***	1.970***
		(0.324)	(0.562)
Lagged 2-Month Future Return		-1.982***	-2.076***
		(0.427)	(0.611)
Lagged Term Structure			0.00322
			(0.0135)
Constant	-1.179***	0.529	0.611
	(0.159)	(0.364)	(0.511)
Observations	61	61	61
R-squared	0.014	0.524	0.524

VI. CONCLUSIONS

The Volatility Index (VIX) is a calculation by the Chicago Board Options Exchange (CBOE) that is designed to measure the market expectation of future volatility implied by the S&P 500 stock index options prices. Inclusion of exposure to the VIX index in an investor's portfolio may provide diversification. However, exposure to the VIX index can only be achieved by investing in VIX futures and options contracts. Barclays introduced in 2009 the VXX Exchange Traded Note that provides exposure to the return to a reference index that reflects the changes in return to a bundle of 1 and 2 month futures contracts on the VIX index, and thus, indirectly, the VIX index.

The VXX ETN is a complicated and risky investment. Equity volatility is notoriously difficult to predict, and while its negative correlation with equity market movements may seem attractive as a long-term hedge, the fact that the VXX ETN's reference index tracks futures contracts instead of the

actual VIX index level means that substantial deviations between the two are likely. Therefore the VXX ETN should be considered only by investors who fully understand the term structure of the VIX futures market and who are prepared for the large, sudden movements and prolonged periods of decline characteristic of volatility exposure.

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RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Darlene B. Hill, Trustee of the Darlene B. Hill Trust u/t/a 9-15-93, and Darlene B. Hill v. Wachovia Securities, LLC a/k/a Wells Fargo Advisors, LLC, and UBS Financial Services Inc., and Thomas G. Gresham

FINRA Case No. 09-05301

Claimant was a 79-year old widow. Her entire life savings (approximately $400,000) was placed with Respondents in March 2008. A new account form was filled out indicating safety of principal as the chief objective. The investments were placed 100% in very volatile equity positions in largely unknown issuers. Over the course of approximately seven months, Respondents lost over 55% of Claimant's investments.

The broker moved fromWachovia to UBS in November 2008. Claimant's assets were placed in a fee-based Asset Advisor account. The approach taken at the hearing was that this went beyond a mere suitability broker recommendation and involved a breach of fiduciary duty by an investment advisor.

Claimants asserted the following causes of action: (1) violations of the Kansas Securities Act; (2) violations of the Federal Securities Act of 1934; (3) suitability/fraud; (4) breach of fiduciary duty; (5) negligence; and, (6) failure to supervise. In the Statement of Claim, Claimant requested: (1) Compensatory damages of $237,000; (2) Punitive damages of $237,000; (3) Attorneys' fees; (4) Costs; and, (5) Such further relief as the Panel deems just, equitable, and proper.

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

Award: The Panel found that Respondents Wachovia and Gresham were jointly and severally liable and ordered them to pay Claimant the sum of $175,000 in compensatory damages, plus $75,000 in attorneys' fees pursuant to K.S.A. 17-12a509(b) and $10,000 in costs.

Claimants' Counsel: Roger N. Walter, Esq., Morris, Laing, Evans, Brock & Kennedy, Chtd., Topeka, Kansas.

Respondent's Counsel: Patrick J. Whalen, Esq., Spencer, Fane, Britt & Browne, LLP, Kansas City, Missouri.

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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.*

Claimant's Expert: James Reardon, JD, CFP, Topeka, Kansas.

Respondent's Expert: Richard Sandow, Cullum & Sandow Securities, Southlake, Texas.

Arbitrators: James A. Hayes (Public Chairperson); Michelle S. Minor (Public)

The award is significant because the Claimant received full reimbursement of her net out-of-pocket losses (i.e., approximately $175,000), along with the award of costs of $10,000 and attorney's fees in the amount of approximately $75,000. Claimant's counsel believes the award, by implication, involved a finding by the Panel that there was a serious breach of fiduciary duty by the Respondents. At the hearing, the Respondent broker's testimony revealed that his version of events differed dramatically from Claimant's version. The broker also admitted he never reviewed the new account forms which were prepared and submitted to Wachovia and further claimed that those account forms were not prepared by him.

Steven Kolow v. Oppenheimer & Co. Inc.
FINRA Case No. 10-03410

Claimant had been a very successful restaurant creator who opened an account with Respondent. Claimant's broker was his closest personal friend. The broker told Claimant that Respondent implemented principal protection safeguards in his actively traded account. Such was not the case, however. The arbitrators were presented with a customer who is, at his core, a truthful and honorable person and who was taken advantage of by his broker's misrepresentations and reckless trading and the indifference of the broker's supervisors.

Claimant's account statement reflected a high level of net income and net worth, and that he had 10 years experience in stocks. Claimant's case focused largely on the fact that the broker was unsupervised. In addition, Respondent and the broker received more than $850,000 in commissions and trading costs from Claimant's account over a period of approximately four years. Claimant also focused on the fact that the broker and Respondent caused the losses by using significant amounts of margin, by concentrating Claimant's account heavily in a few securities, and by trading high-risk options trading while failing to protect those investments in any way or to recommend that he diversify holdings.

Claimants asserted the following causes of action: (1) breach of fiduciary duty; 2) violation of the Colorado Securities Act C.R.S.A. § 11-51-604(3); 3) violation of the Colorado Securities Act C.R.S.A. § 11-51-604(4); 4) violation of FINRA Rule 2010; 5) violation of FINRA Rule 2310; 6)

violation of FINRA Conduct Rule 3010; 7) negligent supervision; and 8) negligence. The causes of action relate to Claimant's purchases of shares of Alcoa, GVI, General Electric, Freeport-McMoran, and Exco-Resources, and call options of General Electric, Freeport-McMoran, and Exco-Resources. In the Statement of Claim, Claimant requested: (1) Disgorgement of all profits earned by Respondent through alleged excessive trading of Claimant's account; (2) Damages in excess of $ 4,000,000.00; (3) Lost investment opportunity costs; (4) Pre-judgment and post-judgment interest; (5) Reasonable attorneys' fees, expert fees, and costs; and, (6) Such further relief as the Panel deems just, equitable, and proper.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent also contended that many of the transactions at issue were initiated by Claimant.

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant the sum of $1,112,500.00 in compensatory damages, plus post-judgment interest at a rate of 9% per annum from the date of the award if the award was not paid within the standard 30-day period.

Claimants' Counsel: Kristen Hudson, Esq., Bradley P. Nelson, and Jose A. Lopez, Esq., Schopf & Weiss LLP, Chicago, Illinois; David Robbins, Kaufmann Gildin Robbins & Oppenheim LLP, New York, New York.

Respondent's Counsel: Peter Byer, Esq., Oppenheimer & Co. Inc., New York, New York.

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

Respondent's Expert: Riverside Financial Group, Cranford, New Jersey.

Arbitrators: Robert D. Greenlee (Public Chairperson); Samuel Clinton O'Daniel (Public); Richard M. Reider (Non-Public)

This case is significant because Claimant's counsel was able to get the three experienced arbitrators to appreciate and empathize with an individual unlike themselves. The trading was over an extended period of time; the customer did not read trade confirmations or monthly statements; the customer and broker spoke every day, many times a day; millions of dollars of transactions took place; and, no downside protection was ever implemented. In addition, there was not any substantive contact between the branch manager and the customer, despite the high degree of trading activity, the speculative nature of that trading and the cumulative losses in the account. In addition, Claimant successfully moved to exclude the broker from being present during the times he was not called as a witness in the case.

Marvin Leiter and Beverly Leiter as Trustees of the Leiter Family Trust v. Morgan Stanley Smith Barney LLC f/k/a Citigroup Global Markets, Inc.
FINRA Case No. 09-06918

Claimant Marvin Leiter was previously a very sophisticated investor who had worked as a former regional director for a large broker-dealer. However, Claimant began to suffer from Dementia and Respondent ultimately neglected his account. His daughter reached out to Respondent for assistance and Respondent gave her unsuitable and improper advice. Respondent engaged in short-term option trading in the accounts.

