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WHO WINS FINRA CASES AND WHY?
AN EMPIRICAL ANALYSIS

Howard B. Prossnitz[1]

Introduction

The questions that every lawyer specializing in FINRA arbitrations routinely asks themselves include: Why did I win that case, but not the other one? Does it make sense? Is there any pattern here? What variables, if any, influence outcomes?

Despite the fact that thousands of FINRA arbitration cases get filed every year and that hundreds of cases go to a final award in front of a full three person Panel, there is essentially no data available about who wins the cases and why. In large part, this is because the published awards follow a tightly scripted form. The number of reasoned awards is small. Dissents are possible, but are usually made without explanation. Even though a decision may consist of eight or nine pages, the hard data in the award is limited. Each award follows the format of setting forth the Representation of the Parties (names of attorneys), Case Information (which pleadings were filed when), Case Summary (list of claims made), Relief Requested (statement of what damages were sought), Other Issues Considered and Decided (rulings on motions), Award (dollar amount of recovery, if any, for each Claimant), Fees (allocation of filing and hearing session fees), and Arbitration Panel signature pages.

This format leaves a lot of unanswered questions such as which legal claims were emphasized, the level of sophistication of the Claimants, their financial circumstances, whether the damage numbers were inflated, and what the net out of pocket losses were. Further, there is nothing said about

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criteria which are typically considered important by Claimants' lawyers in their pre-filing evaluation of cases such as the age of the Claimants, their retirement status, their level of education, the amount of their net worth at stake, and similar factors. As a result, predicting case outcomes and engaging in settlement negotiations is much more of an art than a science. Practitioners evaluate cases based on their own intuition and commonly held assumptions about the importance of various factors. For instance, it is usually assumed that sophisticated clients have a harder time in winning, and that panels typically base damages on net out of pocket losses.

The purpose of this paper was to test the validity of some of these commonly held beliefs. In order to try to introduce more science and less guesswork into evaluating case outcomes, we compiled a database consisting of all customer member awards that went to a final hearing in 2011. The database excludes cases that were settled. According to FINRA, 1,065 cases were closed after hearing in 2011; 2,998 cases were resolved by direct settlement between the parties; 594 cases were settled through mediation; 708 cases were withdrawn; and 464 cases ended through other means such as stipulated award, bankruptcy, stayed by court action, uncured deficient claims and forum denied.

This study analyzes variables that can be gleaned from the published 2011 customer member awards, such as the size of the Respondent firm, whether or not the Claimant was represented by a PIABA member, and whether the Panel was all public or not. The study then focuses on all Morgan Keegan cases that went to a final award between October 2008 and June 2012. One would expect similar results within Morgan Keegan cases since they are product cases with the same Respondent, the same funds, similar facts, and many times, even the same counsel representing the parties. Yet, the results in the Morgan Keegan cases are widely disparate. The question is what variables make a difference? Do we just explain the disparate awards by the arbitrariness of the arbitration system, or are there discernible trends within results?

To get a more in depth understanding of what was critical to success in those cases based on factors that are not disclosed in the published awards, we collected information on 119 Morgan Keegan Claimants in 92 cases that went to award by interviewing their counsel. We gathered information that is not reported in the public awards, such as the working or retired status of the Claimants, the nature of the claims emphasized, whether the Claimants had college degrees, and the percentage of their liquid net worth at stake in the case.[2]

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2. The last published study with relevance to ours is now five years old and was

Description of the Data

We compiled a database of 563 customer-member cases that went to decision in 201. In the charts below, "2011 Cases" refers to these cases that are the customer-member awards for 2011. According to FINRA, in 2011, only 44% of customers were awarded damages in cases that were decided. This percentage was down from 47% in 2010 and 45% in 2009. In our 563 cases, customers won 45.65% of the time.3 Just as importantly, the median recovery rate in a win was 37.28% of the amount sought. The table below shows the variables that were recorded in our database and a brief description of each variable.

Variable	*Description*
Amount Requested	The initial amount that the Claimant requested. This amount includes all requested damages, interest, costs, and fees. We separately recorded punitive damage sought in order to determine if this variable significantly affected the overall amount of damages requested.
Amount Awarded	The total amount that the panel decided to give the Claimant. Note that this does not include reimbursement of FINRA fees. We also separately logged in the amount of punitive damage awards and attorney fee awards.
Arbitrator Reasoned Award	A "yes" or "no" depending on whether the Claimant requested that arbitrators specify their reasons for a decision.
PIABA Representation	A "yes" or "no" depending on whether the Claimant's lawyer is a member of PIABA.

completed before NASD and NYSE arbitrations were merged under the FINRA umbrella. Like any analysis, it was affected by the time period it involved. The authors described the period applicable to their study as one when "the misconduct of these [major brokerage] firms reached its apex with the analyst fraud scandal." Edward S. O' Neal & Daniel R. Solin, *Mandatory Arbitration of Securities Disputes – A Statistical Analysis of How Claimants Fare*, SECS. LITIG. & CONSULTING GROUP 17 (June 2007), http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20 Study.pdf (last visited Sept. 2, 2012).

3. The small difference between our 45.65% win rate and FINRA's 44% win rate is due to the fact we gave Claimants a small boost such as counting cases where there was any monetary relief at all, such as sanctions.

Number of Arbitrators	A number that ranged from one to three depending on case details.
Number of Claimants	The total number of Claimants.
Size of Brokerage Firm	We ranked brokerage firm into 3 size categories depending on the number of retail representatives.
Number of Hearings	The number of hearing sessions which does not include pre-hearing sessions or expungement hearing sessions.
All Public Panel	A "yes" or "no" depending on whether an industry representative was on the panel.
Size of Law Firms Representing Claimant and Respondent	A firm with ten or more attorneys was assigned a "1" a firm with less than ten attorneys given a "0."
Hearing Region	Midwest, Northeast, South, or West.
Number of Claims	The number of claims made against the Respondent.

The amount requested by the Claimant includes only the monetary amount specified as being sought in the award. One Claimant may specify the dollar amount sought in compensatory damages, punitive damages, and interest, while another Claimant may simply request "punitive damages."

One criticism of previous studies is that the Claimants' win rate is an incomplete indicator of success. Just looking at the percentage of cases where a Claimant receives any sum of money is flawed because it makes the system look better than it actually is. In 2011 and previous years, arbitrators have sometimes given just a single dollar to Claimants. This is still counted as a victory for the Claimants even though it is a pyrrhic victory, especially after considering FINRA fees and other costs. Therefore, it makes sense to look at the percentage of relief that a Claimant receives – the "recovery rate." However, even the recovery rate is not a complete measure. The amount of relief requested by customers has been criticized by the industry as intentionally inflated.[4] This may or may not be true. It is correct that the amount of relief sought often changes from the time the Statement of Claim is filed to the hearing. In fact, the FINRA arbitrator script expressly encourages the parties to state their "final" damage request at the time of

4. SIFMA, *White Paper on Arbitration in the Securities Industry*, SECS. INDUSTRY & FIN. MKTS. ASSN. 43 (Oct. 2007), http://www.sifma.org/workarea/download asset.aspx?id=21334. In an effort to gauge the request inflation, we separated the compensatory relief requests and looked at whether punitive damage requests and attorney fee requests lowered the median recovery rate. We came to the conclusion that they did not significantly alter the results.

closing arguments at the very end of the hearing. In looking at Morgan Keegan awards, we examined recovery rates in terms of net out of pocket losses which is not a publicly reported figure, but had to be gathered from Claimants' counsel.[5]

Before we looked at the results for our various hypotheses, we decided to use the same equation that was employed in the O'Neal/Solin study to measure how successful Claimants were against Respondents.[6] The equation is a combination of the percentage of "wins" multiplied by the percentage of money recovered to give an estimate at how much money the average Claimant can expect to receive when he or she is thinking of filing an arbitration claim.

Estimated Recovery Rate = (Percentage of Claimants who win) x (Percentage of Request Awarded)

As an example, if Claimants win 80% of the time and they win 50% of what they request, then the estimated recovery rate is 40%. This equation can also be used by Respondents, who in this example, could estimate a 40% effective loss rate across all of their cases.

We also kept track of where cases were heard. Different states have developed different bodies of law on key issues such as whether privity between buyer and seller of a security is required in order for a buyer to make a claim. States also have different requirements about how easy it is for out of state lawyers to represent Claimants in arbitrations. Some states also have a disincentive to filing state securities law claims because the prevailing party can recover attorneys' fees. Therefore, we kept track of the hearing site to see what impact, if any, the location of the hearing site had on case outcomes. Figure 1 shows that in 2011, the South had more hearings than any other region, while the Northeast and the West had similar numbers of hearings. Of the 172 cases in the South, 50 were Morgan Keegan cases

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5. We leave for another day the issue of whether net out of pocket losses is a fair approach to damages. Many Claimants' lawyers have decried panels' pre-occupation with net out of pocket losses as one of the fundamental shortcomings of the entire system. Here we are trying to determine what factors affect recovery and we are trying to remove from the equation "inflated" damage requests. We looked at whether requests for punitive and emotional damages inflated damage requests and thereby reduced median recovery rates. We found they did not. We also found that punitive damages were awarded 4.67% of the time in win cases – more than we expected. Attorney's fees were awarded 17.9% of the time.

6. O'Neal & Solin, *supra* note 2, at 12.

which, helps to explain why the South had the most hearings. The Midwest was the most under-represented hearing region in 2011.[7]

2011 Cases, Distributed by Region[8]

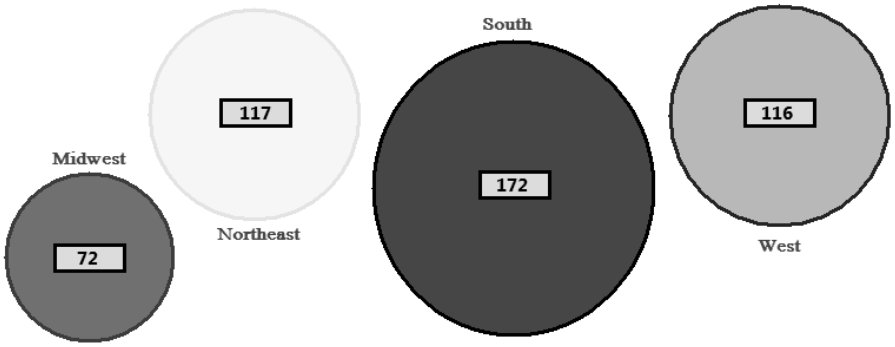

Figure 1

A second important variable was the amount of relief requested and how this variable affects the actual amount of money awarded. Prior studies concluded that the percentage of recovery decreased as the amount sought increased. We classified cases according to the amount of damages sought – less than $25,000, $25,000 to $100,000, $100,000 to $250,000, $250,000 to $500,000, and more than $500,000. Figure 2 shows the number of cases in each bracket that we established.

The next topic that we wanted to discuss was the significance of the size of the brokerage firm respondent. In order to rank brokerage firms by size, we used the number of registered representatives.[9] We set up three categories

7. In addition, of the 563 awards analyzed, there were 86 simplified cases reported which did not identify the hearing site.

8. *See* Census Regions and Divisions of the United States, U.S. Census Bureau, *available at* http://www.census.gov/geo/www/us_regdiv.pdf (last visited Sept. 3, 2012). Note that the "South" includes the Southeast.

9. See www.**investmentnews**.com/assets/docs/CI2701896.PDF (last visited Sept. 6, 2012). The top 12 firms were J.P. Morgan, Charles Schwab, Merrill Lynch, Citigroup, Edward Jones, Wachovia, UBS, A.G. Edwards, Fidelity, Ameriprise Financial, T.D. Ameritrade, and Fifth Third Securities. http://www.investment news.com/article/20071217/CHART/312170056 (last visited Sept. 6, 2012).

– the 12 largest firms, firms ranking from number 13 through 50, and all remaining firms. The cases that fall into each category are listed below in Figure 3.

2011 Cases, Distributed by Amount Sought

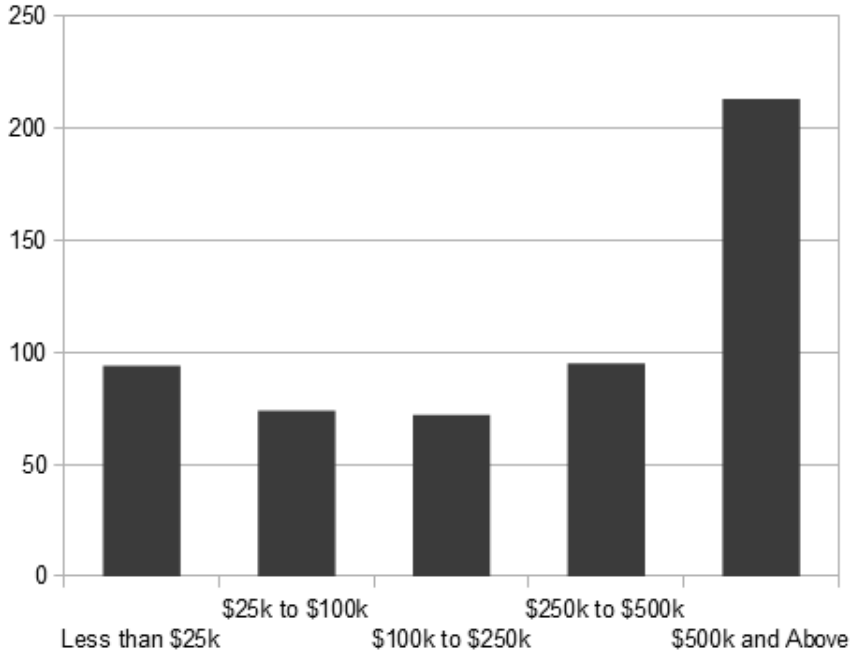

Figure 2

2011 Cases, Distributed by Size of Respondent Firm

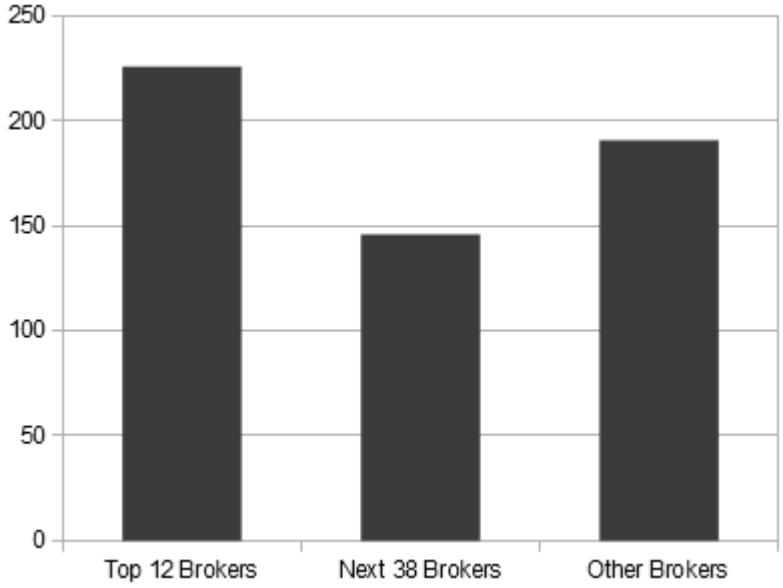

Figure 3

Hypotheses and Results

In the next section of the paper, we test the validity of various hypotheses. Some of these hypotheses came from earlier studies, and some represent conventional wisdom about which factors count in the FINRA arbitration process.

Hypothesis

The smaller an amount that the Claimant asks for, the larger the percentage he is likely to recover.

There are multiple reasons for this hypothesis, not the least of which is that this was the conclusion of prior studies.[10] Another reason is that cases seeking larger amounts are more likely to have inflated damage requests. Claimants can ask for large emotional or punitive damages in addition to out-of-pocket losses sustained. Some Claimants' lawyers routinely ask for

10. *See, e.g.*, O'Neal & Solin, *supra* note 2, at 11.

punitive damages in an amount equal to or greater than the compensatory damages. Another reason to expect a higher percentage recovery in smaller cases is that Claimants who ask for less money may have a simpler case to prove. Many of the cases seeking less than $25,000 ask only for compensatory damages and no soft damages. Further, an arbitration panel may be more hesitant to give out 100% of the request for a large award than to give 100% of the request for a small award.

Finding

The smaller an amount that the Claimant asks for, the larger the percentage of recovery that can be expected.

In Figure 4, there is a downward sloping trend on the graph that represents the percentage of relief awarded to the Claimant, meaning that the more that was requested, the less the Claimant recovered, as a percentage of the request. For example, Claimants who were asking for more than $250,000 received a substantially lower percent of relief than those who asked for under $25,000. This downward trend applies to every successive monetary range of relief requested. There are a few factors that could be at play here. As stated above, we believe that cases in the upper range of damages sought may be bolstered with emotional or punitive damages that are harder to recover than out-of-pocket losses. The greatest difference in percentage of relief received is between Claimants who were asking for less than $25,000 and received on average 74.6% of their request, whereas those asking for more than $500,000 received only 36.6% of their requests.

2011 Cases, Percent of Recovery versus Amount Sought

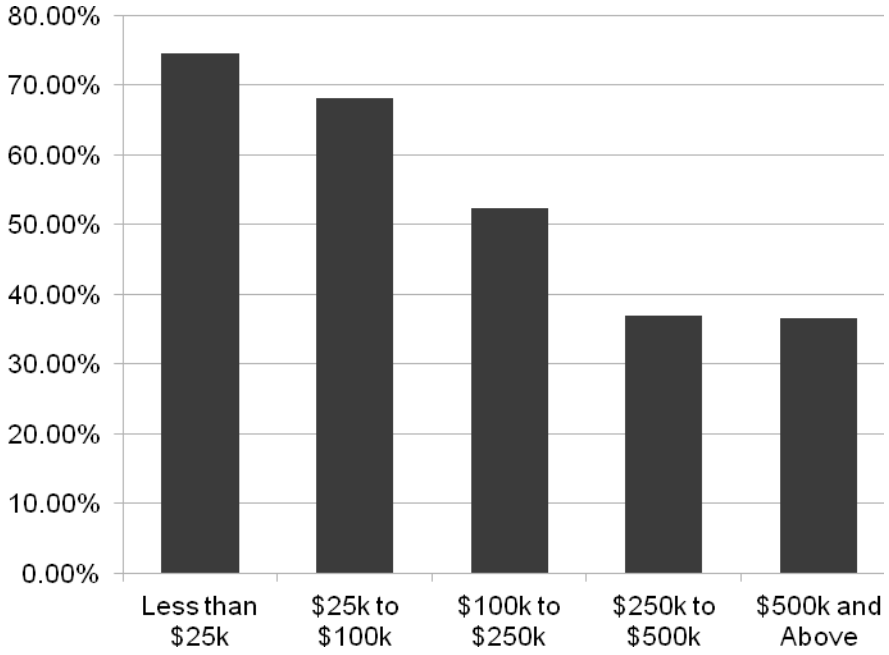

Figure 4

This finding is also confirmed by the following table which compares the number of persons receiving 100% of the amount sought in simplified versus non-simplified cases.

2011	Simplified Cases	Non-Simplified Cases
Number of 100% Awards	14	26
Percentage of time that Claimants got 100% if they won	45.16%	11.82%

Hypothesis

Claimants have the best chance of winning if the panelists are all-public.

The make-up of the panel is the main concern that investors have about arbitration before a case is filed. The most recent study on the matter, completed in 2008, showed that 33.6% of Claimants were concerned that the

arbitrators would be biased and 25.0% of Claimants were concerned about the composition of the panel.[11] At the end of 2008, FINRA started to test out a new program where investors could choose to have a panel that was seated with only public arbitrators.[12] Prior to this point, it was necessary to have one industry member on the panel. The new all-public panel was supposed to help make FINRA more investor-friendly.

FINRA published data on the selection of arbitrators in the pilot program, which ran from October 6, 2008 through January 31, 2011.[13] One of the not too surprising conclusions to come out of the pilot program was that brokerage firms do not want to have all-public panels, while Claimants want them. In 570 pilot program cases, not a single Respondent firm elected to have an all-public panel. In 96% of these cases, firms ranked four or more industry members to be on the panel. Claimants, however, chose not to rank any industry member 51% of the time.