Claimants' theory focused on a combination of Respondent's failure to hedge, and the unsuitable and unauthorized options trading, which the family was told would protect the account. In addition, Claimants alleged unauthorized trading because Respondent never obtained written authority to take orders from the daughter.

Claimants presented numerous alternative damages ranging from approximately $1,000,000.00 to $9,500,000.00. Because out of pocket losses were not the true measure of damages, Claimants did not focus on NOPs. Rather, the alternative damages theories focused on Respondent's failure to hedge and damages related to the actual option trading. One theory specifically focused on Respondent's failure to institute a proper collar in October 2008. The alternative theories were mutually exclusive, because if Respondents had hedged there would not have been options trading.

Regarding Claimant's medical condition, Respondent claimed ignorance. Claimants did not contest that the family did not outright inform Respondents of Claimant's medical condition. Rather, Claimant used CAT Scan and other medical evidence, as well as a neurologist who testified as an expert witness.

Prior to the hearings, the Panel Chairperson was the subject of numerous Motions to Recuse. The basis for these Motions were: outright bias in discovery decisions, failing to provide basic employment info in his disclosure, and refusing to answer inquiries regarding the percentage of revenues he receives from FINRA arbitrations. The latter was raised after the Chairperson disclosed, upon inquiry, that he was serving on panels in 14 arbitration cases at the same and that several cases involved the same Respondent and same law firm that was representing Respondent in this case. In addition, the Chairperson refused to disclose how many cases he had with the actual counsel in this case. Two months prior to the award in this case, the Chairperson dissented on a six million dollar award to a Claimant in a case involving MAT hedge funds.

Claimants asserted the following causes of action: (1) omissions; (2) misstatements; (3) suitability; (4) negligence; (5) failure to supervise; (6) breach of contract; (7) breach of fiduciary duty; (8) breach of the covenant of

good faith and fair dealing; (9) respondeat superior; and, (10) violation of New York's General Business Law Article 22-A.

In the Statement of Claim, Claimant requested: (1) compensatory damages of approximately $9,565,064.00; (2) attorneys' fees pursuant to New York's General Business Law §349; (3) costs; (4) interest at the statutory rate of Florida (8%) or, in the alternative, interest pursuant to New York's CPLR §5004 from January 2007 until the date of payment of the Award (9%); and, (5) punitive damages.

Respondents requested dismissal of the Statement of Claim and that the costs associated with the case be assessed solely against Claimant.

The case proceeded under the Public Arbitrator Pilot Program.

During the arbitration hearing, the Panel denied Claimant's Motion in Limine to Preclude and/or Limit the Testimony of Robert Katzman.

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant $2,388,230.05 in compensatory damages. The Panel also assessed all hearing session fees ($32,400.00) against Respondent.

Claimants' Counsel: Stuart D. Meissner, Esq., Stuart D. Meissner, LLC (New York, New York)

Respondent's Counsel: Brian F. Amery, Esq. and Daniel R. Korb, Jr., Esq., Bressler, Amery & Ross (Morristown, New Jersey)

Claimant's Expert: Jim French

Respondent's Expert: Robert Thorn

Arbitrators: Guy K. Stewart, Jr. (Public Chairperson); Myron E. Levenson (Public); Dennis J. Levin (Public)

This case is significant for several reasons. First, the damages award issued by the Panel was 100% of the alternative damages theory related to Respondent's failure to institute a proper collar in October 2008. Second, this was a case involving a client with Dementia (who testified that the last U.S. President was Eisenhower). In addition, one of Respondent's brokers who had been involved in the case died in middle of the hearings – after Claimant's counsel had questioned him. This was supposed to be an expedited proceeding; however, the hearings lasted six months and involved three sets of hearing dates. Claimant's daughter, who directly interacted with Respondent, did not testify. Rather, all testimony related to the daughter's interaction came from Respondent's witnesses. Third, Claimant's counsel did not relent when dealing with the perceived bias and conflict of interest of the Chairperson. Claimant's counsel opined that if a panelist demonstrates repeated evidence of bias (continued one sided rulings on objections, sustaining almost all of Respondent's objections and overruling almost all of Claimant's objections, etc.), counsel should never given in think that by being nice the biased panelist will go along with you. Although it is not

pleasant and sometimes very painful going through the process, the results can be worthwhile. Fourth, Claimants also used a medical expert to testify as to Claimant's mental condition at the time the relevant events occurred.

Christian Brothers University, Endowment Fund v. Morgan Keegan & Company, Inc.

FINRA Case No. 09-02550

Claimant is the endowment fund for a private Catholic institution of higher education, which is used to provide scholarships to needy students. Claimant had retained a third-party Registered Investment Advisor. The advisor purchased shares of RMK Select High Income Fund in Claimant's account. At the hearing, the third party advisor offered testimony that they had been misled about the risks and overall nature of the proprietary Morgan Keegan funds just as many individual investors had been misled. Morgan Keegan's defense was largely focused on blaming the third party advisor and holding the advisor responsible for all decisions made within the account.

Claimants asserted the following causes of action: (1) Misrepresentations and omissions; (2) Breach of fiduciary duty; (3) Unsuitable investments; (4) Negligence; (5) Failure of supervision; (6) Breach of contract; (7) Violation of FINRA rules; and, (8) Violation of Tennessee statutes. In the Statement of Claim, Claimant requested: (1) compensatory damages in excess of $ 1,000,000.00; (2) interest; (3) costs; (4) punitive damages; and, (6) such other and further relief as the Panel deemed just and proper.

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

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant damages in the sum of $432,061 plus interest at the Tennessee legal rate accruing from April 30, 2009 until the date of payment of the Award, plus $375 representing reimbursement of the non-refundable filing fee paid to FINRA Dispute Resolution.

Claimants' Counsel: Dale Ledbetter, Esq., and Adam Nativ, Esq., Ledbetter & Associates, P.A., Ft. Lauderdale, FL.

Respondent's Counsel: Shepherd D. Tate, Esq., and Samuel L. Felker, Esq., Bass, Berry & Sims PLC, Memphis, TN.

Claimant's Expert: Edward S. O'Neal, Securities Litigation & Consulting Group, Inc., Fairfax, Virginia; Jim Gatewood, Boca Raton, Florida.

Respondent's Expert: Steve Scales, Secure Financial Services, Inc., Colchester, Vermont; Kjell Ekdahl, Applied Financial Analytics, Emeryville, California.

Arbitrators: Jerry Schuchman (Public Chairperson); Ian S. Grieg (Public); Robert Kevin O'Mara (Non-Public)

The award is significant because the panel awarded interest at the Tennessee statutory rate of 10% which presently adds another $155,000 to the amount of the award. Morgan Keegan has filed a Motion to Vacate, as they are now doing whenever there is a sizable award entered against them. Morgan Keegan put on an extremely aggressive attack mode defense in this case against a religious educational institution that is located in the city where Morgan Keegan has its home office. Lastly, Claimant's counsel contends tat the testimony of Morgan Keegan's experts, in many instances could not be supported by facts or existing laws or regulations.

Steven Russell & Ronni Pitiger, as Trustees of the David N. Russell 2000 Trust v. Morgan Stanley Smith Barney, LLC
FINRA Case No. 10-02604

David Russell passed away on May 29th, 2009. In January 2009, David Russell made his mandatory required distribution ("MRD") from his IRA with Morgan Stanley Smith Barney ("MSSB") for $100,000.00. On September 24, 2009, the tax laws changed when Congress enacted notice 2009-82, which provided relief for taxpayers by waiving a required minimum distribution ("RMD") for 2009 and granted taxpayers an extension to November 30, 2009 (from the normal 60 days) to redeposit or "rollover" a RMD back into taxpayer's IRA.

Six months after David Russell passed away, his son Steven Russell, acting in his capacity as executor, attempted to roll over David Russell's RMD into his MSSB IRA account. MSSB wrongfully rejected the rollover stating that they couldn't accept any new money into the account as the account has been coded as "deceased" and therefore no new money could come in. As a result, David Russell's estate incurred additional tax liability of $33,831.00.

The Internal Revenue Code "IRC", under 7701(a)(8) defines an executor as a fiduciary. IRC Section 6903(a) defines a fiduciary's rights and obligations as "assuming the powers, rights, duties and privileges of such other person in respect of a tax imposed." In essence, a fiduciary (or in this case the executor) steps into the shoes of the tax payer. The most analogous case pertaining to the Claimants situation was *Gunter v. U.S.*, 573 F. Supp. 126 (1982), which stands for the proposition that a fiduciary, steps into the shoes of the decedent and if the decedent had lived and could have completed a tax-free rollover then so can the fiduciary.

Claimants asserted the following causes of action: (1) negligence; (2) breach of fiduciary duty; and, (3) negligent supervision. In the Statement of Claim, Claimants requested: (1) Compensatory damages in the approximate amount of $ 33,000.00; (2) Interest; (3) Costs; and, (4) Further relief as the Arbitrator deemed just and proper. At the close of the hearing, Claimants requested compensatory damages in the amount of $ 33,831.00, interest, costs, and attorneys' fees.

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

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant: (1) compensatory damages in the amount of $ 33,831.00; (2) statutory prejudgment interest at the rate of 6% from November 24, 2009 through August 23, 2011; (3) reimbursement of expert witness costs in the amount of $ 3,750.00; and, (4) reimbursement of the non-refundable portion of Claimants' filing fee in the amount of $ 150.00.

Claimants' Counsel: Lars K. Soreide, Esq., Soreide Law Group, PLLC, Fort Lauderdale, Florida.

Respondent's Counsel: Timothy B. Atkins, Esq., Morgan Stanley Smith Barney, Legal and Compliance Division, Pensacola, Florida.

Claimant's Expert: Gary Sellari, CPA, Divine, Blalock, Martin & Sellari, LLC, West Palm Beach, Florida.

Respondent's Expert: Roberta C. Watson, Trenam Kemker, Tampa Florida.

Arbitrators: James A. Hayes (Public Chairperson); Michelle S. Minor (Public)

The award is significant because it represents full recovery of the tax liability incurred by Claimant and demonstrates that brokerage firms have liability even after death on accounts coded as "deceased" if they do not follow the rules relating to fiduciaries and IRC 7701(a)(8).

CASES & MATERIALS

Birgitta Siegal

SUPREME COURT DEVELOPMENTS

Janus Cap. Group, Inc. v. First Derivative Traders
131 S. Ct. 2296 (June 13, 2011).
(S. Ct. limits actors who can be primarily liable under the 1934 Exchange Act, Rule 10b-5)

A five justice majority in *Janus Capital Group, Inc. v. First Derivative Traders* held that there was no implied private right of action under 10b-5 against a mutual fund's related but legally distinct adviser for misstatements made in the fund's prospectuses. Although the fund's investment adviser/administrator had participated in writing and disseminating the misleading statements, the adviser did not "'make' the statements in its own right".

Plaintiff, representing a class of shareholders of Petitioner Janus Capital Group, Inc. ("JCG"), sued JCG and its wholly owned subsidiary Janus Capital Management, LLC ("JCM") for fraud under Section 10(b) of the Exchange Act, Rule 10b-5 thereunder. Plaintiff also asserted control person liability of JCG pursuant to Section 20(a) of the Exchange Act. JCG had created the Janus Investment Funds ("Funds"). JCM was an investment adviser and manager for the Funds.

According to the complaint, the Funds issued and filed prospectuses creating the "misleading impression" that JCG and JCM would undertake measures to "curb market timing" in the Funds. JCM indisputably participated in writing and disseminating the misleading prospectuses. The misleading statements came to light in 2003, when the Attorney General of the State of New York filed a complaint against JCG and JCM alleging that defendants had made secret arrangements to allow for such market timing. News of the AG's complaint caused investors to withdraw significant amounts from the Fund, which resulted in reduced fees to JCM. The stock price of JCG plummeted 25% within 3 weeks. Plaintiff/shareholders alleged that JCG and JCM made false statements in prospectuses filed by the Funds; plaintiffs did not allege that JCM actually issued the prospectuses.

The district dismissed, finding that 1) JCM's dissemination of the prospectuses did not rise to the level of making a misstatement and 2) plaintiffs failed to show that the alleged fraud occurred "in connection with

the purchase or sale of a security", as there was no nexus shown between JCG shareholders and JCM. The Fourth Circuit Court of Appeals reversed and held that the adviser (JCM), "by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents." The Court also held that JCG could be liable as the control person of JCM.

The Supreme Court considered the sole question as to whether JCM, as adviser/manager to the Funds could be liable in a private action filed by shareholders of its parent company, for JCM's preparation of the misleading statements. Writing for the majority, Justice Thomas scrutinized the term 'maker' and concluded that *"[f]or the purposes of Rule 10b-5, the "maker" of a statement is the person or entity with ultimate authority over the statement…[o]ne who prepares or published a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed…Without control, a person or entity can merely suggest what to say, not 'make' a statement in its own right*." 131 S. Ct. at 2302. Those who prepare or publish a statement on behalf of another are not considered "makers" for purposes of finding an implied private right of action under Rule 10b-5.

Although it recognized the close relationship between a mutual fund and its investment adviser, the Court concluded that JCM, JCG and the Funds maintained clearly distinct and independent legal identities. The Court noted that any reapportionment of liabilities in light of the close relationship between funds and advisers would more properly be the responsibility of Congress.

(Note : This decision only addressed claims of primary liability under 10b-5(b); it did not consider liability under subsections (a) or (c), which proscribe certain deceptive conduct, as opposed to statements.)

Erica P. John Fund, Inc. v. Halliburton Company
131 S.Ct. 2179 (June 6, 2011)
(Investors need not prove loss causation at pre-class certification stage)

The Court resolved a conflict among the Circuits as to whether "loss causation" must be proved at the class certification stage in a Rule 10b-5 putative class action. The Fifth Circuit Court of Appeals had determined that in order to invoke the fraud-on-the-market presumption of reliance, the plaintiff must establish that a decline in a security's value was caused by the

correction of a prior misleading statement and that the decline could not be explained by other market factors.

The unanimous decision of the Supreme Court vacated and remanded to the Fifth Circuit. It explained that loss causation is not a component of fraud-on-the-market reliance and therefore not part of the class certification analysis. "[W]e have never before mentioned loss causation as a precondition for involving *Basic'*s rebuttable presumption of reliance. . . . Loss causation addresses a matter different from whether an investor relied on a misrepresentation presumptively or otherwise, when buying or selling a stock." The Court contrasted "loss causation" with "transaction causation," and explained that transaction causation, not loss causation, is the focus of the fraud-on-the-market doctrine relevant to the class certification inquiry. "Loss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory."

AT&T Mobility LLC v. Concepcion
563 U.S. --, 131 S. Ct.1740 (2011)
(The "FAA" preempts state law concerning contractual unconscionability).

On April 27, 2011, the Supreme Court issued its 5-4 decision in *AT&T Mobility v. Concepcion,* which holds that the Federal Arbitration, 9 U.S.C. §§ 1 et. seq., ("FAA") preempts California law which had deemed class action waivers in consumer arbitration agreements to be unconscionable and therefore unenforceable.

The Concepcions purchased their AT&T cell phones and service plans in California. As with many consumer contracts, the agreement provided for arbitration of all disputes between the parties. Moreover, the arbitration clause also demanded that a customer must maintain his or her claim in an "individual capacity and not as a plaintiff or class member in any purported class or representative proceeding." The agreement was non-negotiable.

The district court denied AT&T's motion to compel arbitration according to the terms of the AT&T agreement. Relying on the decision in *Discover Bank v. Superior Court,* 113 P.3d 1100 (Cal. Sup. Ct. 2005), the district court found the arbitration provision to be unconscionable because AT&T could not show that bilateral arbitration adequately substituted for the deterrent effects of class actions. *Discover Bank* held that class action waivers in consumer contracts should not be enforced "when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money." Although the district court acknowledged certain consumer friendly aspects

in the AT&T contracts, such as provisions for some meaningful choices to consumers, it held that its prohibition on class proceedings nevertheless rendered the clauses unconscionable under governing California law. Thus the arbitration clause as written was unenforceable.