Finding

Claimants have a better chance of winning if the panelists are all-public.

The data collected for this question was one of the more interesting points for the study because an all-public panel was not an option at the time of earlier studies. It turns out the concerns of customers detailed in *When Perception Changes Reality*,[14] are well justified. We were able to collect data for 379 mixed panel cases as well as 29 all-public panel cases. The win rate for Claimants with all-public panels went up to 63.0% compared to 45.6% for 2011 cases.

After the pilot program, FINRA looked at this same issue and it also concluded that customers won 62% of the time with all public panels.

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11. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2 J. Disp. Resol. 349, 370, 392 (2008).

12. News Release, Financial Industry Regulatory Authority, FINRA to Launch Pilot Program to Evaluate All-Public Arbitration Panels, FIN. INDUSTRY REG.AUTHORITY (July 24, 2008), http://www.finra.org/Newsroom/NewsReleases/2008/P038958.

13. *Notice to Parties,* Financial Industry Regulatory Authority, Public Arbitrator Pilot Program Summary Sheet With Interim Results, FIN. INDUSTRY REG.AUTHORITY, ../../../../Downloads/http:/www.finra.org/ArbitrationAndMediation/Arbitration/Rules/RuleGuidance/NoticestoParties/P124054http://www.finra.org/ArbitrationAndMediation/Arbitration/Rules/RuleGuidance/NoticestoParties/P124054.

14. *Supra* note 11.

FINRA, however, hedged its bets by stating:

> Preliminary award outcomes show that all-public panels in Pilot Program awarded damages to investors *slightly more often* compared to awards issued by majority public panels in Pilot Program cases. Pilot Program cases – irrespective of panel composition – awarded damages to investors more often compared to awards issued by majority public panels in non-Pilot Program cases. There is not sufficient award data to draw meaningful conclusions.
>
> There have been 55 Pilot Program awards issued by all-public panels. Investors were awarded damages in 26 of 42 contested cases (62 percent).[15]

A 62% success rate compared to a 44% rate is not "slightly more." It is a 40% improvement for public investors. A 62% success rate puts FINRA awards much more in line with the overall results in state court bench and jury trials in non-securities cases. According to a U.S. Department of Justice study, plaintiffs won in almost 60% of trials overall.[16] While the number of all public panel awards so far is too small to be conclusive, so far the all public option has made a big difference. This jump in the win rate suggests that customers should always choose the public option. Hopefully, the all public option will also change investors' perception of the fairness of the process.

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15. Notice to Parties, *supra* note 13 (emphasis added).

[16] Lynn Langton & Thomas H. Cohen, Ph.D., *Civil Bench and Jury Trials in State Courts, 2005* (Bureau of Justice Statistics Special Report), U.S. DEPT. OF JUST. 1 (Oct. 2008), http://bjs.ojp.usdoj.gov/content/pub/pdf/cbjtsc05.pdf

Percentage of 2011 Cases Won Based on Panel Type

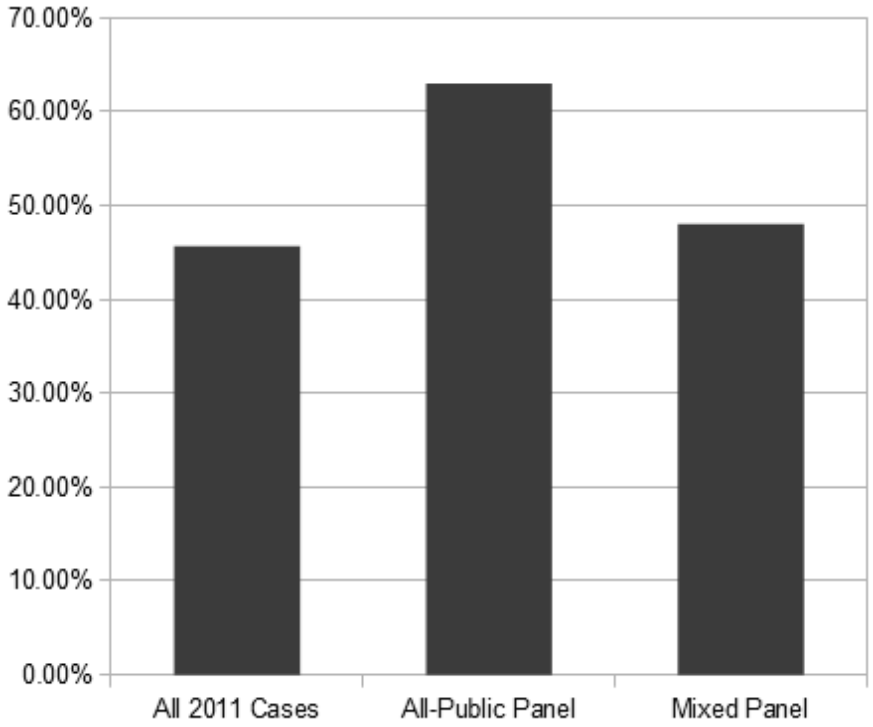

Figure 5

Hypothesis

Claimants who represent themselves are less likely to win.

We assume that customers who represent themselves will have less of an understanding of FINRA's procedural rules, they are less likely to know how to make an effective presentation at hearing, and that they will be at a disadvantage compared with defense lawyers who are experienced in securities cases. Further, it can be difficult for Claimants to find lawyers who are willing to take on smaller cases on a contingent fee basis. Many of these Claimants will be forced into *pro se* representation. *Pro se* parties may also figure that they have little to lose in filing a riskier case. Weaker cases will not be screened out at the filing stage by attorneys who are knowledgeable in the process and do not believe the case is worth filing.

Finding

As demonstrated by Figure 6 below, *pro se* Claimants are a lot less likely to get an award than those represented by counsel.

Hypothesis

Claimants who are represented by a PIABA member are more likely to win.

PIABA is an organization of lawyers who specialize in securities arbitration proceedings. These lawyers should have a better understanding of the system and securities law than other lawyers. PIABA members should also do a better job in screening cases.

Finding

Claimants who are represented by a PIABA member are more likely to win.

In 2011, the win rate for PIABA members was 54.2% versus 40.9% for non-PIABA attorneys. This means that a Claimant who was represented by a PIABA member was 32.5% more likely to receive money from the hearing. Also, the win rate for Claimants who represented themselves was 26.9% which means that PIABA members have a win rate that is double that of *pro se* Claimants. However, Figure 6 shows that the estimated percent recovery rate for PIABA members once an award is achieved is not that much higher than non-PIABA members or *pro se* Claimants. This would suggest that PIABA members do a good job of screening cases, but do not have a magic touch over other lawyers when it comes to average percentage recovery.

Anticipated Recovery Rate Based on Form of Representation

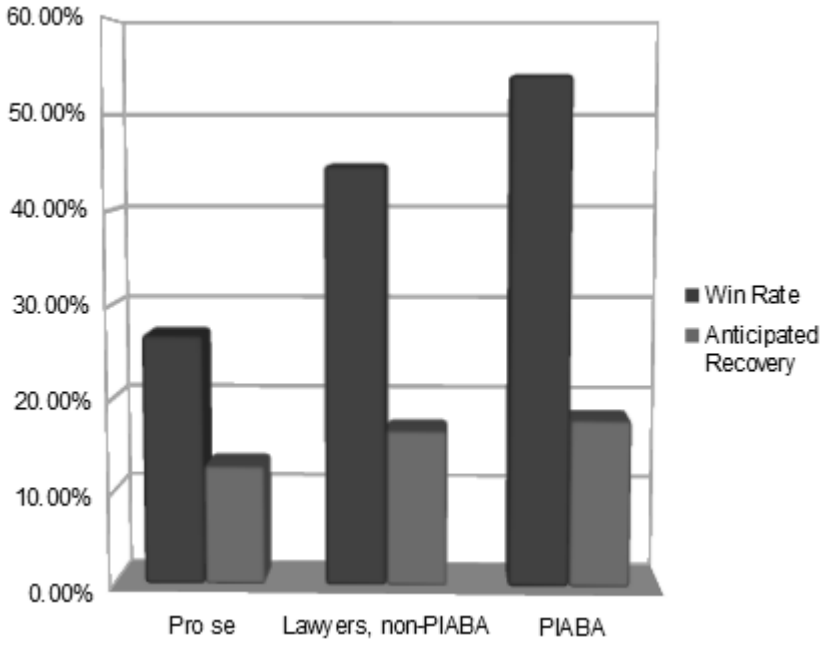

Figure 6

The fact that *pro se* Claimants have a high estimated recovery rate that almost matches the recovery rate of lawyers can be explained by the fact that the vast majority of *pro se* cases involve less $25,000 and are thus expected to yield a 74.6% recovery. Another reason PIABA lawyers saw only a slight edge in their estimated recovery rate may be because their median relief requested was over $100,000, which was more than the 2011 median request.

Hypothesis

Claimants who are represented by a lawyer in a large firm are more likely to win a case and are more likely to recover a higher percentage of what they seek.

This hypothesis tests the assumption that larger firms have will allow Claimants to win more often since they have greater resources to devote to a case, can afford more expensive experts and can staff a case with more lawyers and paralegals. Since many Claimants' firms are either solo practitioners or firms with five or less lawyers, a "large firm" is defined to be

ten or more lawyers. As indicated by the following pie chart, 78% of Claimants were represented by smaller firms.

Cases Distributed by Size of Claimant's Law Firm

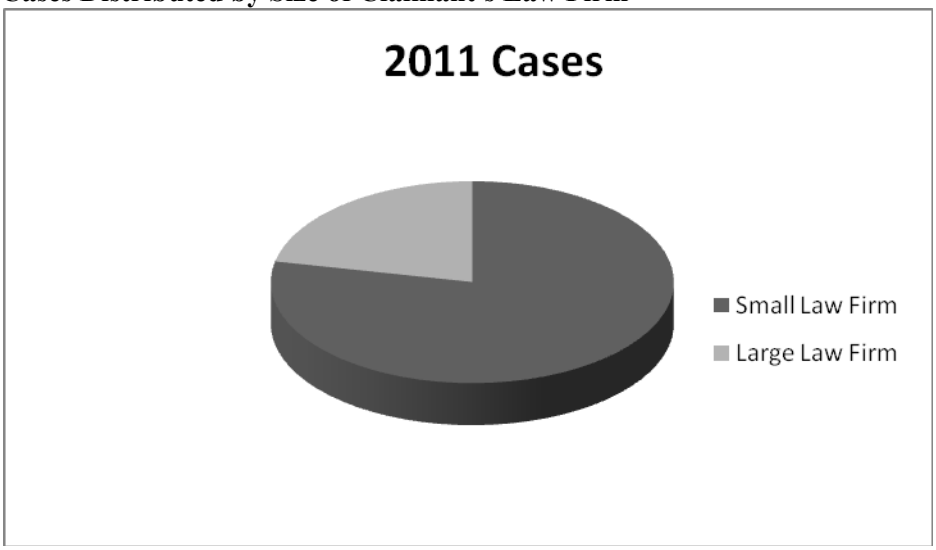

Figure 7

Finding

It makes very little difference whether a Claimant is represented by a firm with ten or more lawyers versus ten or less lawyers.

Figure 8 shows that the size of the Claimants' law firm is inconsequential to win rates. Even with their extra resources, law firms with ten or more lawyers do not end up with improved winning percentages or recovery rates. Our sample pool ended up with 108 cases where Claimants were represented by large firms, or 21.7% of our total sample.[17] The large firms won 49.0% of cases, while small firms won 47.8% of cases. This is an insignificant advantage in the win rate for the larger firms. We also hypothesized that large firms would be able to recover a higher percentage of money than the lawyers working at small firms. This turned out to be a minor difference as well. The median percentage of relief recovered by small

17. *Pro se* cases are not included in this sample.

Win Rate According to Size of Claimant's Law Firm

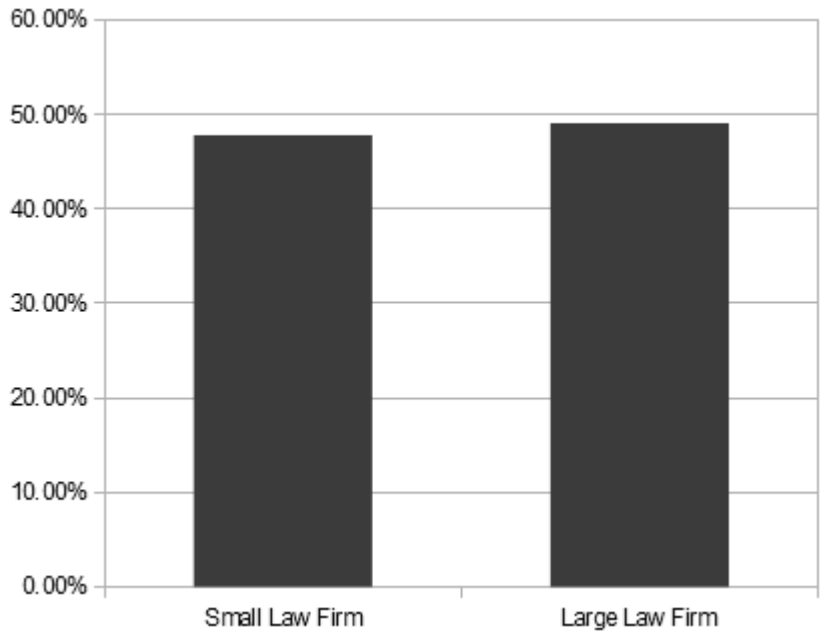

Figure 8

law firms was 35.8% versus 38.5% for large firms. Multiplying the win rate and the percentage of relief recovered to get the estimated recovery rate made the large law firms look slightly more attractive than either of the variables previously discussed, but considering that a case handled by a large firm often costs more (in out of pocket expenses if nothing else), choosing a larger firm is not a good decision for most investors.

Hypothesis

Respondents are more likely to win and Claimants will recover less money if the Respondent is represented by a large firm.

For the same reasons that we tested whether Claimants represented by large law firms will win more often, we test whether Claimants facing large law firms will win less often. The pie chart showing the number of Respondents that use large law firms is the reverse of the chart showing how many Claimants use large law firms. Close to 90% of Respondents are represented by large law firms or in-house lawyers.

Cases Distributed by Who Represents Respondent

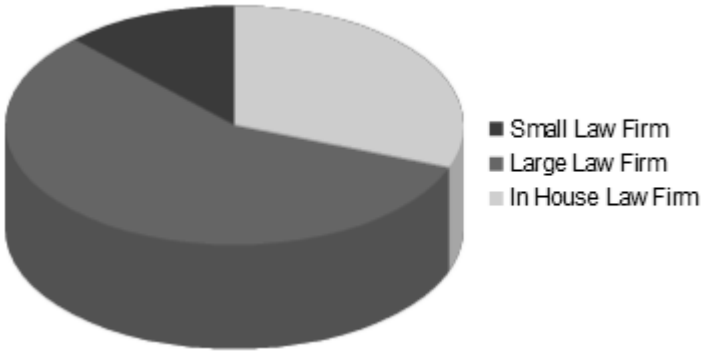

Figure 9

Finding

In terms of whether Claimants achieve a win, it does not matter much whether a Respondent is represented by a small law firm, large firm, or in-house counsel. In terms of containing damages, however, large firms do better.

In-house lawyers defended 30.7 % of the cases we examined. Not surprisingly, in-house lawyers were used to defend smaller cases, small law firms were used for mid-sized cases and large law firms defended large cases. In-house lawyers faced median relief requests of $98,881.76, small law firms defended cases with median relief requests of $371,103.85, and large law firms defended cases with median relief requests of $501,844.37.

Claimant Success Rates by Who Represents Respondents

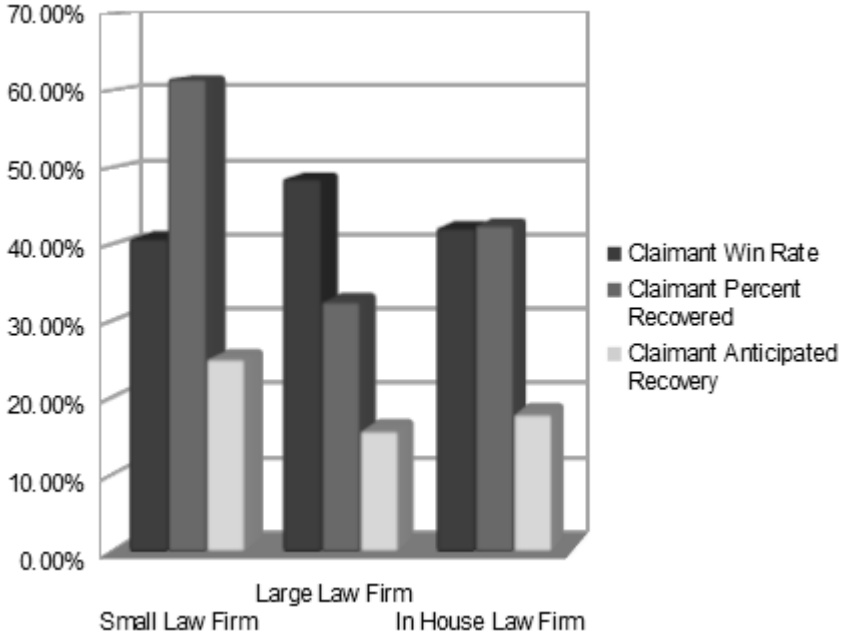

Figure 10

Hypothesis

The larger the brokerage firm, the more likely it is that the Claimant will lose.

This hypothesis suggests that smaller brokerage firms will lose more often than the larger brokerage firms. There are a few assumptions behind this hypothesis. Prior studies have shown that larger respondents do better.[18] Larger respondents have more resources and can pay for more expensive lawyers. Larger brokerage firms should know the arbitration system better than smaller brokers because of how many cases they have to defend each year and should settle the cases they are more likely to lose. The flip side of this assumption is that effective Claimants' lawyers should take their good cases to hearing and settle the weaker cases. Large brokerage firms have more money to spend on compliance and this should translate into better supervision of brokers. For instance, selling away cases are more likely to occur at smaller firms with widely disbursed smaller branch offices where it

18. O'Neal & Solin, *supra* note 2, at 10.

is harder to supervise brokers in remote locations.[19] Another possibility is that FINRA panels are less likely to hit large firms with big awards for fear of not being selected for future panels.

Finding

The larger the brokerage firm, the more likely it is that the Claimant will lose.

It is true that larger brokerage firms will win more often than the smaller brokerage firms. Figure 11 shows that Claimants fare better against the small Respondents by a huge margin. Claimants won 51.9% more often when disputing cases against the smallest firms compared to when they faced firms in the top twelve category.

Not only was the win rate different depending on the size of the brokerage firm, but there was a difference in the percentage of relief recovered depending on who the respondent was. And, following our hypothesis that larger brokerage firms are more successful in arbitration, they were also more successful in limiting recovery rates. The top twelve firms on average paid 34.5% of the relief requested to winners,[20] while the smallest firms paid only 40.6% of the request. Using the estimated recovery rate equation that we set forth earlier, the difference between the top twelve firms and the smallest firms becomes even greater. The estimated recovery rate against large firms was only 12.4% versus 22.1% against smaller brokerage firms. This 12.4% statistic is the most discouraging one for Claimants.

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19. *See* NASD Notice to Members 98-38, NASD Reminds Members Of Supervisory And Inspection Obligations (May 1998), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p004792.pdf; *see also In re Royal Alliance Assoc., Inc.*, Exchange Act Rel. No. 38,174 (Jan. 15, 1997).

20. The top 12 firms were not statistically different from the top 50 firms in terms of the percentage of relief awarded to the Claimants.

Success Rates According to Size of Respondent FINRA Member

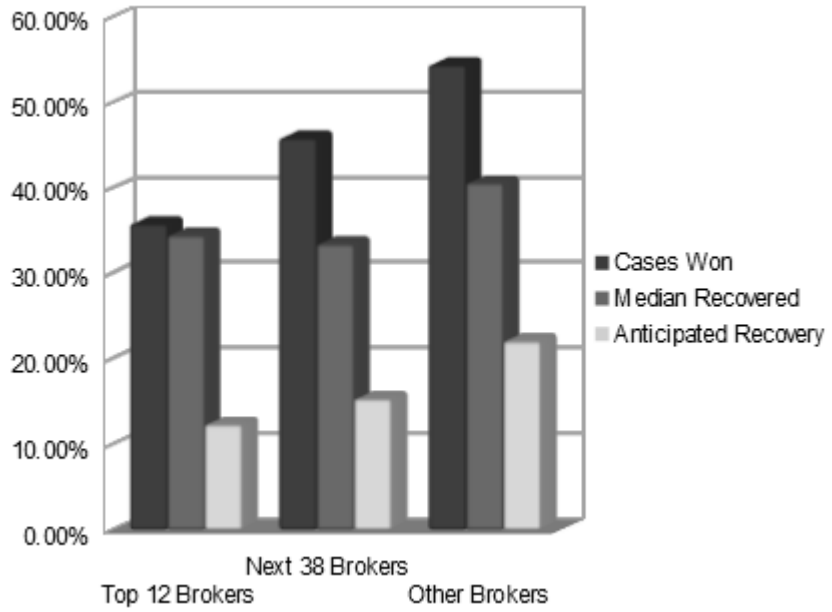

Figure 11

Hypothesis:

Claimants will win simplified cases more often and they will receive a higher percentage of their relief back.

Simplified cases are decided by a sole public arbitrator and the relief requested can be only up to $25,000.[21] Since the arbitrator is public and because the amount requested is low, these two factors should translate into a higher recovery rate. However, a factor militating in the other direction is that many Claimants in simplified cases represent themselves *pro se* and *pro se* Claimants do not do as well.

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21. Effective July 23, 2012 the limit for Simplified Arbitrations was increased to $50,000. *See* FINRA Regulatory Notice 12-30, Simplified Arbitration, (June 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p127156.pdf. Data in this article, however, is based on cases decided prior to the rule change.

Finding:

Claimants will win simplified cases less often than the overall average and they will receive a higher percentage of their relief back.

Figure 13 shows that the win rate for simplified cases was lower than the overall rate for cases in 2011. Only 33 awards were given out in 83 simplified disputes equating to a 39.8% win rate for simplified cases which is lower than the overall 45.6% win rate for 2011. Without simplified cases in the 2011 case pool, the win rate would have been slightly higher, i.e., 46.7% for the year. But, simplified cases serve an important purpose to investors. Investors recovered a high percentage of their claimed relief and simplified cases have very low costs and fees compared to a full arbitration hearing process.

The low win rate is caused by self-represented Claimants. *Pro se* customers in simplified proceedings represented 42 disputes and only won 13 awards. This means that without *the pro se* representation factored into simplified cases, customers won a much more respectable 48.8% of the time.

Percentage of amount sought recovered in simplified cases versus all of 2011

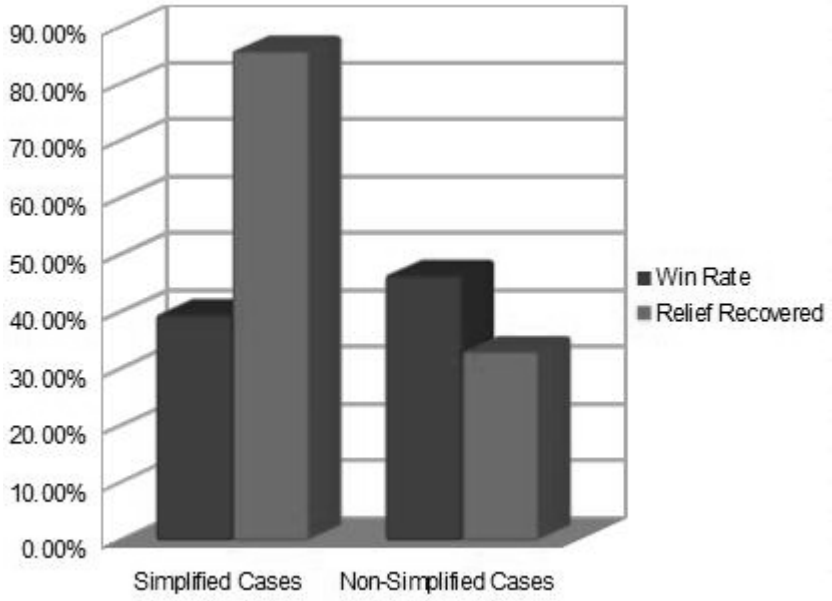

Figure 12

Hypothesis:

Despite difference in laws between states, the results over the four regions should not vary.

Finding:

Win rates were somewhat higher in the South.

This disparity can be explained by the number of Morgan Keegan cases in the South. Win rates were higher in Morgan Keegan cases than the overall sample.

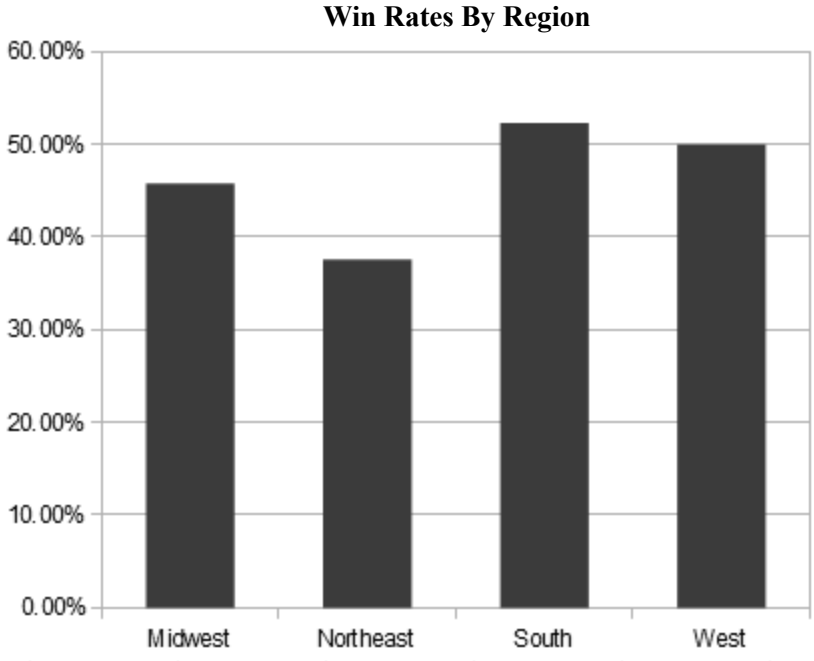

Figure 13

Morgan Keegan cases were analyzed separately and more in depth information was recovered.

Hypothesis

Retired investors and investors who lose more than 50% of their net worth do better than working investors and those who lose less than 50% of their net worth.

Finding

In Morgan Keegan cases, retired investors had a higher win rate. This was also true for people who lost more than 50% of their net worth.

Morgan Keegan Claimants - Win Rates 2008 -2012

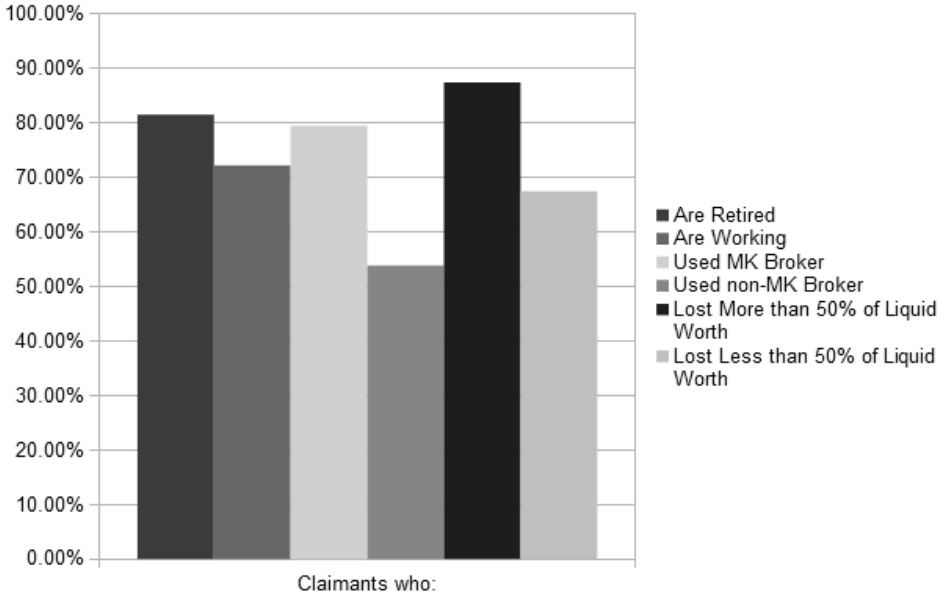

Figure 14

The win rate for a retired Morgan Keegan Claimant was higher than the win rate for a working Claimant, but the difference was not as large as we expected. When Claimants were in privity with Morgan Keegan, they were more likely to be able to recover their money than when a separate brokerage sold the RMK funds to them. When Claimants had a large percentage of their money at stake, it swayed the arbitrators into awarding them money more often than investors who had lots of money besides that which was lost.

Win Rates and Recovery Rates
Morgan Keegan Cases Versus Non Morgan Keegan Cases

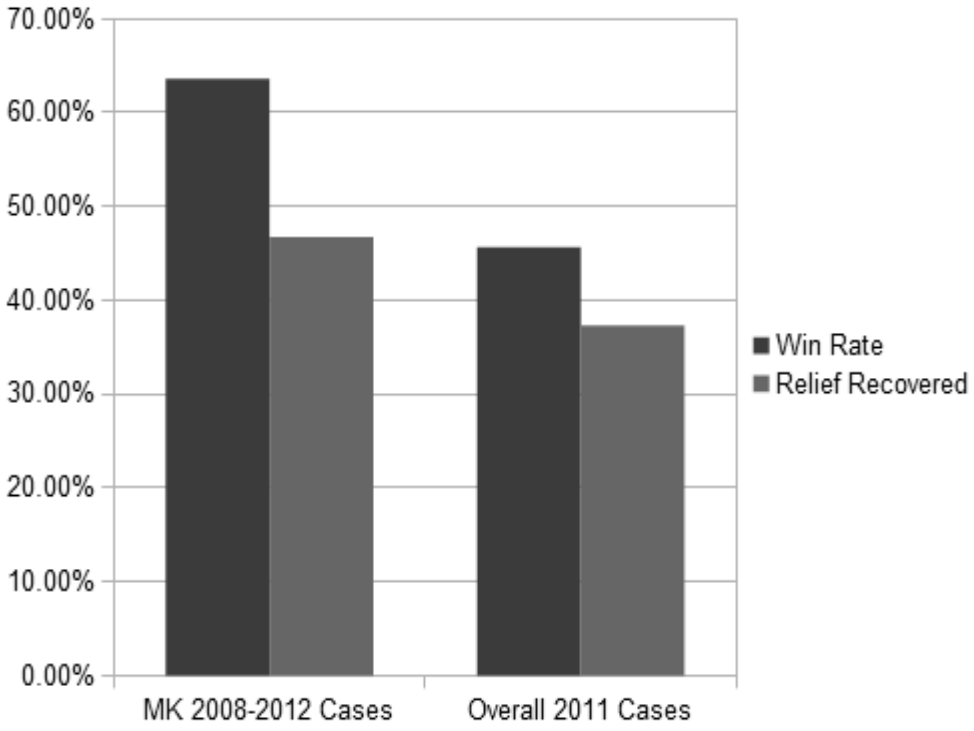

Figure 15

Summary and Conclusions

The key points we found are that:

- It makes a difference to have a PIABA member represent you;
- All public panels make a significant difference so far;
- Larger Respondents do better;
- More sophisticated investors have a harder time on average;
- Effective recovery rates remain low;
- Percentage recovery rates remain higher in smaller cases;
- Size of law firm does not matter much; and,
- Retired Claimants do better.

The need for more hard data remains critical. The best way to refine the results of this study would be access to information such as trading losses,

net out of pocket losses, age of Claimants, education level, retirement status, percentage of portfolio at stake, primary theories advanced in each case, and size of Respondent. At this point, the general statistics published by FINRA do not provide sufficient information for additional analyses.

DISCOVERABILTY OF WELLS SUBMISSIONS: WHAT THEY ARE AND HOW TO GET THEM

Philip M. Aidikoff, Robert A. Uhl,
Ryan K. Bakhtiari, and Jeffrey S. Majors

I. INTRODUCTION

In the last several years, defective securities product cases have invited increased regulatory scrutiny by the U.S. Securities and Exchange Commission (SEC) and other regulatory agencies, such as the Financial Industry Regulatory Authority (FINRA). Consequently, civil litigants seek discovery of documents broker-dealers produce to regulators.

While there is no "SEC privilege" that can be asserted by the party that produced transcripts and related documents to the regulator,[1] the corollary question has arisen as to whether a Wells submission is subject to civil discovery by subsequent third-party litigants. While a majority of courts have permitted discovery of Wells submissions, overruling objections based on attorney-client privilege and work product doctrine, a minority of courts has, under certain circumstances, upheld claims of attorney-client and work product privilege based on the theory of selective waiver.

This article will explain what a Wells submission is, the advantages and disadvantages of making a Wells submission, and the theories articulated by the courts, both majority and minority, in deciding when they are discoverable by subsequent third party litigants.

II. A WELLS SUBMISSION IS A VOLUNTARY RESPONSE TO NOTICE OF AN SEC INVESTIGATION

A Wells submission is a responsive statement provided to the SEC by those under investigation for alleged violation of federal securities laws, submitted in an effort to dissuade the SEC from bringing charges or, in the alternative, to reduce or eliminate charges or remedies pursued.[2] As a

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1. *See infra* Section III(A).

2. *See* KENNETH B. WINER & SAMUEL J. WINER, SECURITIES ENFORCEMENT: COUNSELING AND DEFENSE 16-3 (2005). "In a Wells Submission, [a] prospective defendant can make factual, legal, and policy arguments as to why it would be inappropriate for the Commission to bring the contemplated enforcement action. *Id.*

voluntary process, the SEC is under no obligation to inform the accused of his ability to submit a written statement[3] and the accused is under no obligation to respond.[4] Nevertheless, notice has become standard practice by the SEC, except in cases involving emergency relief or where notice would interfere with a criminal investigation.[5] Though sounding complex, the process is straightforward, as the court in *In re Initial Public Offering Securities Litigation* explained:

> The Wells process is relatively straightforward. Targets of SEC investigations are notified whenever the Enforcement Division staff decides, even preliminarily, to recommend charges. The staff typically identifies the provisions of the federal securities law[(s)]…it intends to charge, the forum in which… enforcement…will proceed (e.g. district court or administrative action), and the relief it intends to seek. Defense counsel [may] then…request a "Wells meeting," at which the staff presents a more detailed account of its case[, including] their view of the relevant facts, the applicable law, and their theory of…violations. The Wells meeting is less a forum for defense counsel to obtain discovery of the

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Even if defense counsel cannot persuade…the Staff or the Commission that… enforcement…should [not] be authorized, [they] may persuade the Staff to narrow the charges or seek less severe remedies." *Id.*; *see also SEC v. Cuban*, 798 F. Supp. 2d 783, 786 (N.D. Tex. 2012).

3. *See SEC v. Zahareas*, 374 F.3d 624, 629 (8th Cir. 2004); *SEC v. Forman*, No. 07-11151RWZ, 2010 U.S. Dist. LEXIS 56802, at *6 (D. Mass. June 9, 2010).

4. *See* 17 C.F.R. § 202.5(c) (2011), which states

> Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation. Upon request, the staff, in its discretion, may advise such persons of the general nature of the investigation, including the…violations [they intend to charge] and the amount of time that may be available for preparing and submitting a [Wells submission] prior to the … staff['s] recommendation to the Commission for the commencement of an administrative or injunction proceeding.

5. *See* WINER & WINER, *supra* note 2, at 16-4; *In re Initial Pub. Offering Secs. Litig.*, No. 21 MC 92 (SAS), 2003 U.S. Dist. LEXIS 23102, at *6 (E.D.N.Y. Dec. 24, 2003).

> Commission's case than it is a dialogue in which…counsel can appreciate whether there are any issues – factual, legal or otherwise – that may affect the Commission's deliberative process. The target may then file [a] Wells submission[, through which they attempt to talk the SEC out of bringing charges, into bringing reduced or amended charges, or into reducing or eliminating the remedies sought through enforcement].[6]

In a Wells submission, "[a] prospective defendant can make factual, legal, and policy arguments as to why it would be inappropriate for the Commission to bring the contemplated enforcement action."[7] Where a prospective defendant submits a Wells submission, it is attached to the staff's recommendation and forwarded to the Commission for review, assuming the recommendation for enforcement is maintained.[8] Responding with a Wells submission is valuable because of the access it affords to ultimate decision makers, by allowing a prospective defendant to bypass the Division of

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6. *In re Initial Pub. Offering Secs. Litig.*, 2003 U.S. Dist. LEXIS 23102, at *6; *see also* WINER & WINER, *supra* note 2, at 16-4, 16-5, 16-6 (stating that "In the initial Wells Call and letter, the Staff will typically provide a cursory outline of the charge[(s)] the Staff has tentatively decided to recommend. For example, the letter might do little more than identify the statutory provisions allegedly violated and the nature of the relief the Staff has tentatively decided to seek (e.g., an injunction, civil penalties, a cease-and-desist order, a bar from association with a broker-dealer)" (internal citations omitted)); *SEC v. Sears*, No. 05-728-JE, 2005 U.S. Dist. LEXIS 44854, at *4 (D. Or. July 28, 2005).

7. WINER & WINER, *supra* note 2, at 16-4.

8. *See In re Initial Pub. Offering Secs. Litig.*, 2003 U.S. Dist. LEXIS 23102, at *3.

> Persons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the commission setting forth their interests and position in regard to the subject matter of the investigation..… In the event a recommendation for the commencement of an enforcement proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the staff memorandum.

In re Initial Pub. Offering Secs. Litig., 2003 U.S. Dist. LEXIS 23102, at *3; *see SEC v. Berlacher*, No. 07-3800, 2012 U.S. Dist. LEXIS 19011, at *10 (E.D. Pa. Feb. 14, 2012).

Enforcement and communicate directly with Commissioners and their senior staff outside the Division of Enforcement.[9]

A. Advantages of a Wells Submission

With the SEC staff limited in its ability to initiate charges,[10] it is the Commissioners, not the Division of Enforcement staff, who determine whether enforcement will proceed, what charges will be brought, and what remedies will be sought.[11] By making a Wells submission, a prospective defendant presents a case for why enforcement should not proceed, by offering arguments, for example, on mistakes of fact and law and matters of public policy.[12] In effect, a Wells submission allows a prospective defendant to bypass the Division of Enforcement, removing the potential for filtering and misunderstanding by Enforcement staff that might otherwise influence the Commissioners' decision to bring charges.[13] Additionally, since a Wells submission follows a defense counsel's attendance at a Wells meeting, use of a Wells submission allows a prospective defendant to offer arguments that cut to the heart of the recommended charges.[14] As such, the process is in keeping with the purpose for which Wells submissions were created: to provide a means through which the Commission can hear a prospective defendant's arguments before determining whether to bring charges.[15]

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9. *See* Mark J. Astarita, *The Wells Notice and NASD Investigations*, SEC LAW.COM (2010), http://www.seclaw.com/docs/wellsnotice.htm (last visited Sept. 6, 2012); WINER & WINER, *supra* note 2, at 16-4.

10. *See* Astarita, *supra* note 9.

11. *See* John J. Carney & Francesca M. Harker, *Benefits and Dangers of an SEC Wells Submission*, BAKERHOSTETLER 2 (Dec. 17, 2009), http://www.bakerlaw.com/files/Uploads/Documents/News/Articles/LITIGATION/Law360_Carney_Harker_December_2009.pdf.