The Ninth Circuit affirmed. It further held that the Discover Bank rule was not preempted by the FAA, which generally requires courts to enforce commercial arbitration agreements according to their terms. Section 2 of the FAA provides that "a written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction...shall be valid, irrevocable, and enforceable, *save upon such grounds as exist at law or in equity for the revocation of any contract*." According to the Ninth Circuit, California's "Discover Bank rule" was a "refinement of the unconscionability analysis applicable to contracts generally in California" and was therefore consistent with Section 2 of the FAA.

Enter the Supreme Court, which held that the FAA prohibits states from conditioning the enforceability of certain arbitration agreements on the availability of classwide arbitration procedures. Justice Scalia wrote that "[r]equiring the availability of classwide arbitration interferes with the fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."

The Court rejected the Concepcions' argument that the *Discover Bank* rule, with its origins in California's unconscionability doctrine, is a ground that "exists at law or in equity for the revocation of any contract" under Section 2 of the FAA. Application of Section 2's savings clause "becomes more complex when a doctrine normally thought to be generally applicable, such as...unconscionability, is alleged to have been applied in a fashion that disfavors arbitration." The Court noted that while the FAA preserves generally applicable contract defenses, "nothing in it suggests an intent to preserve state law rules that stand as an obstacle to the accomplishment of the FAA's objectives." A federal statute's savings clause "cannot be construed as permitting a common law right which would be absolutely inconsistent with the provisions of the act". Stated another way, "the act cannot be held to destroy itself."

The Court also found that California's *Discover Bank* rule "interferes with arbitration" by its allowance for "ex post" demands for classwide arbitration. In addition, the Court referenced inconsistencies between class arbitration and purposes of the FAA for several reasons. The opinion mentions that class arbitration renders the dispute resolution process slower and more costly, while increasing procedural morass. For example, class arbitration requires procedural formality to protect the rights of absent class

members. Class arbitration greatly increases risks to defendants due to its informal procedures and lack of multi-layered judicial review. Accordingly the Court concluded that "arbitration is poorly suited to the higher stakes of class litigation."

In conclusion, the FAA preempts California's *Discover Bank* rule "because it stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

The dissenting opinion, authored by Justice Breyer, argued that the *Discover Bank* rule was consistent with the FAA's language and "falls directly within the scope of the Act's exception permitting courts to refuse to enforce arbitration agreements on grounds that exist 'for the revocation of any contract.'" The dissent also observed that class arbitration is "consistent with the use of arbitration" and is "well known in California and followed elsewhere."

LOWER FEDERAL COURTS

In re Merck & Co., Inc. Securities, Derivative & "ERISA" Litig.
2011 WL 3444199 (D.N.J. Aug. 8, 2011)
(S. Ct. holding in *Janus* inapplicable to officer of defendant.)

Within 2 months of the Supreme Court's decision in *Janus v. Cap. Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (June 13, 2011), the district court of New Jersey faced the question of whether a corporate officer of defendant Merck could be culpable as "maker" of certain material misstatements. Defendant Scolnick had been Merck's EVP for Science and Technology. He moved to dismiss the 10(b) claims against him for several reasons, parsing through the Janus discussion of who is the "maker" of a statement for purposes of the statute. Defendant Scolnick argued he could not be the 'maker' of the misstatements. Scolnick contended he did not have "ultimate authority" over the statements. The district court rejected defendant Scolnick's argument, denied relevant portions of his motion to dismiss, and explained:

> Scolnick's role in the statements attributed to him is in no way analogous to Janus Capital Management's relationship to the statements issued by Janus Investment Fund. Scolnick was at the time of each attributed statement an officer of Merck. He signed SEC forms and was quoted in articles and reports in his capacity as Merck's Executive Vice President for Science and Technology and President of Merck Research Laboratories. He made the

> statements pursuant to his responsibility and authority to act as an agent of Merck, not as in *Janus,* on behalf of some separate and independent entity. *Janus* does not alter the well-established rule that "a corporation can act only through its employees and agents." *Suez Equity Investors, L.P. v. Toronto–Dominion Bank, 250 F.3d 87, 101 (2d Cir.2001)*. It certainly cannot be read to restrict liability for Rule 10b–5 claims against corporate officers to instances in which a plaintiff can plead, and ultimately prove, that those officers—as opposed to the corporation itself—had "ultimate authority" over the statement. Yet, this is the premise that underlies Scolnick's argument that he may not be liable for statements actually attributed to him. Taken to its logical conclusion, Scolnick's position would absolve corporate officers of primary liability for all Rule 10b–5 claims, because ultimately, the statements are within the control of the corporation which employs them. *In re Merck & Co., Inc. Securitie, Derivative & ERISA Lit., supra.*

Therefore, Defendant Scolnick was the 'maker' of the statements at issue under the narrow definition set forth in the Supreme Court's recent *Janus* decision.

Brown v. J.P. Turner & Co.
2011 WL 1882522 (N.D. Ga. May 17, 2011)
(Brokerage firm had no duty to conduct due diligence of non-affiliated private placements it sold to retail investors)

In *Brown v. J.P. Turner & Co.*, District Court Judge Julie E. Carnes dismissed Plaintiffs' Class Action Complaint with prejudice for failure to plead fraud with the requisite particularity under Rule 9(b), and for failure to state legal claims sounding in negligence and negligent misrepresentation. Plaintiffs/ investors sued their broker/dealer, J.P. Turner & Co. in connection with the firm's promotion and sale of private placements issued by affiliates of Provident Royalties LLC. The brokerage firm was not affiliated with Provident, and had not acted as an underwriter or placement agent. In 2009, Provident filed for bankruptcy. Shortly thereafter, the SEC filed suit for fraud and froze Provident's assets.

Plaintiffs alleged that the defendant broker/dealer was liable for (1) failure to comply with the notice and registration requirements of the Georgia Securities Act (GSA); (2) fraud in violation of the GSA; (3) common law negligence and (4) making negligent misrepresentations.

The court focused its discussion primarily on pleading deficiencies under Rule 9(b). [Plaintiffs agreed that under Georgia law the heightened pleading standards of Rule 9(b) would apply to the common law negligence claims as well as the claims based upon fraud.] According to the court, plaintiffs' factual allegations lacked specificity, and were improperly based on "information and belief". Pleadings based "on information and belief are only permissible [w] here it can be shown that the requisite factual information is peculiarly within the defendant's knowledge or control. Plaintiffs conceded that J.P. Turner was neither involved in the drafting of the PPMs, nor otherwise involved in Provident's business operations. Thus, it is unclear how defendant could be in any better position than plaintiffs to discover the details about the misrepresentations underlying this case." (*citations omitted*).

Plaintiff also sought to show the requisite specificity by reference to misrepresentations in the Provident PPMs which defendant distributed to them. Plaintiffs sought to ascribe the making of the PPM misrepresentations to the defendant broker/dealer, thereby casting the broker/dealer as one "making" the misrepresentations. Plaintiffs had relied in part on the First Circuit Court of Appeals' decision in the *SEC v. Tambone* (*Tambone I*), 550 F.3d 106 (1st Cir. 2008), ("underwriter, as a result of its duty to review and confirm the accuracy of the material that it distributes, "impliedly makes a statement" to potential investors that "the information contained in the prospectus ... is truthful and complete.") Judge Carnes rejected the argument as misplaced in light of the undisputed fact that the defendant was not an underwriter. In addition, after Plaintiff's complaint was filed, the First Circuit sitting en banc effectively overruled the previous holding in *Tambone I* and held that "a securities professional does not "make a statement" merely by disseminating information created by others". *Tambone II,* 597 F.3d 436, 442–43 (1st Cir. 2010). Thus, the district court in *Brown* held that defendant brokerage firm could not be liable for inaccurate statements solely by distributing the flawed PPMs.