12. *See* Astarita, *supra* note 9; Carney & Harker, *supra* note 11, at 2. "Wells submissions are usually not the appropriate vehicle to address heated factual disputes but, rather, are best suited to address legal and policy questions the commission might not have fully considered." *Id.*; *see also SEC v. Berlacher*, 2012 U.S. Dist. LEXIS 19011, at *10.

13. *See* Astarita, *supra* note 9.

14. *See In re Initial Pub. Offering Secs. Litig.*, 2003 U.S. Dist. LEXIS 23102, at *6.

15. *See* SEC DIVISION OF ENFORCEMENT, ENFORCEMENT MANUAL 22 (2012), *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf. "The

Another significant advantage of a Wells submission is to influence the staff to amend its recommendation or influence the Commissioners to reduce or amend charges to be brought in the event the submission fails to dissuade them from bringing charges at all.[16] Additionally, it may influence the Commissioners to reduce or modify the remedies sought through enforcement.[17] Providing opportunity for advocacy *before* charges are brought – an avenue not typically available for charges brought by regulatory agencies[18] - the use of a Wells submission may pave the way to a settlement or to reduced charges.[19]

B. Disadvantages of a Wells Submission

In light of the benefits of submission, the decision to respond with a Wells submission should not be made lightly.[20] "Tempted with the possibility of halting litigation before it…begins, many practitioners might not stop to consider the very real dangers a Wells submission presents[,]" including:

> (1) the reality that submissions are not protected from use by the Commission against the offering party;
> (2) that submissions commit the offering party to positions taken before charges have been brought and discovery has been conducted;
> (3) that submissions open the offering party to prosecution for false statements in the event they are false or wrong;
> (4) that statements in the submission are generally admissible despite the prohibition on hearsay evidence;
> (5) that submissions are not protected from disclosure by the Commission to other regulatory and enforcement agencies – namely the Department of Justice; and

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objective of the Wells notice is…not only to [inform the Commission] of the findings [of Division of Enforcement staff], but also, where practicable and appropriate, to have before it the position of persons under investigation at the time it is asked to consider [the] enforcement action." *Id.*

16. *See* WINER & WINER, *supra* note 2, at 16-3.

17. *See id.*

18. *See* Carney & Harker, *supra* note 11, at 3.

19. *See* WINER & WINER, *supra* note 2, at 16-8.

20. *See* Carney & Harker, *supra* note 11, at 5.

> (6) that submissions are generally not privileged, confidential, or otherwise protected from third party discovery.[21]

In fact, the risks associated with Wells submissions are so great that most practitioners forgo opportunity to provide them at all, advising prospective defendants to make the Commission prove its case at trial rather than proving it for them with a submission.[22] There are at least six such risks.

The first risk of providing a Wells submission is that, by making a Wells submission, the offering party is providing the Commission with evidence it may use to prosecute him.[23] Unlike other evidence the Commission will use, it may not have evidence contained in a Wells submission, had it not been provided by the accused. Since the Commission "…routinely seeks to introduce submissions made pursuant to Rule 5(c) as evidence in… enforcement proceedings, when the staff deems appropriate,…[counsel] drafting the Wells submission must be extraordinarily careful in making any factual statements that could later be used as admissions against the prospective defendant."[24]

The second risk of providing a Wells submission is that it commits the offering party to positions before charges have been filed and discovery has been conducted.[25] This makes the prospective defendant vulnerable to exploitation by the SEC and to impeachment by the SEC, the DOJ, and third-party civil litigants.[26] Since a Wells submission predates the filing of charges by the SEC,

> [c]ounsel should be aware that the…Staff might respond to the submission by conducting additional discovery to obtain the evidence that was otherwise missing from the record or by modifying the theory of the case in a manner that will make it harder for the [offering party] to prevail in litigation.[27]

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21. *Id.* at 1.

22. *See* Astarita, *supra* note 9.

23. *See* WINER & WINER, *supra* note 2, at 16-8.

24. Carney & Harker, *supra* note 11, at 3.

25. *See id.*

26. *See id.*

27. WINER & WINER, *supra* note 2, at 16-10.

Allowing the Staff to use statements provided as a roadmap to solidify its case[28] compounds the risk with the possibility of disclosing inaccuracies that may subject the offering party to impeachment in enforcement proceedings, parallel criminal proceedings, and subsequent civil proceedings.[29] With the Commission having completed its investigation by the time it issues the Wells notice, a Wells submission places the offering party in the unique position of responding to allegations provided in broad detail, without access to third party documents, sworn statements, and other evidence in support of his position.[30]

> There is a very real concern that as more information comes to light, legal theories and defenses might need to change. Once [a Wells statement] is submitted, [however], the [offering party is] wedded to a single theory of the case.
> Worse yet, a statement that [counsel] and the defendant honestly believe to be fully accurate and true may turn out to be mistaken.[31]

When this happens, the offering party is vulnerable to impeachment for false or inconsistent statements in an enforcement action by the SEC, in parallel criminal proceedings by the DOJ, and in subsequent litigation by third-party litigants.[32]

The third risk of providing a Wells submission is that it may open the offering party to the possibility of prosecution for false statements, adding

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28. *See* Astaria, *supra* note 9*,* which states*:*

> Prospective respondents must keep this in mind in deciding whether to make such a submission, and must keep in mind that the SEC or NASD has conducted an investigation and made a determination to commence proceedings. It is therefore extremely difficult to argue factual matters in a Wells Submission. If you do, you are simply pointing out that there are disputed fact, and underscoring the fact that the Staff's position is correct, if its facts are correct. The end result of a 'factual' Wells Submission is a hearing, where the SEC Staff has been given advance notice of a respondent's factual defenses, which they might not have obtained.

29. *See* Carney & Harker, *supra* note 11, at 3.

30. *See id.* at 4.

31. *See id.*

32. *See id.*

the threat of expanded prosecution into the mix.[33] While prosecution for false statements is rare, providing statements that are knowingly false not only creates a basis for impeachment, but opens the door to prosecution for knowingly submitting false statements to a federal agency in performance of its duties.[34] As such, it is a risk to consider when providing a Wells submission.

The fourth risk of providing a Wells submission is that statements provided are generally admissible despite the prohibition on hearsay, making their use at trial for purposes other than impeachment important to consider.[35] While statements made in a Wells submission are hearsay when offered to prove the truth of the matter asserted, counsel should be mindful that the SEC, the DOJ, and subsequent civil litigants will generally shape them as admissions under Federal Rule of Evidence 801, making them statutorily defined as not hearsay, despite meeting the elements.[36] Thus, when a Wells submission is provided to the SEC, statements contained in the submission will generally be admitted to prove the truth of the matter asserted, as well as for impeachment purposes.[37]

The fifth risk of providing a Wells submission is that they are not protected from disclosure by the Commission to other regulatory and enforcement agencies. Therefore, by making a Wells submission, the offering party is, in essence, providing it to the Justice Department for prosecution in a parallel criminal proceeding.[38] With the Commission cooperating with the Justice Department through investigations and information sharing now more than ever before, the reality that "…Wells submissions can and have been used against [the offering party] in collateral

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33. *See id.*

34. *See id.*

35. *See* Carney & Harker, *supra* note 11, at 1.

36. *See id.* "Before submitting a Wells submission, practitioners need to be aware of the commission's position that the submission could be used against their client in a future proceeding by the commission as an admission against interest under Federal Rule of Evidence 801(d)(2)…." *Id.*; *see also* WINER & WINER, *supra* note 2, at 16-15. "[T]he SEC Staff routinely informs defense counsel in the Wells Call that the Staff may use the Wells Submission as an admission in [an] enforcement proceeding." *Id.*

37. *See* Carney & Harker, *supra* note 11, at 1.

38. *See* WINER & WINER, *supra* note 2, at 16-8.

criminal proceedings…" makes them dangerous to a party that may also face criminal prosecution by the DOJ.[39]

Finally, the sixth risk of providing a Wells submission is that they are generally not privileged, confidential, or otherwise protected from third party civil discovery.[40] Therefore, by providing a Wells submission, the offering party opens the floodgates to use of the submission by third parties in a subsequent civil action against the party providing the submission.[41]

The discoverability of Wells submissions, specifically whether Wells submissions are protected from discovery by attorney-client or work-product privilege, is the focus of the next section. Case law generally provides that, because attorney-client and work-product protections do not apply based on voluntary waiver of privileges, Wells submissions are generally discoverable,[42] whether admissible or not, as long as they are reasonably calculated to lead to the discovery of admissible evidence.[43] However, minority positions hold that they may not be discoverable based on the theory of selective waiver of privileges.[44] While providing a submission will not make it discoverable by third parties from the SEC,[45] it may make it discoverable from the offering party.[46]

With the benefits and risks of Wells submissions exposed, the fact is that the danger of offering them may substantially outweigh the benefits provided to the prospective defendant.[47]

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39. Carney & Harker, *supra* note 11, at 3.

40. *See* WINER & WINER, *supra* note 2, at 16-8.

41. *See* Carney & Harker, *supra* note 11, at 3.

42. *See infra* Sections III(A)(1)(a) and III(A)(2)(a).

43. *See Bennett v. La Pere*, 112 F.R.D. 136, 138 (D.R.I. 1986). "If one thing is certain, it is this: by its terms, Rule 26(b) does not condition the availability of discovery upon the likely admissibility of the information sought." *Id.*

44. *See infra* Sections III(A)(1)(b)&(c) and III(A)(2)(b)&(c).

45. *See* Philip M. Aidikoff et al., *Discovery of Regulatory Documents: Debunking the Myth of an "SEC Privilege" in Securities Arbitration*, 18 PIABA B.J. 187, 187 (2011). "[C]ase 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." *Id.* at 207.

46. *See* Astaria, *supra* note 9. "[A] well-placed subpoena can obtain a copy of the submission, to be used in later civil litigation by private citizens." *Id.*

47. *See id.*

> Therefore, a Wells submission should be carefully considered and should not be automatic. More often than not, a prospective respondent should…declin[e] to make a submission. However, there are instances where the submission is a valuable tool for the defense, and can be used to limit the…charges that are filed…and[,] in some instances, [to] avoid the [threat of prosecution] altogether.[48]

III. DISCOVERABILITY OF RELEVANT WELLS SUBMISIONS

Before statements in a Wells submission can be used by third-party litigants against the providing party in a separate action, the evidence must be discovered by the party seeking to use it. As the Federal Rules of Civil Procedure make clear, the question of whether evidence is discoverable is separate from the question of whether it can be admitted at trial.[49] With the requirements for discovery being substantially broader than the requirements for admissibility, Rule 26 provides in relevant part that evidence need not be admissible in order to be discoverable in a subsequent action.[50] Specifically, it provides:

> Parties may obtain discovery regarding *any matter*, *not privileged*, *that is relevant to the claim or defense of any party*, including the existence, description, nature, custody, condition, and location of any books, documents, or other tangible things and the identity and location of persons having knowledge of any discoverable matter. For good cause, the court may order discovery of any matter relevant to the subject matter involved in the action. *Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the*

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48. Astaria, *supra* note 9.

49. *See Bottaro v. Hatton Assocs.*, 96 F.R.D. 158, 159 (E.D.N.Y. 1982); *First Nat'l Bank of Oklahoma v. Bank of America, N.A.*, No. CIV-09-172-M, 2009 U.S. Dist. LEXIS 84301, at *4-5 (W.D. Okla. Sept. 15, 2009).

50. *See id.*; *Bennett v. La Pere*, 112 F.R.D. at 138. "If one thing is certain, it is this: by its terms, *Rule 26(b)* does not condition the availability of discovery upon the likely admissibility of the information sought." *Id.*

> *discovery of admissible evidence*. All discovery is subject to the limitations imposed by Rule 26(b)(2)(i), (ii), and (iii).[51]

With the rule allowing discovery of *any* matter: (1) that is not privileged; (2) that is relevant to a claim or defense; and, (3) that is reasonably calculated to lead to the discovery of admissible evidence, the ability to discover Wells submissions and statements they contain requires consideration of each of these issues.[52] Because questions of whether evidence is relevant to a claim or defense and whether that evidence is reasonably calculated to lead to the discovery of admissible evidence are case-specific concerns, this article assumes relevancy. The question of whether privilege applies to protect relevant submissions from discovery is discussed below.

A. Wells Submissions Are Generally Not Protected From Discovery

While discovery of Wells submissions is hotly contested by the offering party as being protected by privilege in civil litigation,[53] case law makes clear that such submissions are generally not protected by attorney-client and work-product privilege based on the theory of voluntary waiver by the providing party.[54] However, a minority of courts provide that they may be protected based on the theory of selective waiver.[55] Additionally, submissions are not protected by an alleged regulatory or "SEC privilege."[56]

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51. Fed. R. Civ. P. 26(b)(1) (emphasis added).

52. *See id.*; *Bennett*, 112 F.R.D. at 138; *see also SEC v. Nacchio*, No. 05-cv-00480-MSK-CBS, 2007 U.S. Dist. LEXIS 5435, at *13 (D. Colo. Jan. 25, 2007).

53. *See Holtsinger v. Voros*, No. CIV S-03-0732-MCE-CMK-P, 2009 U.S. Dist. LEXIS 57889, at *12 (E.D. Cal. June 23, 2009); *Nacchio*, 2007 U.S. Dist. LEXIS 5435, at *15.

54. *See infra* Section III(A)(1)(a) and III(A)(2)(a).

55. *See infra* Sections III(A)(1)(b)&(c) and III(A)(2)(b)&(c).

56. *See* Aidikoff, *supra* note 52, at 187, which states:

> 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.

As a result, relevant Wells submissions are generally discoverable by third party litigants.[57]

1. A Majority of Courts Hold That Wells Submissions Are Not Protected By Attorney-Client Privilege

A common privilege invoked by offering parties to protect Wells submissions from discovery by third-party litigants is the attorney-client privilege, which operates to protect confidential communications between attorneys and their clients. Created "…to encourage [']full and frank communications between attorneys and their clients[,']"[58] it is grounded in necessity, based on the reality that "assistance can only be safely and readily availed when free from the consequences…or apprehension of disclosure."[59] Because it could obstruct the truth-seeking process, the attorney-client privilege is construed narrowly; courts have limited its protection to "*only* those disclosures---necessary to obtain legal advice—which might not have been made absent the privilege."[60] "Accordingly, voluntary disclosure of purportedly privileged communications has long been considered inconsistent with the assertion of the privilege. As the court in *In re Columbia/HCA Healthcare Corp. Billing Practices Litigation* explained:

> As a general rule, the []attorney-client privilege is waived by voluntary disclosure of private communications by an individual or corporation to third parties. In addition, a client may waive the privilege by conduct which implies a waiver of the privilege or…consent to disclosure.[61]

The ability to shield submissions from discovery turns on the meaning of voluntary disclosure and whether or not submissions to regulators are included as such. Courts have fashioned three approaches to whether disclosure to regulators in a Wells submission operates as a waiver of

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Id. (citations omitted).

57. *See Westinghouse Elec. Corp. v. Republic of Phil.*, 951 F.2d 1414, 1418 (3d Cir. 1991).

58. *Id.* at 1423 (citing *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981)).

59. *Id*.

60. *Id.*

61. *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289, 294 (6th Cir. 2002). (internal citations omitted).

attorney-client protections: (1) disclosure as a complete waiver of attorney-client privilege in the submission; (2) disclosure as a selective waiver of attorney-client privilege in the submission; and (3) disclosure as a selective waiver of attorney-client privilege in the submission, but only to the government when the government agrees to a confidentiality order.[62]

a. Disclosure of Wells Submissions as a Complete Waiver of Attorney-Client Privilege

In the first approach, the D.C. Circuit in *Permian Corp. v. United States* held that voluntary disclosure of attorney-client privileged information to anyone other than the attorney or client operates as a complete waiver of attorney-client privilege against third-parties.[63] In *Permian*, Occidental Petroleum proposed an acquisition by an exchange offer for outstanding shares of Mead.[64] Mead's management resisted the takeover and sued to enjoin the transaction.[65] In the course of litigation with Mead, Occidental produced millions of pages of discovery, which it sought to preserve claims of privilege and confidentiality in by careful screening, by stipulating that privileges were retained in the event privileged information was inadvertently produced and by protective order issued by the court.[66]

As a result of problems raised by Mead, the SEC opened an investigation into Occidental's involvement in possible violations of petroleum pricing regulations through its subsidiary Permian.[67] In response, the SEC was

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62. *See id.* at 295.

> A review of the positions presented by the various courts reveals three general opinions on the issue – selective waiver is permissible,; selective waiver is not permissible under any situations,; and selective waiver is permissible in situations where the Government agrees to a confidentiality order,– and the Court will examine each.

Id. (internal citations omitted).

63. *See Permian Corp. v. United States*, 665 F.2d 1214, 1215 (D.C. Cir. 1981).

64. *See id.*

65. *See id.*

66. *See id.* at 1215-16.

67. *See Permian Corp.,* 665 F.2d. at 1216.

provided with 1.2 million pages of documents in discovery from Occidental.[68] In an attempt to speed the investigation and not hold up the acquisition of Mead, the SEC negotiated an agreement with Occidental that allowed it to obtain confidential Occidental information from Mead which had it organized around issues and claims for use at trial.[69] As part of the agreement, the SEC agreed that all documents produced pursuant to the agreement would be stamped with a restrictive endorsement precluding disclosure to third parties by the SEC.[70]

In a subsequent action, "…the Department of Energy sought documents from the SEC for use in an investigation of" Occidental's involvement through Permian in violations of petroleum pricing regulations.[71] Pursuant to its agreement with Occidental, the SEC notified Occidental of its intent to supply documents to the Department of Energy and Occidental sued to enjoin the discovery of documents from the SEC, claiming attorney-client, work product protections, and limited waiver of privilege against the SEC, but not against subsequent parties.[72] On the issue of attorney-client privilege and work product protection, the district court agreed that the documents were not discoverable.[73] On appeal, however, the D.C. Circuit Court reversed, rejecting the Eighth Circuit's selective waiver of the attorney-client privilege theory in favor of a strict approach that waived attorney-client privilege once disclosed to *any* third party – government or not.[74] Finding that Occidental should not be able to pick and choose among its opponents - by waiving attorney-client protections against some and asserting it against others - the Court held that "[w]e believe … the attorney-client privilege should be available only at the traditional price: a litigant who wishes to assert confidentiality must maintain genuine confidentiality."[75]

The D.C. Circuit's rejection of selective waiver in *Permian* was joined by the First Circuit in *United States v. Massachusetts Institute of*

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68. *See id.*

69. *Permian Corp.*, 665 F.2d at 1216.

70. *See id.*

71. *Id.* at 1217.

72. *See id.*

73. *See id.* at 1215.

74. *Permian Corp.*, 665 F.2d at 1215.

75. *Id*. at 1222.

Technology;[76] by the Second Circuit in *In re John Doe Corp.*;[77] by the Third Circuit in *Westinghouse Electric Corp. v. Republic of the Philippines*;[78] by the Fourth Circuit in *In re Martin Marietta Corp.*;[79] by the Sixth Circuit in *In re Columbia/HCA Healthcare Corporation Billing Practices Litigation*;[80] and by the Federal Circuit in *Genentech v. United States International Trade Commission*,[81] making complete waiver the majority approach to voluntary disclosure of attorney-client privileged communications in a submission to the SEC.[82]

b. Disclosure of Wells Submissions as a Selective Waiver of Attorney-Client Privilege

In the second approach, the Eighth Circuit held in *Diversified Industries, Inc. v. Meredith*, that voluntary disclosure of attorney-client privileged information to the SEC operates as a selective waiver of attorney-client privilege to the SEC, but not against subsequent parties.[83] Diversified Industries, a Delaware manufacturer operating in Missouri, conducted an internal investigation of bribes paid to domestic officials and submitted an internal report to the board, which acted accordingly.[84] The report was obtained by the SEC through an administrative subpoena. A civil action was also brought against Diversified by one of the customers it purportedly bribed for conspiracy, tortious interference, and violations of the Clayton

76. *See United States v. Mass. Institute of Tech.*, 129 F.3d 681, 686 (1st Cir. 1997).