After dismissing all counts for failure to properly plead with particularity, the court continued to analyze the legal sufficiency of the common law claims (negligence and negligent misrepresentation). Judge Carnes stated that she had not "found any Georgia authority that imposes a duty on a broker to conduct due diligence concerning the investment materials it provides to clients." Furthermore, the court noted that 1) even if there had been such a duty, the plaintiffs failed to allege the element of reliance which would be required on the facts at hand and 2) that even if reliance had been properly alleged, the reliance would be unreasonable, "as the PPMs expressly advise potential investors that they should only rely on information provided by Provident itself".

Note: The complaint in *Brown v. J.P. Turner* pre-dates the regulatory guidance provided by FINRA Notice to Members 10-22, which deals with a broker/dealer's duties when recommending private placements such as the Provident securities at issue. The court's opinion did not address any regulatory guidance or whether SRO standards would have been relevant to its analysis. Accordingly, standing alone, the decision should not foreclose the possibility that such guidance could be persuasive in future 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 at rbakhtiari@aol.com or Robin S. Ringo, rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *Release No. 34-64984/File No. SR-FINRA-2011-035; Proposed Rule Change toAdopt FINRA Rules 2210, 2212, 2213, 2214, 2215 and 2216 in the Consolidated FINRA Rulebook* was submitted to the Securities and Exchange Commission by Peter J. Mougey on August 23, 2011.

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

Re: SR-FINRA-2011-035 - Notice of Filing of Proposed Rule Change to Adopt FINRA Rules 2210 (Communications with the Public), 2212 (Use of Investment Companies Rankings in Retail Communications), 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), 2214 (Requirements for the Use of Investment Analysis Tools), 2215 (Communications with the Public Regarding Security Futures), and 2216 (Communications with the Public About Collateralized Mortgage Obligations (CMOs)) in the Consolidated FINRA Rulebook

Dear Ms. Murphy:

Thank you for the opportunity to comment on the above-referenced proposal to amend NASD Rules 2210 and 2211 regarding communications with the public. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA mostly supports the proposed revisions to these rules.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules relating to the communications between brokerage firms and the general investing public.

First, the proposed rules generally appear to be same as the current rules with respect to the requirement that an appropriately qualified registered principal of the firm approve the newly defined "retail communications"

before use or filing with FINRA. PIABA supports the continuation of these rules.

When FINRA first proposed changing some of these rules, PIABA raised a concern about Proposed Rule 2210(b)(1)(D), which previously stated that principal approval would not be needed for communications that are "solely administrative in nature." However, FINRA changed the Proposed Rule. The newest version of Proposed Rule 2210(b)(1)(D) has eliminated the "solely administrative in nature" language and instead now excludes principal review for "any retail communication that does not make any financial or investment recommendation or otherwise promote a product or service of the member". PIABA believes this language invites differing interpretations as to which communications would be subject to review. We believe the "solely administrative in nature" language is superior.

PIABA also supports the proposed rules which provide record-keeping requirements that mirror those of Securities Exchange Act Rule 17a-4. The proposed filing requirements generally appear to be the same as the current rules, with one main difference – the filing requirements apply to all retail communications, not just advertisements as under the current scheme. Proposed rule 2210(c)(2) also expands the category of communications that fall within the pre-use filing requirements, including self-created rankings, retail communications regarding CMOs and security futures, communications regarding bond mutual fund volatility ratings, and communications concerning derivatives and structured products. PIABA supports this change.

Another major change involves retail communications related to closed-end investment companies and funds. The proposed rule requires firms to file all retail communications concerning closed-end funds within 10 days of use, including those used after the IPO (the current rules only apply to communications used during the IPO). Again, PIABA supports this change.

The content standards for communications are similar to current standards. PIABA supports the continued use of these standards.

One area where FINRA is requiring less disclosure involves interested partners, officers, and firms. Under the current rules, a firm would be required to provide disclosure if the firm, officers, or partners have a financial interest in the securities of the recommended issuer. However,

the proposed rules only requires disclosure "if the firm or any associated person with the ability to influence the substance of the communication has a financial interest in the recommended issuer."

PIABA raised concerns about this proposed change in its previous letter and continues to have those same concerns. This proposal would substantially narrow the number of parties whose financial interests have to be disclosed. Less disclosure is always a concern for the public investor, and PIABA hopes that FINRA will consider a proposed rule that provides for greater disclosure.

With the few exceptions as noted above, PIABA supports most of the rule changes that have been proposed concerning communications with investors. Once more, we appreciate the opportunity to comment on these proposed rule changes.

Respectfully submitted,
Peter J. Mougey
President

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The following PIABA Comment Letter regarding *Release No. 34-64954/File No. SR-FINRA-2010-036;Notice of Filing Proposed Rule Change and Amendment No. 1 to Amend the Codes of Arbitration Procedure to Permit Arbitrators to Make Mid-case Referrals* was submitted to the Securities and Exchange Commission by Peter J. Mougey on August 18, 2011.

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

Re: File No. SR-FINRA-2010-036 – Amendment No. 1, Effect of Arbitration on FINRA Regulatory Activities; Arbitrator Referral During or at Conclusion of Case

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Association[1], I thank you for the opportunity to comment on the above-referenced rule proposal filed by the Financial Industry Regulatory Authority ("FINRA"). The currently proposed rule is reflected in Amendment No.1 to SR-FINRA-2010-036. It replaces and supersede FINRA's initial 2010 proposal on this topic.

FINRA seeks to amend FINRA Rule 12104 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code") so as to broaden the power of arbitrators to make mid-case referrals to FINRA Dispute Resolution. The proposal also allows for recusals, and cost assessments against the parties, including apparently the innocent investors, when an arbitrator makes a mid-case referral due to his belief that a "threat, whether ongoing or imminent, is likely to harm investors unless immediate action is taken". Proposed Amendment No.1 provides that: 1) mid-hearing referrals

1. PIABA is a bar association whose member attorneys are devoted to representing the interests of investors in disputes with the securities industry. PIABA was established in 1990 as an educational organization for securities arbitration attorneys who represent the public investor in securities disputes. PIABA members are involved in promoting the interests of the public investor in securities and commodities arbitration

be allowed only after evidentiary hearings have begun (Rule 12104(b)); 2) referrals be made only to the Director of Arbitration, who would inform the parties of the fact of referral, and advise the parties they may then seek recusal of the referring arbitrator under existing [Arbitration] Code provisions, with added costs and expenses assessed pursuant to traditional recusal situations (Rule 12104(c)); 3) the President and Director of Dispute Resolution will determine whether the referral needs to be forwarded to appropriate FINRA divisions; and 4) post-hearing referrals may be made not only for disciplinary proceedings, but also for conduct that arbitrators believe may violate the rules of FINRA.

PIABA commends FINRA's efforts to address the investor protection concerns identified by PIABA and others who objected to FINRA's initial 2010 proposal. Most notably, FINRA's current proposal eliminates the "new panel" option of the initial proposal that would have allowed any party to demand dismissal of the entire panel upon the referral of even a single arbitrator. In addition, FINRA properly proposes to limit mid-case referrals to only those cases where an arbitration hearing is underway, and even then, such referrals should be delayed if the conclusion of the case is near and other stated concerns are satisfied. While PIABA supports these improvements to FINRA's initial 2010 proposal, it objects to the currently proposed rule 12104(c), which states, among other things, that the parties will be advised if an arbitrator has made a referral and that the parties may seek to recuse the arbitrator under existing procedure. According to FINRA's discussion, assessment of costs associated with replacing and educating a newly appointed arbitrator would be at the discretion of the panel. Under such a rule, an aggrieved investor involved in an arbitration could be assessed the costs associated with replacing the arbitrator. This is unfair. An investor already victimized should not be required to pay these additional costs in cases where recusal invariably would arise through the likely past conduct of a member firm respondent. Furthermore, the proposed rule will invite recusal motions, as well as appeals, however frivolous, to the detriment of investors. Thus, the current proposal is not sufficiently tailored to address investor protection concerns, and would likely negatively impact investors.