77. *See In re John Doe Corp.*, 675 F.2d 482, 489 (2d Cir. 1982).

78. *See Westinghouse Elec. Corp. v. Republic of Phil.*, 951 F.2d at 1418.

79. *See In re Martin Marietta Corp.*, 856 F.2d 619, 623 (4th Cir. 1988).

80. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 294.

81. *See Genentech v. U.S. Int'l Trade Commn.*, 122 F.3d 1409, 1417 (Fed. Cir. 1997).

82. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 294. "The prevailing view is that once a client waives the privilege to one party, the privilege is waived en toto." *Id.*

83. *See Diversified Indus. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977).

84. *See id.* at 599-600.

Antitrust Act.[85] The customer sought to obtain the audit report provided to the SEC, as well as the board minutes for the meeting where outside counsel presented the findings of the internal audit to the board.[86] The district court ordered production of documents sought, finding they were not protected by attorney-client privilege, which had been voluntarily waived by providing the documents to the SEC.[87] On appeal, the Eighth Circuit reversed, finding that documents were protected from disclosure to the third party customer based on the theory of selective waiver.[88] Finding that Diversified provided documents pursuant to an administrative subpoena "…in a separate and nonpublic SEC investigation…" the court found any waiver that occurred was limited (i.e. "selective"), in that it waived attorney-client protections against the SEC but not against third parties in unrelated proceedings.[89]

The approach, which is good law in the Eighth Circuit and has been favorably cited by the Northern District of Texas in *In re LTV Securities Litigation*[90] and the Southern District of New York in *Byrnes v. IDS Realty Trust*,[91] but has been rejected by the First Circuit in *United States v. Massachusetts Institute of Technology*;[92] the Second Circuit in *In re John*

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85. *See id.* at 600.

86. *See id.* at 599.

87. *See id.*

88. *See id.* at 611.

89. *Diversified Indus.*, 572 F.2d at 611.

> We finally address the issue of whether Diversified waived its attorney-client privilege with respect to the privileged material by voluntarily surrendering it to the SEC pursuant to an agency subpoena. As Diversified disclosed these documents in a separate and nonpublic SEC investigation, we conclude that only a limited waiver of the privilege occurred. To hold otherwise may have the effect of thwarting the developing procedure of corporations to employ independent outside counsel to investigate and advise them in order to protect stockholders, potential stockholders, and customers.

Id.

90. *See In re LTV Secs. Litig.*, 89 F.R.D. 595, 605 (N.D. Tex. 1981).

91. *See Byrnes v. IDS Realty Trust*, 85 F.R.D. 879, 689 (S.D.N.Y. 1980).

92. *See United States v. Massachusetts Institute of Tech.*, 129 F.3d at 686.

Doe Corp.;[93] the Third Circuit in *Westinghouse Electric Corp. v. Republic of the Philippines*;[94] the Fourth Circuit in *In re Martin Marietta Corp.*;[95] the Sixth Circuit in *In re Columbia/HCA Healthcare Corporation Billing Practices Litigation*;[96] and the Federal Circuit in *Genentech v. United States International Trade Commission*;[97] making it a minority approach to the issue of waiver of attorney-client privilege.[98]

c. Disclosure of Wells Submissions as a Selective Waiver of Attorney-Client Privilege When the Government Agrees To Confidentiality

In the third approach, the Southern District of New York held in *Teachers Insurance & Annuity Association of America v. Shamrock Broadcasting Co.*, that voluntary disclosure of attorney-client privileged information to the SEC operates as a complete waiver of attorney client privilege against all parties, "…*unless* the right to assert the privilege in subsequent proceedings is specifically reserved at the time the disclosure is made."[99] In *Teachers*, Shamrock was investigated for alleged improper dealings by a corporation in connection with a "…series of questionable loans and other debentures by Shamrock."[100] The SEC subpoenaed numerous documents in connection with its investigation of Shamrock, which Shamrock provided.[101] The SEC subpoena did not limit the use of documents to the SEC and Shamrock did not attempt to quash or otherwise evade the

93. *See In re John Doe Corp.*, 675 F.2d at 489.

94. *See Westinghouse Elec. Corp. v. Republic of Phil.*, 951 F.2d at 1418.

95. *See In re Martin Marietta Corp.*, 856 F.2d at 623.

96. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 294.

97. *See Genentech v. U.S. Int'l Trade Commn.*, 122 F.3d at 1417.

98. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 294. "The prevailing view is that once a client waives the privilege to one party, the privilege is waived en toto." *Id.*

99. *Teachers Ins. & Annuity Assn. of America v. Shamrock Broadcasting Co*., 521 F. Supp. 638, 644-45 (S.D.N.Y. 1981).

100. *See id.* at 640.

101. *See id.*

subpoena on basis of privilege.[102] Documents were then subpoenaed by Teachers Insurance in a shareholder action against Shamrock.[103] Shamrock objected on the basis of attorney-client privilege.[104] At trial, the district court concluded "I am of the opinion that disclosure to the SEC should be deemed a complete waiver of the attorney-client privilege *unless* the right to assert the privilege in subsequent proceedings is specifically reserved at the time the disclosure is made."[105] Finding no basis to deny Shamrock's production under a protective order, stipulation, or other express reservation of attorney-client privilege in the documents disclosed, the court held privilege had been waived by Shamrock as against subsequent parties.[106] The court's finding in *Shamrock* is supported by the District of Colorado's finding concerning a Wells-type submission in *In re M&L Business Machine Co., Inc.*,[107] creating a second minority approach to the waiver of attorney-client privilege.[108]

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102. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.,* 293 F.3d at 294.

103. *See id.*

104. *See Teachers Ins. & Annuity Assn. of America*, 521 F. Supp. at 644.

105. *Id.*

106. *See id.* at 646; *see also In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 300 ("The court noted that '[i]t does not appear that such a reservation would be difficult to assert, nor that it would substantially curtail the investigatory ability of the SEC….' Such a stipulation would also 'make clear that…the disclosing party had made some effort to preserve the privacy of the privileged communication, rather than having engaged in abuse of the privilege by first making a knowing decision to waive the rule's protection and then seeking to retract that decision in subsequent litigation'" (quoting *Teachers Ins. & Annuity Assn. of America*, 521 F.Supp. at 646)) (alterations in original).

107. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 301 (citing *In re M&L Business Mach. Co.*, 161 B.R. 689, 696 (D. Colo. 1993)). Steps taken to preserve confidentiality, the existence of an explicit agreement between the offering party and the United States Attorney not to disclose the material provided, and the fact that disclosure was not made for the benefit of the disclosing party distinguished this case from others where documents were produced in hopes of obtaining favorable treatment from the SEC. *See id.*

108. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 294.

2. A Majority of Courts Hold That Wells Submissions Are Not Protected By Work Product

Another common privilege invoked to protect Wells submissions from discovery by third-party litigants is work-product protection, which operates to shield the mental processes of an attorney from discovery by opponents[109] by protecting "any document prepared in anticipation of litigation by or for an attorney."[110] "The logic behind the work product doctrine is that opposing counsel should not enjoy free access to an attorney's thought processes[,]" including development of legal theories, development of trial tactics and legal strategies, and presentation and review of information.[111] By protecting the thought process of counsel, "… the doctrine grants counsel an opportunity to think or prepare a client's case without fear of intrusion by an adversary."[112] While protection is necessary to preparing a client's case, the limits of protection are guided by common sense and the practicalities of litigation and are not determinative in the event of disclosure to third parties.[113] As the court in *In re Steinhardt Partners, L.P.* explains:

> Once a party allows an adversary to share the otherwise privileged thought processes of counsel, the need for the privilege disappears. Courts therefore accept the waiver doctrine as a limitation on work product protection. The waiver doctrine provides that voluntary disclosure of work product to an adversary waives the privilege as to other parties.[114]

Unlike protection afforded by attorney-client privilege, where protection is waived by voluntary disclosure of communication to third parties, the issue of whether work product privilege is waived turns on whether work product was disclosed to an adversary or not.[115] As the court in *Westinghouse Electric Corp. v. Republic of the Philippines* explains:

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109. *See id.*

110. *Id.* at 304 (citing *In re Antitrust Grand Jury*, 805 F.2d 155, 163 (6th Cir. 1986)).

111. *See In re Steinhardt Partners, L.P.*, 9 F.3d at 234; *see also Westinghouse Elec. Corp. v. Republic of Phil.*, 951 F.2d at 1427.

112. *In re Steinhardt Partners, L.P.*, 9 F.3d at 234.

113. *See id.* at 235.

114. *In re Steinhardt Partners, L.P.*, 9 F.3d at 235..

115. *See id.*; *see also Westinghouse Elec. Corp. v. Republic of Phil.*, 951 F.2d at 1428.

> A disclosure to a third party waives the attorney-client privilege unless the disclosure is necessary to further the goal of enabling the client to seek informed legal assistance. Because the work-product doctrine serves instead to protect an attorney's work product from falling into the hands of an adversary, a disclosure to a third party does not necessarily waive the protection of the work-product doctrine. Most courts hold that to waive the protection of the work-product doctrine, the disclosure must enable an adversary to gain access to the information.[116]

Therefore, unlike attorney-client privilege, in determining whether work product protections apply, the ability to shield submissions from discovery turns on the identity of the third party to whom work product was exposed and the circumstances surrounding disclosure.[117] There are at least three approaches to consider: (1) the Eighth Circuit's voluntary disclosure to an adversary as a complete waiver of work product protections;[118] (2) the D.C. Circuit's voluntary disclosure to an adversary as a selective waiver of work product protections when confidentiality is promised prior to disclosure;[119] and (3) the Third Circuit's voluntary disclosure to an adversary as a selective waiver of work product protections based on the underlying goal of the work product doctrine.[120]

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116. 951 F.2d at 1428.

117. *See id.* "Even though the courts generally agree that disclosure to an adversary waives the work-product doctrine, they disagree over the reasons behind this principle and thus, over its application to specific circumstances." *Id.*

118. *See In re Chrysler Motors Corp. Overnight Evaluation Prog.*, 860 F.2d 844, 846 (8th Cir. 1988).

119. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d at 304 (citing *Permian Corp. v. United States*, 665 F.2d at 1215). "Indeed, in *Permian*, which so roundly rejected selective waiver as to attorney client privilege, the D.C. Circuit upheld a finding by the district court that the agreement between Occidental and the SEC preserved the work product protection." *Id.*; *see also id.* (citing *In re Subpoena Duces Tecum*, 738 F.2d 1367, 1375 (D.C. Cir. 1984)). A party waives work product protection unless it demands "…on a promise of confidentiality before disclosure to the SEC." *Id.*

120. *See Westinghouse Elec. Corp. v. Republic of Phil.*, 951 F. 2d at 1429. "In other words, a party who discloses documents protected by the work-product doctrine may continue to assert the doctrine's protection only when the disclosure furthers the doctrine's underlying goal." *Id.*

a. Disclosure of Wells-Type Submissions to an Adversary as a Complete Waiver of Work Product

In the first approach, the Eighth Circuit, which upheld selective waiver of attorney-client privilege in *Diversified*, held in *In re Chrysler Motors Corp. Overnight Evaluation Program*, that voluntary disclosure of work product protected material to an adversary operates as a complete waiver of work product protection against subsequent parties.[121] In *Chrysler*, "Chrysler established a [']quality control['] program whereby workers disconnected the odometers on new cars and then took the cars home overnight for a [']test drive[']."[122] When the truth came out, plaintiffs and the government launched suits against Chrysler sounding in mail and odometer fraud.[123] To determine the extent of the fraud, Chrysler conducted an internal investigation and prepared a report of how many cars were involved in the program.[124] Chrysler released findings as a computer tape to counsel for the plaintiff's class on the condition that counsel for the class agree that the tape was qualified work product and that release did not constitute a waiver of work product protection.[125] Chrysler subsequently refused to produce the tape to the government, claiming work product protection based on preparation in

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121. *See In re Chrysler Motors Corp.*, 860 F.2d at 846.

122. *In re Columbia/HCA Healthcare Corp.*, 293 F.3d at 305.

123. *See In re Chrysler Motors Corp..*, 860 F.2d at 844. "[C]lass actions had been prompted by a 1986 federal indictment charging Chrysler with sixteen counts of mail fraud and odometer fraud. The government alleged that during 1985 and 1986 as many as 60,000 new vehicles had been driven with disconnected odometers as part of Chrysler's Overnight Evaluation Program." *Id.*

124. *See id.*

125. *See id.*

> Chrysler agreed to provide co-liaison counsel for the class action plaintiffs with access to the computer tape for the limited purpose of expediting the due diligence review. Chrysler agreed to provide the computer tape on the condition that co-liaison counsel for the class action plaintiffs agreed that the computer tape was attorney work product and that Chrysler's making the computer tape available to co-liaison counsel for the class action plaintiffs did not constitute a waiver of work product privilege.

Id.

anticipation of the criminal case and related class actions.[126] In considering whether Chrysler's voluntary disclosure to the plaintiff's class constituted a waiver of work product protections against subsequent parties, the Eighth Circuit found that it did and was not persuaded by use of a confidentiality agreement restricting the material from subsequent disclosure.[127] Holding that confidentiality alone is the dispositive factor in determining whether work product provided to an adversary is privileged, the court found work product protections were not only waived with regard to the plaintiff's class, but against subsequent third parties.[128]

In its holding that voluntary disclosure of work product protected material operated as a complete waiver of protection against subsequent parties, the Eighth Circuit in *Chrysler* was joined by the First Circuit in *United States v. Massachusetts Institute of Technology*,[129] the Sixth Circuit in *In re Columbia/HCA Healthcare Corp. Billing Practices Litigation*,[130] and the Northern District of California in *In re Worlds of Wonder Securities*

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126. *See* 860 F.2d at 844.

127. *See id.* at 847. "Nor does the agreement between Chrysler and co-liaison counsel for the class action plaintiffs not to disclose the computer tape to third-parties change the fact that the computer tape has not been kept confidential. [']Confidentiality is the dispositive factor in deciding whether [material] is privileged.[']" *Id.* (citing *Chubb Integrated Sys., Ltd. v. Nat'l Bank of Washington*, 103 F.R.D. 52, 67 (D.D.C. 1984)).

128. *See id.*

129. *See In re Columbia/HCA Healthcare Corp. Billing Practices Litigation*, 293 F.3d at 306 (citing *United States v. Massachusetts Inst. of Tech.*, 129 F.3d at 687). "The First Circuit upheld the [']prevailing rule that disclosure to an adversary, real or potential, forfeits work product protection.[']" *Id.*

130. *See In re Columbia/HCA Healthcare Corp.*, 293 F.3d at 306, which further states:

> Even more than attorney-client privilege waiver, waiver of the protections afforded by the work product doctrine is a tactical litigation decision. Attorney and client both know the material in question was prepared in anticipation of litigation; the subsequent decision on whether or not to [']show your hand['] is a quintessential litigation strategy. Like attorney-client privilege, there is no reason to transform the work product doctrine into another [']brush on the attorney's palette'['] used as a sword rather than a shield.

Id. at 307 (citing *In re Steinhardt Partners, L.P.*, 9 F.3d at 235).

Litigation,[131] making complete waiver the dominant approach to voluntary disclosure of work product to an adversary.

b. Disclosure of Wells Submissions to an Adversary as a Selective Waiver of Work Product When Confidentiality Is Promised By the SEC Prior to Disclosure

In the second approach, the D.C. Circuit held in *Permian Corp. v. United States*, *In re Sealed Case*, and *In re Subpoenas Deuces Tecum* that voluntary disclosure of work product to an adversary can operate as a selective waiver of work product protections when disclosure is made in response to a promise of confidentiality by the SEC.[132] In *Permian*, Occidental also objected to the Department of Energy's discovery of materials from the SEC on grounds of work product protection and selective waiver.[133] Specifically, it argued that, pursuant to its agreement that allowed the SEC to secure Occidental documents from Mead on the condition that documents were stamped with a restrictive endorsement precluding disclosure by the SEC to subsequent parties, work product protections were waived by agreement against the SEC but not against subsequent parties like the DOE.[134] The district court agreed on the issue of work product and limited waiver.[135] On appeal, the D.C. circuit affirmed, holding that, while selective waiver did not apply to attorney-client privilege, the district court's finding of selective waiver by agreement with the SEC was not erroneous.[136]

The court's decision was joined by subsequent decisions in *In re Sealed Case*[137] and *In re Subpoenas Deuces Tecum*,[138] and in part by the Second

131. *See In re Worlds of Wonder Secs. Litig.*, 147 F.R.D. 208, 211 (N.D. Cal. 1992). "[W]aiver of work product to the SEC also waives work product to others." *Id.*

132. *See Permian Corp. v. United States*, 665 F.2d at 1215; *In re Sealed Case*, 676 F.2d 793, 823 (D.C. Cir. 1982); *In re Subpoenas Duces Tecum*, 738 F.2d at 1375.

133. *See Permian Corp.*, 665 F.2d at 1220.

134. *See id.*

135. *See id.* at 1215.

136. *See id.*

137. *See In re Sealed Case*, 676 F.2d at 823.

138. *See In re Subpoenas Duces Tecum*, 738 F.2d at 1372-75. The court considered the following factors in its determination that selective waiver did not apply in fact

Circuit in *In re Steinhardt Partners, L.P.*, providing the first minority approach to voluntary disclosure of work product to an adversary when confidentiality is promised by the government.[139]

c. Disclosure of Wells Submissions to an Adversary as a Selective Waiver of Work Product Based On the Underlying Goal of the Work Product Doctrine

In the third approach, the Third Circuit held in *Westinghouse Electric Corp. v. Republic of the Philippines*,[140] that voluntary disclosure of protected material to an adversary operates as a selective wavier of work product protections when disclosure is in furtherance of the underlying goal of the work product doctrine.[141] In *Westinghouse*, the SEC launched an investigation into contracts procured by Westinghouse through illegal payments to foreign officials.[142] In response, Westinghouse conducted an internal investigation and disclosed materials created to the SEC and DOJ, but not to the Republic of the Philippines, claiming work product protections and selective waiver as a basis for refusal.[143] In considering whether Westinghouse's voluntary disclosure to the SEC and the DOJ constituted a

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under the facts of the case: (1) the party attempting to use work product privilege sought to use it in a way that was not consistent with the purpose of the work product doctrine; (2) the party attempting to use work product privilege had no reasonable basis for believing materials disclosed to the SEC would remain confidential; and (3) waiver of work product under the circumstances "…would not trench on any policy elements not inherent in…" the work product privilege. *Id.* at 1372. The court noted the outcome may have been different had the party attempting to use the privilege either maintained pure confidentiality by not disclosing work product or by insisting on a promise of confidentiality by the SEC before disclosing work product to it. *See id.* at 1375.

139. *See In re Steinhardt Partners, L.P.*, 9 F.3d at 236. "In denying the petition, we decline to adopt a *per se* rule that all voluntary disclosures to the government waive work product protection. Crafting rules relating to privilege in matters of governmental investigations must be done on a case-by-case basis." *Id.* (citation omitted).

140. 951 F.2d 1414 (3rd Cir. 1991).

141. *See Westinghouse Electric Corp. v. Republic of Phil.*, 951 F. 2d at 1429.

142. *See id.* at 1418.

143. *See id.* at 1418-19.

selective waiver as to the SEC and DOJ, but not against subsequent parties, the Third Circuit considered the goal of the work product doctrine and the reasons behind Westinghouse's disclosures to the SEC and DOJ.[144] Finding that the goal of the doctrine was to protect the adversarial system by allowing attorneys to prepare their cases without fear of work product created being used against their clients, it attributed Westinghouse's disclosures to an effort to forestall charges and to secure lenient treatment in the event charges had merit.[145] Holding that its reasons for disclosure were inapposite to the goal of the work product doctrine, since Westinghouse was free to prepare its case without fear of work product being used against it – at least until it waived protections by disclosing documents to the government - the court denied its claim of selective waiver and ordered the production of documents sought.[146] Thus, the use of selective waiver to protect work product voluntarily disclosed when disclosure furthers the purpose of the work product doctrine is the second minority approach to voluntary disclosure of work product to an adversary.

IV. CONCLUSION

In deciding whether to make a Wells submission, a potential target of the SEC must consider the possibility that a Wells submission will likely be discovered by subsequent third party civil litigants. While it is true that Wells submissions generally deny the anticipated claims, it is still useful for a

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144. *See id.* at 1429-30.

145. *See id.*

146. *See id.* at 1429.

> We hold that Westinghouse's disclosure of work product to the SEC and to the DOJ waived the work product doctrine as against all other adversaries.. . . [P]arties who have disclosed materials protected by the attorney-client privilege may preserve the privilege when the disclosure was necessary to further the goal underlying the privilege. We require the same showing of relationship to the underlying goal when a party discloses documents protected by the work-product doctrine. In other words, a party who discloses documents protected by the work-product doctrine may continue to assert the doctrine's protection only when the disclosure furthers the doctrine's underlying goal.

951 F. 2d at 1429.

subsequent civil litigant to know that the target has taken a fixed written position, which may or may not be supported later by discovery of all relevant documents. On the other hand, a successful Wells submission that results in no claims being filed by the SEC will reduce the likelihood of any successful subsequent litigation. Accordingly, one should weigh carefully the pros and cons of making a Wells submission.

VARIABLE UNIVERSAL LIFE CHANGES EVERYTHING

Theodore E. Affleck, CLU[1]

Up until the late 1970s, the life insurance product world was generally populated by term and whole life (WL) products. As the name implies, term insurance provides coverage for a specified limited time period, or term, at which point the policy terminates, usually without value. WL insurance, on the other hand, offers coverage for life and has a guaranteed premium, a guaranteed death benefit, as well as a schedule of guaranteed cash values. The first versions of universal life (UL) entered the marketplace in the late 1970s. Its generic name was flexible premium adjustable life, and it presented itself largely as a response to four perceptions (legitimate or otherwise) that had generally characterized WL products –

1) WL premiums were relatively expensive. Because they were guaranteed for the lifetime of the insured, actuaries determined those premiums based on extremely conservative assumptions regarding investment earnings, mortality, and expenses.
2) WL products generally offered very little flexibility. WL premiums had to be paid every year, either via cash outlay, via a policy loan, or via dividends (or some combination of these). Moreover, the WL policy's death benefit couldn't be increased unless dividends were used to buy paid-up additions or one-year term insurance, and it could only be decreased after some complicated gyrations by the insurance company. Finally, WL policy's cash value was generally inaccessible (except via a policy loan or by withdrawing dividend values).
3) A WL policy's guaranteed cash value produced a relatively low rate of return. At the time, returns were usually based on 4-5% interest stemming from the insurance company's general account consisting generally of fairly conservative, fixed income, long-term

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investments. For "participating" life insurance policies (issued primarily, although not exclusively, by mutual companies), any dividends were primarily based on investment earnings, from those general account assets, in excess of the policy's contractual guarantees.

4) The dividend scales of participating WL policies were generally slow to respond to rapidly changing movements in the investment markets. Participating WL dividend scales changed only annually, and the long-term, low turnover assets making up the typical life insurance company general account made it a slow-moving beast if there ever was one.

Nevertheless, by paying those guaranteed premiums each and every year, the WL policy owner at least enjoyed four guarantees from the insurance company:

1) The face amount of the policy would be paid to the beneficiary upon the death of the insured (whenever it might occur);
2) The policy's guaranteed cash value would increase every day, regardless of external events and conditions (during the best of times and during the worst of times);
3) Guaranteed cash value would always be available to the policy owner as a policy loan, or, as the cash surrender value in the event that the policy owner surrendered the policy; and
4) The policy's other non-forfeiture values would continue life insurance coverage on a non-premium paying basis, either at a reduced amount for the insured's lifetime (reduced paid-up insurance), or at the same amount for a specified, but limited period of time (extended term insurance).[2]

When universal life (UL) policies were first introduced in the late 1970s, UL premiums were still invested in (and were still guaranteed by) the insurance company's general account. But those premiums were usually placed in a specifically designated portion of that general account still consisting almost exclusively of fixed-income instruments (usually devoid of any equity investments), but in much shorter term durations. UL addressed all of the perceived weaknesses of WL discussed earlier –

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2. These are not insignificant guarantees. Even throughout the depression years of the 1930s and 1940s, no life insurance company ever defaulted on any of these four contractual promises. The two most recent (and notable) life insurance company failures (Mutual Benefit and Executive Life) occurred primarily because of asset mismanagement. The contractual obligations of both companies were absorbed by the industry and state regulators and were never compromised.

1) UL's illustrated premium, although generally not guaranteed, was almost always considerably less (as much as 30–40% less) than a corresponding WL premium (because it wasn't based on conservative assumptions but instead generally assumed current, non-guaranteed interest and current, non-guaranteed mortality);
2) UL's premium was very flexible (i.e., it could be increased, decreased, skipped, or ultimately and truly vanished);
3) UL's death benefit was adjustable (i.e., it could be increased, usually with evidence of insurability, or decreased, although usually with some restrictions and often a charge);
4) UL policy owners could make withdrawals from the policy's cash value (although usually with restrictions, and always with a corresponding decrease in the policy's face amount); and
5) UL interest crediting rates in the 1980s often reflected "new money rates" of 10-14% and were subject to more-frequent-than-annual change (in some cases as often as monthly).

Variable universal life (VUL) was a natural by-product of UL, particularly after the inevitable interest rate decreases in the mid-1980s started to take their toll on participating WL dividend scales and UL interest crediting rates. Life insurance companies quickly developed VUL products, which could be sold using a sales illustration that assumed a gross investment return of as much as 12.0%.[3] Survivorship variable universal life (SVUL) products, insuring two people with the death benefit paid after the second death, followed shortly thereafter.[4]

It is the investment return that differentiates VUL products from UL products. Instead of being invested in the insurance company's general account and getting a specific credited interest rate, VUL premiums are invested in one or more separate accounts, each of which behaves very much like a mutual fund. Each separate account has its own specified investment objective and strategy (e.g., intermediate bonds, small-cap growth stocks, large-cap value stocks, European energy stocks). The performance of each

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3. The October 19, 1987 stock market crash (biggest single day loss in the Dow Jones Industrial Average – 22.61%) temporarily spooked this initial enthusiasm for variable life insurance products for about 3-4 years.

4. If a married couple has a federal estate tax exposure, then with proper estate planning, they can usually arrange to defer those estate taxes until the second death. Survivorship (second-to-die) life insurance pays a death benefit in a timely manner to help offset those estate taxes. For purposes of this article, any reference to variable universal life (VUL) is intended also to refer to survivorship variable universal life (SVUL).

separate account from one day to the next reflects the underlying performance of its various investments. The policy owner chooses how premium payments are to be allocated among the available separate accounts.

Like any mutual fund, there are no guarantees as to the performance of any separate account, and there is no contractually guaranteed minimum interest.[5] The aggregate cash value of any VUL policy reflects the investment performance of the underlying separate accounts. While a particular separate account might enjoy positive investment performance in a particular calendar year of as much as 20-30%, it is also entirely conceivable for that same separate account to suffer an investment loss during another calendar year of equal magnitude.[6] Because the policy owner assumes the full investment risk, VUL policies are securities within the meaning of the federal securities laws and must be registered under the Security Act of 1933, and the separate accounts must register as investment companies under the Investment Company Act of 1940. In addition, FINRA reviews and approves VUL prospectuses, which must be provided to VUL applicants, and policy forms.[7] In order to sell VUL, an agent must be a registered representative through a registered broker/dealer.

Most VUL policies offer a wide choice of separate account alternatives (anywhere from 20 to 50 or more), presenting a wide range of investment objectives and "risk."[8] The policy owner might choose a fairly conservative mix of money market, bond, and fixed income separate accounts, or a fairly aggressive mix of various equity-based separate accounts. Life insurance companies will quite often offer a process that helps the VUL policy owner determine a personalized risk profile which in turn helps determine just how

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5. The one exception here is with a "fixed account" that is available in most VUL contracts. This is not a separate account, but instead is invested in the insurance company's general account, comes with a guaranteed interest rate (usually in the range of 3.0-4.0%), and may get credited with a higher interest rate if conditions permit.

6. The S&P 500 Index, a good proxy for many equity-based separate accounts, enjoyed positive investment returns in excess of 30% in 1991 (+30.47%), 1995 (+37.58%), & 1997 (+33.36%), but lost 37% during calendar year 2008.

7. FINRA is the Financial Industry Regulatory Authority, created in July 2007 through the consolidation of the NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.

8. Insurance companies often have a stable of their own proprietary separate accounts, but usually also provide a selection of separate accounts from other investment companies (e.g., Fidelity, Vanguard, Janus, T. Rowe Price).

to allocate premium payments among those various separate accounts. The policy owner may make periodic changes in the allocation of premium payments and may also reallocate the current values of the various separate accounts. Additionally, the VUL policy may include a "dollar cost averaging" provision that allows a gradual investment into one or several of the separate accounts, as well as a "portfolio rebalancing" feature that allows a periodic reallocation (done automatically on a quarterly, semi-annual, or annual basis) of monies among separate accounts in order to restore a particular percentage relationship between and among them.

All of the inherent flexibility that characterized FUL products continued with VUL products with respect to premium patterns, face amount changes, and cash value accessibility. In this sense, VUL continued the significant paradigm shift regarding life insurance premiums that had begun with universal life products. Rather than simply fulfilling a contractual obligation, as was the case with a WL premium, a VUL premium funded a cash value account in the policy owner's name. This cash value account, augmented or reduced by whatever investment gains (or losses) the separate accounts posted, is the source of the various charges that are deducted each month. The primary deduction is the cost of insurance (COI) charge, but administrative expense charges, face amount charges, asset-based charges, and the cost of any other optional benefits may also be deducted monthly. As long as the combination of premium payments (net of any sales loads or charges that might also be assessed – usually ranging from 5-10%) and cumulative investment return among the separate accounts maintains a sufficiently large cash value account to cover the monthly deductions, the contract's death benefit remains in force. But VUL policies have the additional burden of coping with the risk of market losses, a risk that does not confront UL policies.

Nevertheless, it is the VUL policy owner's responsibility to maintain sufficient cash value to cover all of the deductions that take place every month.[9] The policy owner may have to pay more premium than originally illustrated in order to offset any investment losses. If, for whatever reason, the cash value account is insufficient to cover the monthly deductions, the insurance company will initiate the policy's grace period provisions and ultimately lapse the contract unless the policy owner responds to the company's requests for additional premium payments.

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9. Some VUL products provide no-lapse guarantee provisions that require hefty annual premiums and guarantee the policy's death benefit, for a limited period of time, even if the policy's cash value cannot cover the monthly deductions.

Virtually all VUL policies have a schedule of surrender charges, generally lasting for 10-20 years, which the insurance company assesses if the policy owner voluntarily surrenders the policy. Most VUL policies ask their surrender charge schedule to play other contractual roles as well. For example, pro-rata surrender charges are usually assessed if the policy owner reduces the death benefit or makes a partial withdrawal from the policy's cash value. In addition, most VUL policies limit policy loans and partial withdrawals to a specified percentage (usually 90%) of the policy's cash surrender value (i.e., policy's cash value or fund value less the current surrender charge). Surrender charges are designed to discourage early surrenders, but they also allow the insurance company to recover certain expenses whose recovery is otherwise amortized over the first 10-20 years of the policy.

The Importance of the Death Benefit Option

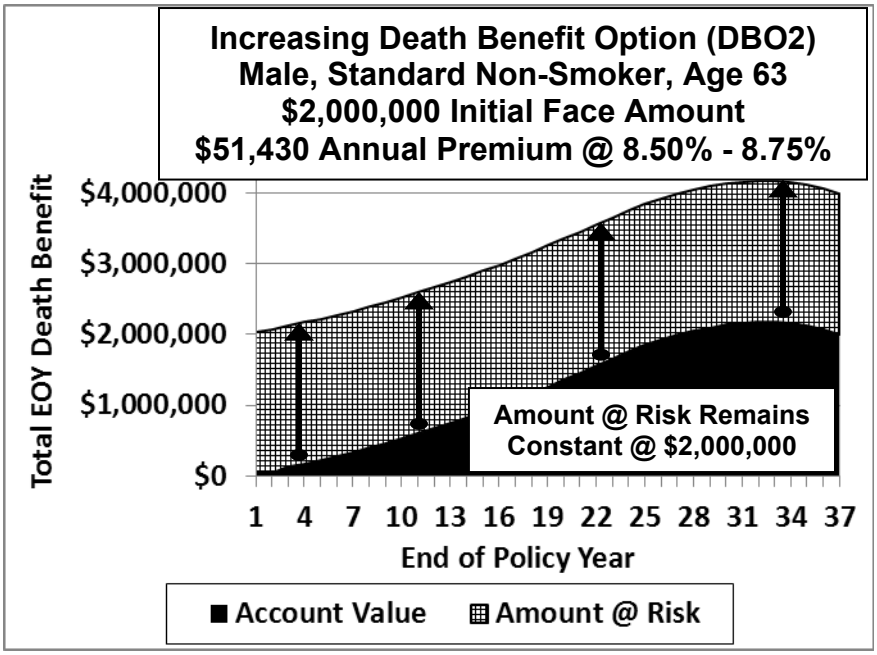
Most VUL insurance policies offer at least two basic death benefit options – the Level Death Benefit Option, usually characterized as DBO1, and the Increasing Death Benefit Option, usually characterized as DBO2. This latter one is not as common but perhaps is easier to explain and understand. With an Increasing Death Benefit Option (DBO2), in the event of the death of the insured, the death benefit would include whatever the policy cash value was at that time paid in addition to the policy's face amount. On the other hand, a Level Death Benefit Option (DBO1) would simply pay the policy's face amount, inclusive of the cash value.[10] The difference is significant. The choice of the death benefit option is the determinative factor on the "amount at risk" (the difference between the policy face amount and the cash value) which is the basis for calculating the monthly deduction that is taken for the COI charges and therefore affects the amount of the policy's resulting cash value.[11]

The following graphs highlight the difference. Both assume a standard, non-smoker male, age 63, with a $2,000,000 death benefit, typical current

10. A policy with a $2,000,000 face amount (DBO2) and cash value of $350,000 on the date of death would pay a total death benefit equal to the sum of these two amounts, $2,350,000. With DBO1, the death benefit is just $2,000,000.

11. There are other variations of death benefit options, e.g., the Return of Premium Option (DBO3) simply returns the cumulative premiums paid in addition to the policy's basic death benefit and is often used in certain split dollar plans.

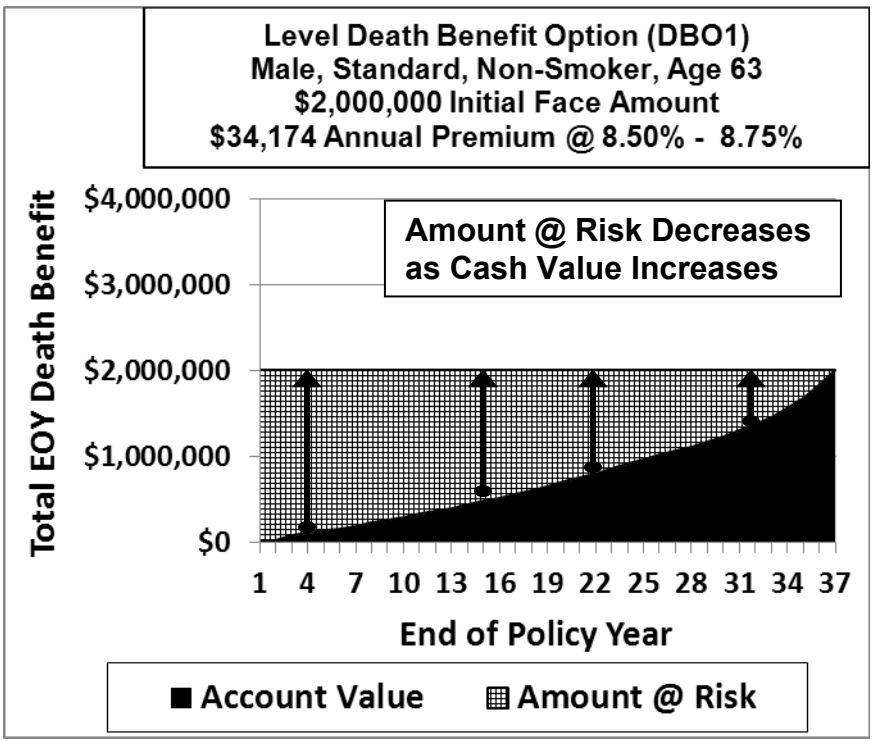
expense charges, and an assumed annual interest credit that increased from 8.50% to 8.75% in the 16th year. The first graph illustrates DBO2 (increasing) under which the monthly COI charge deduction is based on a constant "amount at risk" (always $2,000,000). The COI charge increases each year because the COI rate/per $1,000 increases each year. In the later years, the COI charges can become quite substantial, making the cash value work that much harder to ensure it will always cover those increasing charges. The illustration software "solved" the $51,430 annual premium (i.e., what annual premium "endows" the policy with a $2,000,000 cash value at age 100 assuming current cost factors and investment returns).[12]



On the other hand, a "level" death benefit (DBO1) presents a completely different pattern as displayed by the following graph. Under this premise, as the cash value increases (as a result of premium payments and investment earnings), the "amount at risk" (i.e., the difference between the face amount

12. VUL illustration software is often asked to solve for a premium assuming a specified objective (in this case a total cash value amount of $2,000,000), at a specified duration (in this case, at the end of 37 years), while usually assuming current cost factors and a current assumed investment return (in this case, 12.0% gross).

and the cash value) decreases, which has the effect of slowing the increase in COI charges. The amount of the COI monthly deductions may increase from one year to the next, but not nearly as quickly as with a DBO2 death benefit option where the "amount @ risk" always remains constant. All things being equal, the level death benefit will have larger cash values. In this instance, the software "re-solved" for a lower annual premium ($34,174) that endowed the policy face amount with a $2,000,000 cash value at age 100 assuming current cost factors and assumed investment returns.

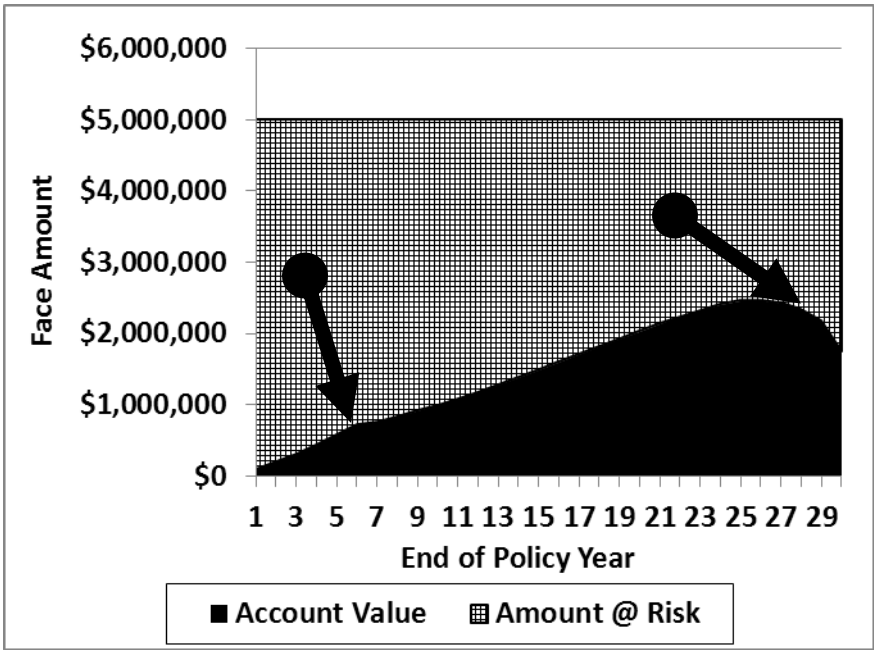


Limitations and Risks with How VUL Policies Are Illustrated and Sold

Most VUL policies are sold using a sales illustration generated by the life insurance company's proposal software. Current regulations require a VUL sales illustration to include a set of projected values and benefits that assume a 0.0% return and guaranteed (maximum) loads and charges. While every VUL policy must specify its guaranteed loads and charges, the focus of most sales illustrations is usually on the projection of values and benefits that

assumes a positive gross investment return (as much as 12.0%) and the policy's ***current*** loads and charges.