FINRA should not require public investors who are forced into the industry arbitration forum to be saddled with any unnecessary delays or added costs when an arbitrator finds that an industry party or non-party is posing a "serious threat" likely to harm investors on a massive scale. These burdens should be borne by industry respondents, or by FINRA as part of its mission to better to detect fraud. These and other procedures in FINRA's

current proposals are inconsistent with the provisions of Section 15A(b)(6) of the Act[2] and should be rejected.

The Purpose of the Proposed Rule

At the outset, we note that the proposed rule generally appears to be a solution without a problem, the implementation of which would pose penalties on investors who have been harmed by the conduct of FINRA members. The purpose for the proposed rule, as set forth in Amendment No. 1, is vaguely referenced as the detection of "well publicized securities frauds that resulted in harm to investors" as justification.[3] While overall goals of investor protection are laudable, the rule proposal fails to identify those frauds. Nor does the proposal illustrate how mid-hearing referrals in customer cases (followed by disclosure of the referral, likely recusal motions, and added costs to investors), might have protected public investors in the past.

FINRA should be required to set forth specifics relating to the background and context of this rule proposal, as opposed to generalizations, before imposing new burdens or delays on investors involved in arbitration. Indeed, operation of the proposed rule may discourage claimant investors from presenting information that may implicate widespread fraud. Arbitrators similarly may be reluctant to refer matters than might lead to recusal motions and inability to be selected for future arbitrations. Such anomalous results do not serve FINRA's core purpose of protecting investors.

Proposed Rule 12104(b), Grounds For Mid-Case Referrals

While FINRA's purpose stems from recent well-publicized securities frauds, FINRA later states that the threshold for mid-hearing referrals is lower than that of concluding there has been fraud. The arbitrator need only

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

3. FINRA does not identify specific examples where such disasters could have been alleviated through arbitrator referrals. Moreover, FINRA could and should already urge any person with information suggesting such horrific scandals to contact FINRA's ombudsman, the SEC or other authority immediately, on an anonymous basis if needed. PIABA speculates that the well-publicized securities fraud refers to the Bernie Madoff matter. Our research indicates that there were no arbitration claims commenced against Mr. Madoff's 'investment advisory arm' prior to his surrender to the authorities.

have reason to believe a matter or conduct "poses a serious threat, whether ongoing or imminent, that is likely to harm investors unless immediate action is taken". FINRA states that by establishing this threshold, which is lower than requiring a conclusion of fraud, a prevailing investor will be less prone to appeals. PIABA believes the threshold basis for mid-referrals is sufficiently ominous. The proposed threshold for referral clearly implicates serious wrongdoing, on a widespread scale. Appeals would be no less likely under the proposed threshold, than it would be if the threshold required detection of widespread fraud. While the referral may be important, PIABA cannot support mid-hearing referrals that require disclosure to the parties, either of which may file consequent appeals, however frivolous. Moreover, the provisions for recusal and subsequent activity are onerous and unnecessary as discussed below.

Proposed Rule 12104(c) – Recusal

Rule 12104(c) would require that the parties be informed of the "fact" of referral. The proposal goes on to highlight that any party could then seek to recuse the arbitrator under existing rules in the Code. Put another way, if an arbitrator observes a 'serious threat' likely to harm investors if immediate action is not taken, (almost certainly against the member firm or associated person), counsel for that industry party could attempt to recuse the arbitrator for that reason, and potentially bring frivolous appeals whether or not recusal is granted. It is fairly well presumed that counsel for the respondents will always make such a recusal motion. Some arbitrators may also be bullied into recusal by counsel, thereby imposing undue burdens on the investor who has to cope with delays and costs incurred to resume arbitration with a new arbitrator.

FINRA should amend this section of the rule proposal to emphasize that mid-hearing referrals do not support independent, new grounds for recusal. Furthermore, FINRA should consider including in its Arbitrator Training Manuals and Reference Guides those authorities, including those cited in it proposed rule filing, which explain that arbitrators formation of views concerning evidence during the course of hearing does not give rise to bias requiring recusal.

Customers Likely Will Suffer Prejudice And Unjustified Costs Upon Application of Proposed Rule 12104(c)

Although FINRA's proposed rule may only come into play in cases where an arbitration hearing is scheduled over weeks or months, with gaps between hearing dates, the prejudice and costs to those investors could be devastating. For example, FINRA proposes that in three person panels, the parties may stipulate how evidence will be presented to the replacement arbitrator and to the structure of new hearing dates. However, in the probable event that the parties cannot so stipulate, particularly as to materials concerning the scandalous issues referred, FINRA would allow the arbitrators, including the replacement arbitrator, to decide what evidence will be reviewed and how to proceed. The investor would thus forfeit the ability to present his case as he would otherwise be entitled to do, had there not been a mid-case recusal. The new panel may shy away from considering evidence that led to the recusal, even if highly relevant to the case. In one arbitrator cases, the replacement arbitrator similarly would dictate what evidence to accept from the prior proceeding if the parties do not stipulate.

In addition, recusal and replacement of arbitrators often result in delayed hearing dates, with herculean efforts needed to re-schedule according to availability of the parties, witnesses, counsel, and the new panel. Existing arbitrators and counsel may already have full schedules for the immediate future, causing unnecessary delay. In any case, whether a hearing can be rescheduled, resumed quickly or not, the costs to counsel and the parties can be significant. Experts and lay witnesses will likely have to travel yet again to the new hearing dates. Claimants may have to take off from work, again. Counsel will have to expend many hours to effectively re-start the hearing, potentially many months in the future, on a matter they were prepared to try and complete earlier in time. Counsel may be already committed to other matters for an extended time beyond the original hearing dates, leaving claimants with the burden, stress and expense of needing to retain new counsel. We appreciate fully that FINRA does not intend to create avenues for these added, unnecessary costs, or to interfere with the parties' ability to continue with counsel. Nevertheless, the proposed rule presents real risk of these added burdens. Over time, investors may decide arbitration is too costly and skewed to undertake in the first instance.

There is also the concern that regardless of whether the recusal is granted, respondents will use the fact that an arbitrator made a referral as grounds to file a motion to vacate if an award is not in their favor. Whether or not courts are likely to grant such a motion, investors will incur additional delay and expenses related to defending the motion. Arbitration, which is

meant to be a speedy and efficient means of resolving disputes, will become even less so than it is now.

The Proposed Provisions For Recusal Are Unworkable and Unnecessary

In addition to the unfair burden and significant expense the proposed rule would impose upon investors, the procedures may create new and potentially never-ending problems. For instance, what happens if the replacement arbitrator, or existing arbitrators, come upon the same information and make the same referral? Is another recusal possible? Would the member firm or associated person likely implicated in the referral be able to challenge the entire panel on the basis that all the arbitrators heard the same evidence as the referring arbitrator? Would Claimants' counsel be able to argue that the non-referring arbitrators should recuse themselves if they did not see or agree with the 'threat' reported by the referring arbitrator? Would not replacement arbitrators be able to review the record (though not executive sessions) and also identify the same "serious threat" that led to the mid-case referral? Will any of the arbitrators know that the previous arbitrator(s) was recused under either of the Code's provisions for recusal, because he saw a serious threat likely to harm investors unless immediate action was taken? In all likelihood, the non-referring arbitrators will have at least some idea of the circumstances and evidence. Should an investor be prevented from presenting the scandalous evidence to the replacement arbitrator, once those questions are placed in the hands of the arbitrators? And, for the arbitrators to answer these questions, would they not have to review at least a proffer concerning the 'serious threat'? In short, the rule proposal raises more questions than answers.

PIABA also submits that there is no showing of any kind that the proposed rule would benefit investors. On the other hand, it is very likely that the proposal would unfairly and unnecessarily prejudice investors, unlucky enough to have a case where the industry wrongdoing extends beyond their case. The extra costs, expenses, rescheduling and potential inability to present evidence to the replacement arbitrator if it implicates the basis for the mid-case referrals outweighs the vaguely stated benefits of the proposed rule. Such a doubly aggrieved investor would be subjected to costs and time needed to educate replacement arbitrators at a minimum. The proposed rule would also effectively foster frivolous appeals.