The following graph stems from an illustration used to sell an actual SVUL policy to a married couple (both age 70, both considered to be "standard" non–smoker risks), with a $5.0 million face amount (DBO1), an on-going annual premium of $125,000 in years 1-6 ($0 in yrs 7+), and a fairly typical set of loads and charges. Despite the absence of any premium outlay after the 6th year, and despite increasing COI charges, this sales illustration, with an assumed gross investment return of 12.0%, depicted the policy continuing through the 30th year (their age 100).[13] But the escalating COI charges in the outlying years reverses the trend and begins a downward spiraling pattern of illustrated cash values (after the 26th year).



There are several critical issues regarding the way this particular SVUL policy (and most VUL / SVUL policies for that matter) are illustrated and

13. The assumed investment management fee (.66%) and the policy's initial M&E risk charge (.75%) subdues the 12.0% assumed "gross" investment yield to an initial "net" investment return of 10.59%.

sold that can adversely affect the ability of the policy to sustain itself over its anticipated duration (maturity or payment of the death benefit):

- 1) Policy owner actions regarding premiums, face amount changes, and cash values;
- 2) Company actions regarding current COI rates and other loads and charges;
- 3) Contract verbiage may cause policy to lapse on the basis of its cash surrender value;
- 4) FINRA currently permits an illustrated gross investment return of up to 12.0%[14]; and
- 5) The sales illustration usually assumes a constant investment return every year

- 1) There are certain policy owner actions that would affect the original premise of a VUL sales illustration. For example, the policy owner might take extra advantage of VUL's inherent flexibility and skip a few premiums, or pay a lower amount. Either of these actions would imply a corresponding increase in subsequent premium outlay in order to offset their negative impact on the policy's ability to sustain itself until its ultimate disposition. Similarly, a VUL policy presents any number of opportunities for the policy owner to increase the life insurance death benefit, usually after submitting evidence of insurability. If that increase is not accompanied by a corresponding increase in premium outlay (a higher annual premium and/or a longer duration of anticipated premium payments), then it will be more difficult to maintain the policy in force since the policy's cash value account would be charged with a larger COI deduction. A partial withdrawal of the policy's cash values would obviously leave the policy with less cash value to cover the monthly deductions.[15] And finally, a policy loan also affects the original premise, since it usually means a lower interest crediting rate on the cash value collateralizing the loan, and the loss of the investment return that might otherwise have been achieved.[16]

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14. On 10/20/09, FINRA published a proposed rule change (SR-2009-070) regarding variable life insurance sales illustrations. Among the proposed changes was a new maximum assumed gross investment return of 10.0% (reduced from 12.0%). As of 4/1/12, this proposed rule change had still not been implemented.

15. Partial withdrawals do not increase the amount at risk because the policy's face amount would decrease by a corresponding amount equal to the amount of the partial withdrawal.

16. Interestingly enough, policy loans are actually a good defensive measure against falling equity markets because the life insurance company moves the borrowed

- 2) The life insurance company usually reserves the right to increase any of its ***current*** policy loads, rates, and charges (provided their current level is lower than the contractually guaranteed maximum ceiling). In most instances, the company can do this any time it chooses, for any reason it wants. Any gap between a particular cost factor's current amount and its contractually guaranteed maximum amount provides the company with some "wiggle" room if it needs to recover more expenses, improve profits, or offset losses. The risk of course is that the company does just that – increases some or all of these loads, rates, and charges, either incrementally, or precipitously up to the contractually guaranteed maximum ceiling. Higher loads, rates, & charges simply mean lower actual cash values. For example, in the case cited above, the illustration assumed a current sales charge of 7.75% for the first 20 years, and 5.75% thereafter. This kind of charge is very typical – it helps the insurance company recover premium taxes (state and federal) and part of its commission expenses. But the policy specified a guaranteed sales charge of 7.75% in all years and reserved the company's right to increase the current 5.75% after the first 20 policy years up to 7.75%.[17]

  Virtually all VUL policies make monthly deductions from their cash value. The primary monthly deduction from the policy's cash value is the cost of insurance (COI) charge that recovers the cost of providing the life insurance protection in the first place. The COI charge is the result of multiplying the current COI rate/per $1,000 (corresponding to the insured's gender, attained age, and risk classification) by the policy's "amount at risk" (usually the difference between the face amount and the cash value (i.e., the pure amount of insurance). Every VUL policy contains a schedule of its maximum guaranteed COI rates/per $1,000. In most instances however, the insurance company illustrates a proposed policy and administers an in-force policy using a "current" schedule of COI rates/per $1,000 that is usually much less (oftentimes 40–50% less) than the guaranteed rates. COI rates/per $1,000 usually increase annually, and COI charges ultimately become the largest component of the monthly deductions. Since life insurance companies are not inclined to revise the schedule of their current COI rates very often, most

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money from the separate accounts (on a pro-rata basis) into the policy's fixed account where it earns a fixed interest rate, usually at some small spread lower than the interest rate charged on the loan.

17. As it turned out, this company decreased the current sales charge to 6.25% beginning in the policy's 3rd year.

revisions that have occurred have been increases (with some notable exceptions), either in anticipation of worsening mortality experience, or in order to achieve greater expense recoveries (i.e., larger profits) from the product line. An upwards revision to a policy's current schedule of COI rates means that the underlying cash values must work that much harder in order to maintain the life insurance benefit provided by the policy. Other monthly deductions from a VUL policy's cash value include administrative charges, face amount charges, and the cost of other benefits (e.g., disability waiver of premium). The illustration cited above assumed a monthly administrative charge of $30 for years 1-5 and $10 for years 6+ (not at all atypical, but in this instance, both were also contractually guaranteed). This illustration also assumed a current (and guaranteed) monthly face amount charge which amounted to 52¢/per$1,000 of the policy face amount for years 1-7.[18]

- 3) The surrender charge provisions within most VUL/SVUL policies help insurers recover initial expenses, discourage early surrenders and face amount reductions, and limit the amount of partial withdrawals and policy loans. But UL policies may also ask their surrender charge schedule to play a key role in determining when the insurance company would invoke the policy's grace period provisions and finally lapse the policy for insufficient value to cover the monthly deductions. The traditional paradigm regarding such a lapse is really quite simple — as long as the policy's cash value (or fund value, or account value) can cover the monthly deductions, the life insurance coverage (and any other benefits that are being provided by the policy) remains in force. Perhaps that paradigm was never entirely valid to begin with, since as many as half of all existing VUL policies have verbiage that invokes the policy's grace period provisions (and therefore permits the company to lapse the policy) on the basis of its cash surrender value (e.g., when the fund value, ***minus the applicable surrender charge***, can no longer cover the monthly deductions).[19]

  That kind of provision is counterintuitive to most policy owner perceptions. If a VUL policy has plenty enough cash value to cover the

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18. That charge is determined as follows: $.52 x 5,000 = $2,600 / month, or $31,200 each year (just during yrs 1-7).

19. This issue was the subject of an article authored by Mr. Affleck and published in the May 2006 issue of *Journal of Financial Service Professionals* – "Lapsing on Surrender Values: Counterintuitive to Most Perceptions." There is an abstract of this article on Mr. Affleck's website, and a reprint of this article is available upon request.

monthly deductions, why would a life insurance company then subtract out the policy's current surrender charge to determine sufficiency, particularly when the policy owner has no intention of surrendering the policy? Quite simply, "surrender value" lapsing ensures that the life insurance company always gets its surrender charge in the event of an involuntary lapse for insufficient value. In other words, the company still recovers those expenses that would otherwise have been either 1) recovered through actual surrender charges assessed when the policy owner surrendered the policy, or 2) amortized over the early policy years through other policy cost factors.[20]

- 4) Current FINRA regulations permit VUL sales illustrations to project values and benefits assuming an annual "gross" investment return of up to 12.0%. In fact, that is how VUL policies are usually illustrated and sold, including the SVUL illustration linked to the earlier graph. But regardless of the gross investment return assumed in the illustration, that gross rate is subdued by two separate cost factors unique to VUL products. The first is an assumed investment management fee. Every separate account has its own investment management fee that recovers the expenses of managing the investments underlying that separate account. This management fee is reflected in each separate account's daily unit value (i.e., it comes off the top of whatever investment performance that is experienced by that particular separate account). This fee might be as little as .25% for something relatively simple like a money market separate account, or as much as 1.50% for something more complex like a separate account investing primarily in foreign energy stocks. In this case, the sales illustration assumed an "average" investment management fee of .66%.

  The second cost factor unique to VUL products is the Mortality & Expense (M&E) Risk Charge (usually ranging from .50% to 1.0%). This charge will usually be reflected in each separate account's daily unit value (unless it is included among the monthly deductions discussed earlier). In this instance, the illustration assumed a "current" monthly account value M&E Risk Charge of .0625% (annualized to .75%) in all years. The M&E Risk Charge recovers for the company a "spread" between the separate accounts' actual performance and how much of that

20. In 2008 (when S&P 500 index had a -37.0% loss), at least one company actually amended its VUL contracts with an endorsement that essentially changed each policy to an account value lapse premise, thereby avoiding inadvertent surrender value lapses caused solely by the huge market losses their life insurance policies were experiencing.

performance gets credited to the policy. After reflecting an assumed investment management fee of .66% and the policy's current M&E Risk Charges of .75%, the 12.0% gross investment return assumed by this SVUL illustration was subdued to a "net" rate of 10.59% for all years.[21]

Generally speaking then, the gross investment return assumed in a VUL illustration is reduced to a "net" rate that is .75% to 2.50% lower because of the assumed investment management fee and the policy's M&E risk charge. In other words, an assumed gross investment return of 12.0% would be subdued to 9.50%–11.25%. But even a net rate of 9.50%, projected over a 30-40 year time frame produces a very enticing package of projected values and benefits. Indeed, a track record of 9.50%/yr would be envied by most professional mutual fund (and separate account) managers. But more to the point however, if the illustration software has assumed a gross investment return of 12.0% to "solve" for a premium (not at all uncommon with VUL), then the resulting "solved" premium may not be able to sustain the policy unless the aggregate separate account performance achieves a return of 12.0% or more. And even then, as we will see in the next section, it is the pattern of market "ups and downs" that is ultimately more controlling. In fact, the gyrations of the equity markets and the huge negative return in 2008 (-37.0%) have actually caused some companies to cap their maximum assumed illustration rate at 10.0%. Indeed, some industry practitioners, including this author, feel a downward adjustment by FINRA to the current maximum rate of 12.0% is long overdue.

- 5) Regardless of the gross investment return assumed in VUL sales illustrations, most illustrations are fundamentally flawed by the assumption of a constant investment return for each and every year. Whatever the illustration assumes as a gross investment return (be it the maximum allowable 12.0% rate, or something more conservative such as 10.0% or even 8.0%), that assumption is usually repeated in each year of that illustration. The problem with such constancy built into the sales illustration is that it ignores the key component in the product's generic name – variable. If there is one certainty regarding the investment returns of a VUL policy, it is that they will never be constant from one year to the next. In fact, depending on the mix of separate accounts and their underlying performance, the investment returns may vary

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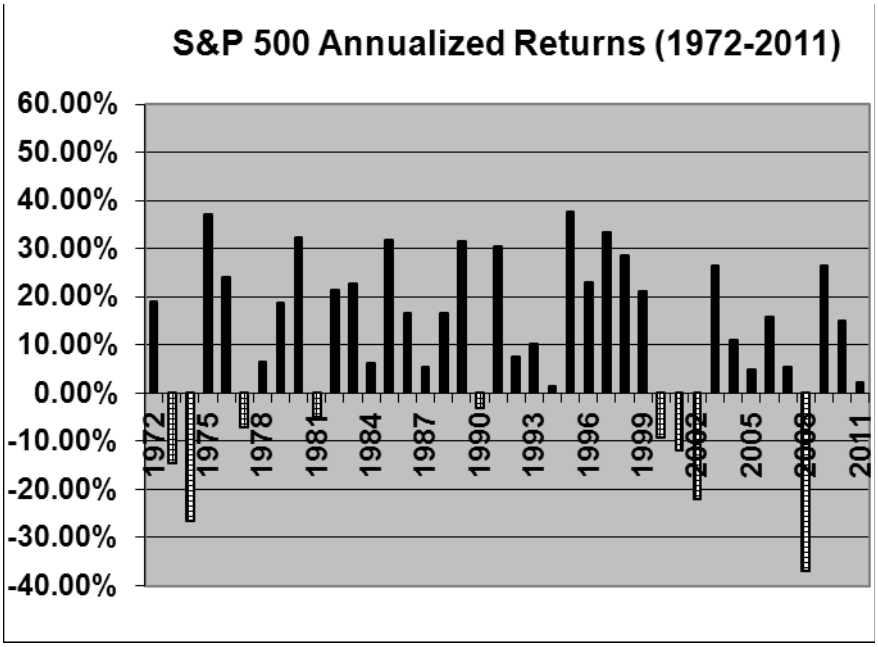
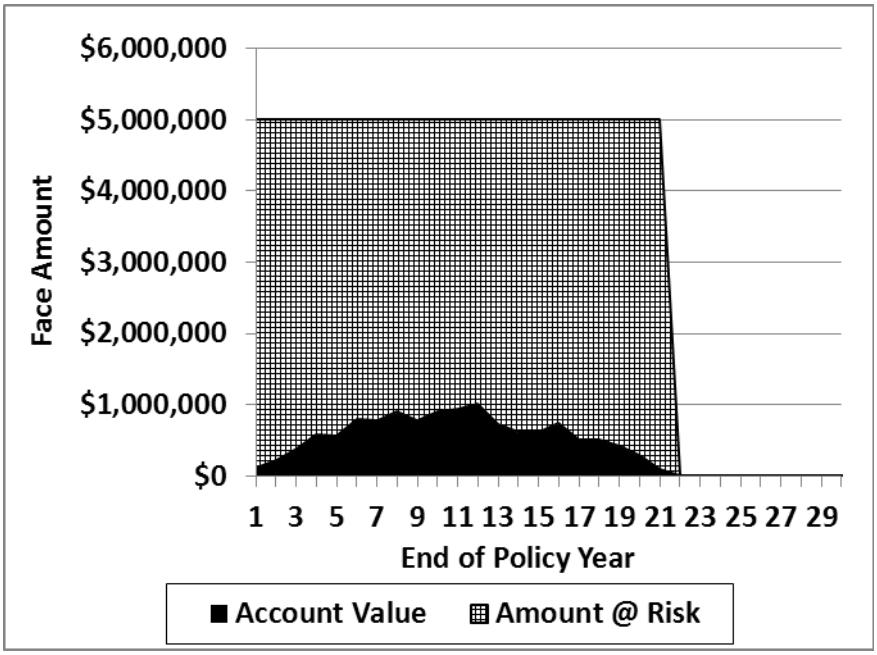
21. The "net" rate is determined by subtracting the sum of the investment management fee and the M&E risk charge (.66% + .75% = 1.41%) from the gross rate as follows: 12.0% - 1.41% = 10.59%. [NOTE: The company reserved the right to increase the M&E risk charge to .0833% (annualized to 1.0%) at any time.]

drastically, between occasionally very positive returns and occasionally very negative returns. That variability is demonstrated in the following graph that portrays the annualized returns for the S&P 500 Index for 1972-2011 (including the virtually unprecedented –37.0% negative return in 2008). This degree of variability (particularly the negative returns) can wreak havoc on a VUL policy, which must maintain a generally increasing cash value in order to cover its generally increasing pattern of COI charges.



We can test the sensitivity of a particular set of input parameters and cost factors to a randomized pattern of variable investment returns. The following graph depicts how the same SVUL policy described above would have fared under one randomized set of S&P 500 returns from 1954 – 2011 assuming the same input parameters regarding premium and current cost factors. Under this particular sequence of randomized S&P 500 investment returns, the aggregate investment performance failed to keep pace with the monthly deductions. There were just too many negative returns and not enough premium outlay and positive investment performance to offset the pattern of accelerating monthly deductions. In the absence of drastic increases in premium outlay and/or an increase in the number of premium payments, the life insurance company would end up lapsing the policy,

sometime during the 22rd policy year (at their age, 91), for insufficient value to cover the monthly deductions.

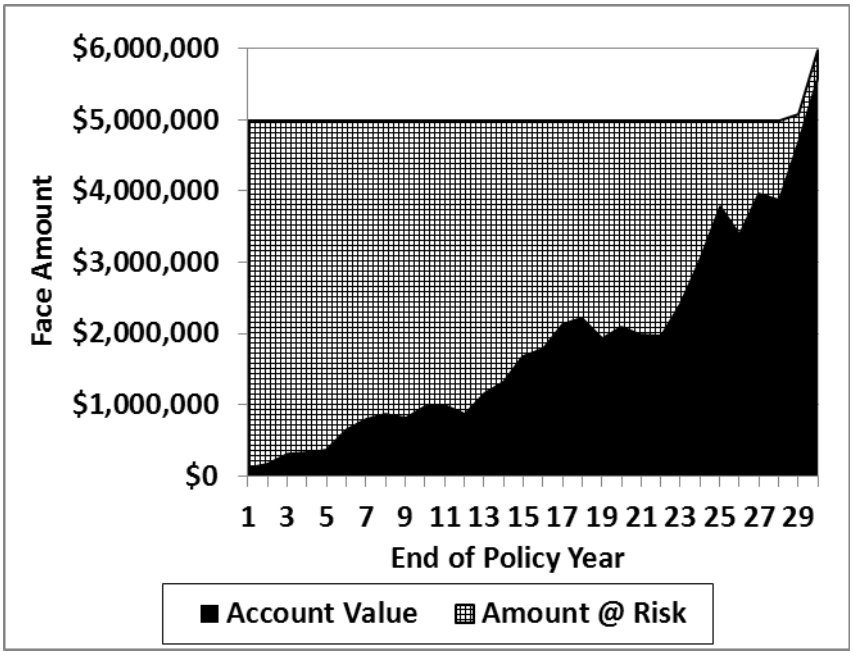


While this kind of analysis is helpful, the following facts must also be acknowledged –

- a different set of assumed S&P 500 returns could produce a dramatically different result
- a multiple set of randomized returns would produce a wide range of different results
- some of those randomized return sets generate enormous values

The following graph portrays the result of a different randomized pattern of S&P 500 returns but with the same inputs regarding premium outlay (i.e., six annual premiums of $125,000) and the same current cost factors. The result is a dramatically different picture than depicted by the preceding graph (i.e., the illustrated account value undergoes the inevitable "ups and downs" but a generally increasing pattern of increases over the 30-year time frame). This graph demonstrates the "reverse" compounding effect of the COI rates being charged against the "amount at risk." If the pattern of variable investment returns is generally favorable, then the resulting increase in cash value diminishes the amount at risk; thereby lessening the amount of the COI