Text of Proposed Section 12104(e) Should be Approved

FINRA's proposed Rule 12104(e) governing post-hearing referrals is substantially identical to current Rule 12104(b), with minor, positive changes. The Proposed Rule 12104(e) slightly expands the grounds for arbitrator's post-hearing referrals. At the conclusion of an arbitration, arbitrators may refer matters or "conduct" that came to their attention during the course of the hearing, and which may violate the rules of FINRA or other applicable laws and rules. The referral need not be limited to one for disciplinary investigation; it may be referred generally for any FINRA investigation. PIABA supports these particular changes which will efficiently promote investor protections.

FINRA expends considerable resources in training its arbitrator pool to be the fair and impartial triers of arbital disputes. An arbitrator must always maintain an appearance of neutrality and lack of bias until all of the evidence has been presented in a particular case. Although laudable in trying to prevent harm to the investor public, the proposed rule serves to transform neutral arbitrators into police officers. FINRA employs scores of investigators and auditors to regulate the financial industry - it's the job of these employees to ferret out widespread fraud, not the independent arbitrators appointed to fairly determine cases. With this in mind, consideration should be given to withdrawing the proposed rule change as it relates to mid-hearing referrals.

Conclusion

Existing FINRA Rule 12104 requires a panel to wait until after they have issued an award before making a disciplinary referral. We are unaware of any situation where the public at large was harmed by waiting until the hearing is concluded. FINRA does not adequately explain or illustrate how mid-case referrals could have prevented widespread harm in the past, or how the proposed procedures are best tailored to meet the important goals of fraud detection.

The proposed Rule 12104(c) would cause more harm than good to public investors who practicably may be unable to ever present the full extent of their case, should it implicate imminent harm to others as well as to themselves. FINRA's proposed manner of dealing with mid-case referrals is misguided. The proposed rule invites recusal motions, delayed arbitration hearings, possible relinquishment of investor claims, and frivolous appellate activity, all at the expense of investors who were compelled to arbitration by

the same member firms whose conduct likely caused the arbitrator referral. PIABA believes the proposal can and should be further improved. Alternatively, the current rule should be left substantially intact[4], with adoption only of the minor changes reflected in proposed 12104(e).

We thank you again for the opportunity to comment upon this rule proposal, and welcome further dialogue as the SEC or FINRA may desire. At present, we urge the SEC to either reject this rule, or to require further amendment as suggested by our comments herein.

Respectfully submitted,
Peter J. Mougey
President

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4. Arbitrators could alternatively be permitted to make anonymous referrals. FINRA Enforcement could then investigate the arbitrator referral and determine whether violations are occurring. However, FINRA Enforcement should not be confused with FINRA Dispute Resolutions. These are two separate functions, both of which are necessary to protect the investing public. They should not be combined to the benefit of the arbitrating member firm and the detriment of the arbitrating customer. Anonymous referrals would provide the desired benefit without the unacceptable collateral damage.

The following PIABA Comment Letter regarding *Release No. 34-64736/File No. SR-FINRA-2011-028;Notice of Filing Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook* was submitted to the Securities and Exchange Commission by Peter J. Mougey on July 20, 2011.

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

Re: File Number SR-FINRA-2011-028 Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules

Dear Ms. Murphy:

The Public Investors Arbitration Bar Association ("PIABA") appreciates the opportunity to provide the Commission with comments regarding the Proposed Consolidated FINRA Supervision Rules. PIABA is a bar association comprising attorneys who represent investors in securities arbitrations. Our members and their clients have a strong interest in FINRA rules which govern the conduct of securities firms and their representatives, with a goal of providing investor protection.

PIABA does support the adoption of consolidated rules governing supervision. PIABA appreciates that FINRA has made it clear in the supplementary materials to the rules that firms are required to design a supervisory system which includes supervision for all of the firm's business lines irrespective of whether they require broker-dealer registration. This is particularly important given that so many firms are one-stop shops, offering investors all sorts of services. Investors must be protected, especially when the firms themselves do not make it clear that the various services being offered come with varying levels of regulatory protections.

PIABA also supports the inclusion of clear guidance regarding the supervision of offices of supervisory jurisdiction (OSJs) and non-OSJ branch offices. The supplementary materials to the rules make it clear that a principal who is engaging in sales cannot supervise his own conduct. The supplementary materials also make it clear that on-site principals must have a physical presence on a regular and routine basis in the offices the principal is supervising. Both of these provisions add clarity to the current rules.

Notwithstanding that the proposed rules are a move in a positive direction in some aspects, there are certain aspects of the rules that still raise concerns. FINRA initially published the proposed rules for comment in May 2008. At that time, PIABA took the opportunity to voice concerns about certain aspects of the proposed rules. While FINRA has addressed certain of our concerns in the current regulatory notice, it has essentially dismissed them. Accordingly, we will set forth those concerns once more at this time.

The concerns which we raise involve areas that we perceive as important to providing firms and their brokers clear rules regarding permissible and impermissible conduct. When disregarded, the rules should provide customers the ability to hold a broker-dealer and its associated persons responsible for improper conduct. In its initial release, FINRA indicated that it believed the proposed rules reflected "a more flexible approach to certain supervision requirements."[1] Those of us who represent the investing public against members of the industry who violate the rules, know all too well the difficulty in proving a violation of a rule, a regulation, or a law without a clear statement of what that rule, regulation or law is. We are concerned that the term "flexible" appears to be a euphemism for "reduced" or "diminished" supervision requirements. We strenuously oppose any changes that reduce the protection of investors or that will make proof of misconduct more difficult.

1. FINRA Regulatory Notice 08-24, p. 3.

PIABA Is Opposed to "Principles-Based Regulation"

PIABA believes a strong, uniform fiduciary duty will make significant progress towards protecting investors' interests. The rule, however, includes numerous references to "risk-based" review. There has been a great deal of discussion of "risk-based" review in the same breath as "principles-based" regulation. These concepts have become popular in Europe and have been promoted by the Federal Reserve Chairman[2] and the former Treasury Secretary[3], among others. However, in the wake of the financial crisis, it became clear that principlesbased regulationswere ineffective. In a recent speech, current Treasury Secretary, Tim Geithner, warned, "The United Kingdom's experiment in a strategy of 'light touch' regulation to attract business to London away from New York and Frankfurt ended tragically. That should be a cautionary note for other countries deciding whether to try to take advantage of the rise in standards in the United States."[4]

To the extent that FINRA's use of the "risk-based" concept may signal a first step down the slippery slope of "principles based" rules and regulation, PIABA takes this opportunity to go on record as strongly opposing such a trend.

Given the accelerating pace of industry-wide scandals in recent years, it is our belief that more, rather than fewer, bright-line rules are needed. Unscrupulous members of the industry have had enough difficulty keeping their conduct in line with specific rules; one can hardly expect that their behavior would improve under a generic set of "principles." If the purpose of regulation is to protect the investing

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2. Ben S. Bemanke, "Regulation and Financial Innovation" (speech, Financial Markets Conference, Federal Reserve Bank of Atlanta, Sea Island, GA, May 15, 2007), available at www.federalreserve.gov/ boarddocs/Speeches/2007/20070515/default.htm.
3. Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform, March 31, 2008, available at http://www.forbes. com/2008/03/31/treasury-paulsonregulation-biz-cx_bw_0331paulson text.html.
4. Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference, June 6, 2011, available at http://www.treasury. gov/press-center/pressreleases/Pages/tg1202.asp.

public, we do not see how a move toward less specificity will accomplish the purpose.

Moreover, "principles-based regulation" is entirely unsuitable and inappropriate for a self-regulatory organization like FINRA. We point out two primary reasons.

First, without clear rules by which compliance professionals can monitor and train registered representatives, supervisors, and officers of broker-dealers, compliance professionals will lose any ability to impose even superficial control over misconduct. Those being monitored can rightly say that they haven't broken any rule or crossed any bright line, and they can rightly say it is only the compliance professional's opinion that a "principle" has been violated.

Second, in enforcement by the Commission or other regulators, or in arbitration by customers who have been wronged by an industry person, the ability to prove a violation which will subject the violator to sanctions or an award of monetary compensation will be greatly diminished if the regulator or the consumer can point to no clear rule that has been violated.

Our position is in line with that of many compliance professionals. For example, in the August 6, 2007 Securities Industry News, one compliance professional was quoted as saying: "Our clients are compliance professionals. They do not want principles-based regulation. [The new approach] will be a significant industry shift in that most broker-dealers want to maximize profit. But clear rules are helpful for compliance professionals. If the compliance professional can no longer use the rule to instruct the broker-dealer about what to do, it will increase tension. ... The downside is that it will be harder for compliance professionals. Compliance has a seat at the table now. I would like to think that the idea of a principles-based rules system is that you get to the underlying idea of risk, and doing the right thing. But if there are not clear rules, you wonder how far the line is going to get pushed."

Further, while it may be contended that "principles-based regulation" can work for a true governmental regulatory agency provided the agency is fully funded with adequate staff to perform the needed tasks, the same cannot be said for an SRO, where critics would say the "fox guards the henhouse." Certainly, pressure for an SRO to

be lenient in enforcing rules against its own members can more easily be brought to bear than when rule enforcement is by an independent governmental regulatory agency.

Even those who favor principles based regulation recognize that with the extent of agency capture in the United States, and the failure to properly fund independent regulators, we are not ready for such a change. As one commentator put it: "... a principles-based system relies on dedicated, well-funded regulators who are interested in regulating."[5] That definition cannot apply to any selfregulatory organization. FINRA should not be moving toward "principles based regulation" now or in the future.[6]

Risked-Based Review

The proposed rule is peppered with the term "risk-based review." For example, Proposed Rule 3110(b)(2) requires that all transactions related to the investment banking or securities business of a firm be subject to a registered principal's review to be evidenced in writing. By itself, this is a clear and enforceable rule and registered principals know exactly what is expected of them. However, the Supplementary Material, in paragraph .07, provides that "a member may use a risk-based review system to comply with Rule 3110(b)(2)." The term "risk-based" also appears for review of correspondence (Supplementary Material to Rule 3110, paragraph .08) and for annual examination of transfers of funds between customers and brokers or between customers and third parties (Proposed Rule 3110(c)(2)(B)).

Nowhere is the term "risk based" defined. Thus, proposed rules provide for a "risk based" standard with no meaningful direction as to

5. James Surowiecki, "Parsing Paulson," The New Yorker, April 28, 2008.
6. The oft-stated rationale in favor of principles based regulation is that it will improve our nation's competitive position in the capital markets. This is a doubtful proposition. Indeed, the historical success of the United States in attracting capital from investors around the world is due in large part to the perception that investors receive greater protection in our country than elsewhere. We believe the United States can retain its preeminence only by continuing to assure that our markets are the safest place in the world for investors. A move toward principles based regulation is precisely the wrong way to go.

the type of review. One obvious concern is that FINRA will view the concept of "risk-based" review of offices and "risk based" supervision of brokers with reference to the level of "risk" to the broker-dealer, as opposed to the level of "risk" to the customer.

While we support any FINRA proposal to provide greater protection to the investing public, we emphatically oppose any efforts to diminish or erode consumer protections. We view the reference to "risk-based" rules or regulation as the first step in such erosion. We urge FINRA to establish well-defined standards which will ensure that everyone will understand the rules, and there can be no question what is expected of members of the industry.

Non-Reporting of Oral Complaints

Proposed Rule 3110(b)(5) would limit the customer complaints which a firm is required to "capture, acknowledge, and respond to." Specifically, the firm would need to "capture, acknowledge, and respond to" written complaints only, thereby allowing firms to conceal oral complaints from customers. This proposal is purely and simply "anti-consumer" and benefits the firm and its associated persons over the customer. In response to PIABA's concerns, FINRA stated that "the proposed rule change does not include oral complaints because they are difficult to capture and assess, whereas members can more readily capture and assess written complaints."[7] However, because something is difficult is not a sufficient justification for not providing investor protection.

PIABA had suggested that in the case where an oral complaint is made, that the firms be required to provide the customer with a form to file a complaint. If the customer does not choose to write the complaint, the member should reduce the complaint to writing, offer its counter statement to the oral complaint, and send a copy to the customer. The firm should then be required to report the complaint along with the firm's response. FINRA has stated that it "encourages members to provide customers with a form or other format that will allow customers to detail their complaints in writing" and goes on to

7. SEC Release No. 34-64736, pg. 45.

remind firms that "the failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010."[8] FINRA's response to PIABA's raised concerns is internally inconsistent. If firms are required to address an oral complaint under Rule 2010, then clearly they must "capture and assess" the oral complaint to do so. Consequently, reporting the oral complaint they have "addressed" cannot be too "difficult" for them.

Many customers, in our experience, are unable or reluctant to put their thoughts in writing. Since the financial services industry routinely solicits customers of all education levels, and of all financial levels, the industry should make sure that even those who do not type, cannot write well, and/or are intimidated by the thought of writing a letter, are given the same ability to complain and have their complaints recorded and heard by regulators. Moreover, it must be recognized that communications between a broker and client are almost always oral, typically conducted over the telephone. Accordingly, it may be expected that most complaints are, at least initially, communicated orally. The fact that they are communicated in this way makes them no less a complaint, nor does it make the complaint any less important to the client. Simply put, the exclusion of unwritten complaints ignores the essential character of broker-customer relations. Requiring complaints to be in writing before they are acknowledged is clearly inconsistent with FINRA's stated objective of protecting the investing public.

Limitation of Reporting to Firms Grossing at Least $150 Million

Former NYSE Rule 342.30 required members of the Exchange to report certain information relating to specified issues to senior management. Proposed FINRA Rule 3120(b) would retain the substantive reporting requirements of the NYSE Rule, but would only require such reporting by firms who had exceeded $150 million in gross revenues on the prior year's FOCUS reports. As FINRA explained in the initial proposal, and has restated in this proposal, "the additional information required of members with more than $150

8. Id.

million in gross revenue will prove to be valuable information for FINRA's regulatory program, in addition to being valuable compliance information for the senior management of the firm."[9]

FINRA has failed to offer a rationale as to why this information would not be just as relevant to firms grossing less than $150 million. PIABA believes this is exactly the type of information that all firms, irrespective of size, should be required to report.

Retention of Correspondence and Internal Communications

Paragraph .11 of the Supplementary Material to Proposed Rule 3110 sets forth the record retention period applicable to correspondence and internal communications. FINRA has conformed the rule to that of the SEC Rule 17a-4(b), thereby continuing the retention period at just three years. In its prior letter, PIABA had suggested that it would be more appropriate for the record retention rule to conform, at a minimum, with the eligibility provisions for customer disputes contained in FINRA Rule 12206, which is six years. To reduce the record retention rules to a shorter time period only makes it more difficult for a customer to prove a violation of a rule, regulation, or law. In the age of electronic storage, there should be little argument over reasonably increasing the time periods for document retention. Whereas the document retention rules once posed a burden in terms of finding warehouse space, electronic storage space may be obtained at near-zero cost.

In addition, PIABA would like to see a rule requiring that these kinds of records, as well as any other customer-related documents, be made available upon request to customers and former customers within a reasonable time and at no charge.

Family Member and Other Accounts

The proposed rules contain provisions designed to prevent and detect insider trading. In determining which accounts would receive

9. Id. at pg. 64

heightened scrutiny, proposed rule 3110(d)(3)(A) defines "covered account" as "any account held by the spouse, child, son-in-law, or daughter-in-law of a person associated with the member where such account is introduced or carried by the member." This definition is unduly narrow. It should include the associated person's parents, siblings, mother-in-law and father-in law, as well as any life partner.

Conclusion

PIABA appreciates the opportunity to comment on these important rule changes. These changes are broad in scope and will materially affect the supervisory responsibilities of the brokerage industry. PIABA requests that the Commission review the concerns raised herein, and take the necessary steps to provide greater investor protection.

Respectfully submitted,
Peter J. Mougey
President