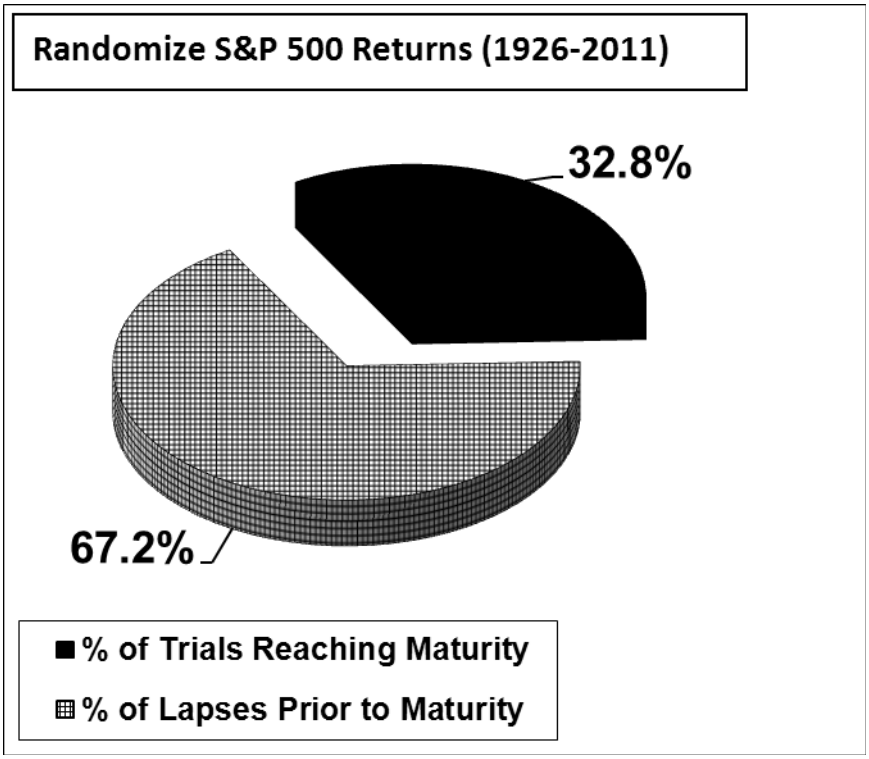
charge that ends up being deducted, which in turn diminishes the amount at risk for the following month's deduction, and so on and so on.[22]



In fact, we can employ "Monte Carlo" testing to assess the likelihood of a particular VUL illustration staying in force (and thereby maintaining the life insurance death benefit in force) until maturity or some other arbitrary point in time. The process makes multiple projections, or iterations, each one assuming a different randomized pattern of S&P 500 returns (from the period of time running from the very first return in 1926 up through 2011), and each one reflecting the proposed premium pattern and the policy's set of current cost factors. The process keeps track of each iteration, while also providing

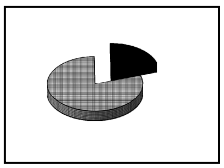
22. This graph actually shows the death benefit increasing in the 29th year. In accordance with IRS Code §7702, particularly with "DBO1 policies," when the fund value starts to approach the policy's face amount, the insurance company will automatically start increasing the face amount to preserve a certain amount of "corridor" between them, thereby allowing the policy to continue satisfying the definition of a "life insurance policy." Satisfying that definition is important if the policy is to enjoy the significant tax advantages afforded to life insurance (e.g., no current income taxation on the inside buildup of cash values, and the death benefit being completely income tax-free to the beneficiary).

extremely useful data along the way. The following graph depicts the results of 1,000 trial iterations, all of which assume the identical input parameters and the identical cost factors used in the original illustration. Of these 1,000 trial iterations, only 328 sustained the policy's death benefit through the end of the 30th policy year (policy maturity at their age 100). In other words, this policy, with the given inputs regarding premium, benefits, and cost factors, has about a 33% chance of sustaining itself through to the policy's scheduled maturity in 30 years, what we can refer to as a 33% Success Quotient. Not surprisingly, the average (annualized) rate of return (ROR) among these successful iterations was 12.5%. But not all of the successful iterations had high RORs – indeed, the lowest ROR among the successful iterations was just 7.6%.[23]

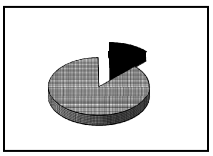


23. Rate of Return (ROR) represents the annualized interest rate earned by a series of deposits (in this case premium payments) to arrive at a specified amount (in this case the policy's cash value) over a specified time frame (in this case for 30 years).

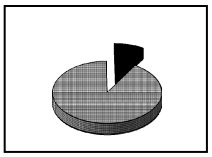
The balance of these trial illustrations (67.2%) failed to sustain the $5.0 million life insurance death benefit through the end of the 30th policy year (i.e., they lapsed for insufficient value to cover the monthly deductions). The first lapse occurred in the 18th policy year (their age 88), and the average lapse occurred in the 24th year (their age 94). The average annualized rate of return (ROR) among the lapsed iterations was 7.4%. Interestingly enough, 92 of these 672 lapses (13.7%) had annualized RORs for the period of time they did sustain the death benefit that actually exceeded the original illustration's initial assumed net rate of 10.59%. In fact, one failed iteration had an annualized return of 13.9%. By the same token, 72 of the 328 successful maturities (22%) had annualized RORs that actually fell short of that same 10.59% net rate. It all depends on when the negative returns occur.



We can also run other "Monte Carlo" tests to reflect adjustments to the S&P 500 returns that are used. For example, we can reduce each S&P 500 return by a given percentage to reflect the impact of the separate accounts' investment management fee and the insurance company's "M&E" Risk charge. Reducing each randomized S&P 500 return by 1.0% reduces the Success Quotient to **20.2%**. Obviously a larger reduction to the S&P 500 returns would reduce the Success Quotient even further.

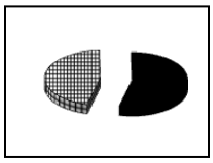


Some VUL policy owners feel a degree of security by allocating a percentage of their premium payment to the policy's fixed account. The thinking here is that if some of their premium payment is allocated to the fixed account (where it will always earn at least 3-5%), then when the separate accounts do suffer negative returns, the overall impact on the policy's cash will be "less negative." But that feeling of security turns out to be somewhat misguided. If we continue to reduce each randomized S&P 500 return by 1% and now also allocate 20% of each payment to the fixed account (assumed to earn 4.0%), the Success Quotient is reduced to just **12.9%**. While allocating a portion of each premium to a fixed account succeeds in lessening the degree of negative returns, it also results in an "unintended consequence" – most of the positive returns end up less positive as well.



But there are other adjustments that can be made that add another twist to this risk cocktail. For example, we can run another series of "Monte Carlo" tests to reflect an upwards adjustment to the current monthly COI rates/per $1,000 that underlie the original sales illustration (while still absorbing the 1% reduction to the randomized S&P 500 returns and

allocating 20% of each premium to the fixed account). Under this premise, increasing COI rates by just 15% reduces the Success Quotient to **8.8%**.



While it would be unusual for a company to increase its COI rates/per $1,000 up to their contractually guaranteed maximum levels, such an action would not be unprecedented. To assess the impact of that possibility, we can run still another series of "Monte Carlo" tests to reflect the 1% reduction to the randomized S&P 500 returns, the 20% allocation to the fixed account, but now with an increase of the COI rates to their maximum levels. Under this premise, we can determine that paying a higher annual premium of $140,000 for 15 years increases the Success Quotient to **54.0%.**

Of course, another alternative strategy is to simply "wait and see" – watch what happens and make adjustments to the amount of annual premium and/or the number of premium payments along the way. That is not an altogether bad strategy, provided it starts early on in the process, is consistently maintained, and actually instigates upwards adjustments in premium payments when and as needed. But waiting too long to implement this strategy or employing it inconsistently brings, to mind the message of a not-so-easily-forgettable oil filter commercial, making the case for the immediate use of the product, "you can pay me now, or, you can pay me later." Implicit in that cautionary tale is the notion that paying later (as a consequence of either not buying an oil filter earlier, or not adequately funding a VUL policy earlier) could mean "paying a lot more later."

A Revised Illustration for Variable Universal Life

Whenever an agent uses a sales illustration for Whole Life or Universal Life, current regulations require the insured/applicant's signature, essentially acknowledging receipt of a complete illustration and various understandings regarding any "non-guaranteed elements." Quite often however, the insurance company issues the policy differently than was depicted on the original sales illustration — perhaps with a change in face amount, or with an additional benefit added (or deleted), or with a less favorable risk classification than had been originally assumed. In these circumstances, current regulations require the agent/company to present a revised illustration to the owner/applicant (for signature), so that he/she/they can assess the impact of the change on the policy's anticipated performance (both guaranteed and otherwise).

These current regulations dealing with life insurance sales illustrations are the by-product of a Task Force commissioned by the National Association of Insurance Commissioners (NAIC) in 1996.[24] But these regulations, including those pertaining to this provision, specifically exempted variable life insurance from their purview because the Task Force could not resolve issues dealing with guaranteed values in VUL illustrations.[25] Nevertheless, in these situations, most companies still require a revised illustration for VUL policies because it is the right and proper thing to do (i.e., it has essentially become a ***de facto*** life insurance industry standard even though not required by regulation).

But not all companies and agents adhere to that standard. VUL policy owners who, as a result of the policy's underwriting process, end up with a less favorable risk classification than was originally illustrated, may be unaware of the impact of that less favorable risk classification on the illustrated (and actual) performance of their life insurance policy. In these instances, the life insurance company almost certainly issued the policy with a higher set of COI rates/per $1,000 (both guaranteed and current) than were assumed in the original sales illustration. The author is familiar with one FINRA arbitration proceeding on this very point in which the defendant agent did not feel compelled to provide a revised illustration, and the defendant company did not feel compelled to compel him to do so either – because the regulations did not require one. If a revised illustration had been provided in this case, there may have been a different outcome.[26]

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24. These regulations were adopted by virtually all states and became effective in 1998. They are quite specific in this regard - "Section 191–14.9(1) If a basic illustration is used by an insurance producer or other authorized representative of the insurer in the sale of a life insurance policy and the policy is applied for as illustrated, a copy of that illustration, signed in accordance with these rules, shall be submitted to the insurer at the time of policy application. A copy shall also be provided to the applicant. If the policy is issued other than as applied for, a revised basic illustration conforming to the policy as issued shall be sent with the policy. The revised illustration shall conform to the requirements of this rule, shall be labeled "Revised Illustration" and shall be signed and dated by the applicant or policy owner and producer or other authorized representative of the insurer no later than the time the policy is delivered. A copy shall be provided to the insurer and the policy owner."

25. That Task Force resolved to address the issue at a later date, but so far (16 years later) has failed to do so.

26. This issue was the subject of an article authored by Mr. Affleck and published in the July, 2007 issue of *Journal of Financial Service Professionals* – "A Revised Illustration for Variable Universal Life: The Right and Proper Thing to Do." There

In addition to the revised illustration issue, there are several other VUL sales illustration issues that could be addressed if such a Task Force were to be reconvened by the NAIC (not necessarily a complete list, but perhaps a place to start):

- requiring companies to notify policy owners, in the policy's annual statement, of any adverse change(s) in non-guaranteed elements during the prior year that could affect the policy (as required in the regulations that currently apply to WL and UL);
- lowering the maximum assumed gross investment rate to something less than 12.0%;
- resolving inconsistencies in how various companies characterize their policies' "net" rate (i.e., should it be net of just the assumed investment management fee, or net of both that and the policy's M&E Risk Charge?);
- considering the role played by the actual historical performance of separate accounts;
- assessing the value of multiple variable return simulations, e.g., "Monte Carlo" testing;
- determining how best to help consumers understand:
    1) the inherent risks in VUL;
    2) the impact of changes in non-guaranteed elements (e.g., COI charges);
    3) no-lapse guarantee provisions applicable to VUL policies; and
    4) extended maturity options (beyond age 100).

Conclusion

The possibility of substantial capital appreciation with a variable life insurance policy, over the long-term, may be a suitable trade-off against the risk of market losses. For that reason, most life insurance professionals regard variable universal life (VUL) or survivorship variable universal life (SVUL) as a perfectly legitimate choice for younger insureds who have a longer time horizon to enjoy the benefits of life insurance protection and who

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is an abstract of this article on Mr. Affleck's website, and a reprint of this article is available upon request.

are also interested in accumulating potentially large amounts of cash value on a tax-deferred basis inside their life insurance policy. But VUL/SVUL policies must be more than adequately funded in order to withstand the inevitable swings in varying investment performance, and those extra risks outlined above must be thoroughly understood. On the other hand, older insureds/married couples usually have shorter time horizons and are usually not so interested in developing large amounts of cash value in their life insurance policies, other than to fund adequately the anticipated monthly deductions. Instead, they usually want to put the policy into an irrevocable life insurance trust (ILIT), pay as little as possible for it, and simply wait for the insured/second insured person to die. Accordingly, most life insurance professionals, including this author, generally regard variable universal life (VUL) or survivorship variable universal life (SVUL) as an inappropriate product design for the older insured/married couple.

NEW RULE, OLD REQUIREMENTS: WHY THE NEW FINRA SUITABILITY RULE CODIFIES PRE-EXISTING INDUSTRY STANDARDS

Shrutih Tewarie[1]

I. INTRODUCTION

On November 17, 2010, the SEC approved FINRA's motion to adopt a new set of requirements that would expand and redefine FINRA's Suitability Rule.[2] FINRA drafted the new rule as part of the initiative to develop a consolidated FINRA Rulebook.[3] The new rule was initially slated to go into effect on October 7, 2011.[4] The securities industry, however, responded adversely to this implementation date, and FINRA member firms argued that this date provided them with too little time to make the necessary adjustments to meet the requirements of the new rule.[5] Consequently, on

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1. Shrutih Tewarie received her J.D. from Cornell Law School in 2012 and her B.A. in Quantitative Economics and International Relations from Tufts University in 2009. She is an incoming associate at the Boston office of Foley Hoag LLP. Shrutih would like to thank Professor Jacobson at the Cornell Securities Law Clinic for all his advice and guidance in writing this article. She would also like to thank her parents and her brother for their invaluable support, and her friend Saad Rizwan for his indispensable help and encouragement.

2. FINRA, Regulatory Notice 11-25: New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations 1 (May 2011), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123701.pdf.

3. FINRA, Regulatory Notice: 09-25: Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligation*s* 1 (May 2009), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118709.pdf.

4. FINRA, Regulatory Notice 11-02: SEC Approves Consolidated FINRA Rules Governing Know Your Customer and Suitability Obligations 1 (Jan. 2011), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.

5. *See* Regulatory Notice 11-25, *supra* note 2, at 2.

January 10, 2011, FINRA announced that the new implementation date for the rule would be July 09, 2012.[6]

This article will analyze the new Suitability Rule, and will explain why the rule is not that new after all, but for the most part codifies already existing industry standards. Part II of this article will summarize and explain the new rule. Part III will summarize industry reaction to the new rule and analyze the changes that FINRA member firms will have to undergo to meet their obligations under the new rule. Part IV will argue why the new rule simply codifies existing industry standards. Part V is a conclusion discussing the impact of the rule on suitability claims brought by investors.

II. FINRA RULE 2111: THE NEW SUITABILITY RULE

FINRA Rule 2111 is modeled largely after former NASD Rule 2310.[7] Rule 2111 requires that firms and their associated persons "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through … reasonable diligence [by the firm or broker] to ascertain the customer's investment profile."[8]

Rule 2111 impacts firms' suitability obligations in three meaningful ways. First, member firms must now meet suitability obligations when they provide advice regarding "investment strategies."[9] More specifically, supplementary material to Rule 2111 explains that the term "investment strategy" should be interpreted broadly, and includes "an explicit recommendation to hold a security or securities."[10] Previously, suitability obligations would be triggered only when there was a recommendation to buy or sell a security and a resulting investment transaction occurred.[11] The

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6. *See id*.

7. Regulatory Notice 11-02, *supra* note 4, at 2.

8. *Id*.

9. FINRA Rule 2111,FINRA Manual, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 (last visited Sept. 5, 2012).

10. *Id.*

11. Gregory Kilby & Melvin Moseley, *New FINRA Rules on Knowing Your Customer and Suitability*, WARNER NORCROSS & JUDD LLP (Feb. 1, 2011),

new rule is triggered when there is a recommendation, regardless of whether an actual transaction follows, and regardless of whether the recipient of the recommendation is an existing customer of the member firm.[12] While the rule does not specifically define what constitutes a recommendation, several factors are relevant in determining whether conduct amounts to a recommendation, including the content, context, and manner of presentation of a communication.[13] The more a communication about a strategy or security is tailored to the customer, the more likely the communication will be regarded as a recommendation.[14] Further, a communication can constitute a recommendation regardless of whether the communication came from a person or a computer program, and whether it was made in person or over the phone.[15] Additionally, even though some communications may not be deemed recommendations when viewed individually, they can constitute a recommendation when viewed in the aggregate.[16]

Second, the new rule has expanded the list of relevant factors firms and associated persons must consider when they ascertain a customer's investment profile.[17] Former NASD Rule 2310 required only that firms make "reasonable efforts" to obtain information about a customer's financial status, tax status, investment objectives, and any such information "considered to be reasonable" in making a recommendation.[18] Under Rule 2111 however, firms should look to factors such as "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs [and] risk

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http://www.wnj.com/Publications/New-FINRA-Rules-on-Knowing-Your-Customer-and-.

12. *Suitability and Know Your Customer Rules: FINRA staff highlights FINRA Rules 2111 (Suitability) and 2090 (Know Your Customer)*, FINRA (Mar. 21, 2011) http://www.finra.org/Industry/Education/OnlineLearning/Podcasts/Suitability/P123368.

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. Kilby & Moseley, *supra* note 11.

18. *Id*.

tolerance…."[19] FINRA considers these factors generally relevant under the new rule, but the factors are not considered an exclusive list.[20] A firm must "use reasonable diligence to obtain and analyze" these factors, unless the firm "has a reasonable basis to believe" that one or more of the factors are not relevant for the customer's investment profile.[21] In such instances, the firm and the broker must document with specificity why they hold such a belief.[22]

Third, Rule 2111 requires that broker-dealers satisfy three different suitability obligations.[23] First, firms and their associated persons must make an objective inquiry to assess whether there is "a reasonable basis to believe, based upon reasonable diligence, that the recommendation is suitable for at least some investors."[24] Supplementary material to the rule notes that what constitutes reasonable diligence in determining reasonable basis suitability depends on and varies with the complexity and/or risks involved with the investment or strategy at issue.[25] The exercise of reasonable diligence must provide the broker with "an understanding of the potential risks and rewards associated with the recommended security or strategy."[26] A suitability violation occurs where a broker does not have such an understanding and still recommends a security.[27] Second, a broker must have a reasonable basis to believe that a certain recommendation is suitable for the customer.[28] Thus, the analysis shifts from a general finding that the investment or strategy is suitable for someone, to the second suitability analysis, which requires a finding that the recommendation is suitable for the specific customer. Third,

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19. FINRA Rule 2111(a), *supra* note 9. Even though Rule 2111 itself does not define each of the terms, "the terms are to be understood commensurate with their meaning in financial analysis." FINRA, Regulatory Notice 11-25, *supra* note 2, at 4.

20. FINRA Rule 2111.04, *supra* note 9.

21. *Id*.

22. *Id*.

23. *See* FINRA Rule 2111.05, *supra* note 9.

24. FINRA Rule 2111.05(a), *supra* note 9.

25. *Id*.

26. *See id.*

27. *Id*.

28. FINRA Rule 2111.05(b), *supra* note 9.

the broker must meet a quantitative suitability requirement.[29] Under this requirement, brokers must ensure that investment recommendations, even if suitable in isolation, are suitable and not excessive in the aggregate given the customer's investment profile.[30] Factors such as the turnover rate, cost equity ratio, and use of in-and-out trading in the account are used to determine whether there was excessive trading.[31] FINRA introduced this requirement to combat churning.[32]

III. INDUSTRY REACTION TO FINRA RULE 2111

When FINRA initially announced that it would amend the Suitability Rule, FINRA received more than 1,000 comments.[33] Industry reaction to the new rule has been very strong, with law firms, consulting companies, and financial writers all advising broker-dealers on how to deal effectively with and implement the new rule's requirements.[34] At first, several industry members suggested that FINRA delay implementation of the new rule in light of the requirements of the Dodd-Frank Consumer Protection Act of 2010 ("Dodd-Frank").[35] Dodd-Frank requires that the SEC study broker-

29. FINRA Rule 2111.05(c), *supra* note 9.

30. *Id*.

31. *Suitability and Know Your Customer Rules, supra* note 12.

32. Kilby & Moseley, *supra* note 11.

33. Seth Lipner, *FINRA's New Suitability Rule Doesn't Go Far Enough*, FORBES (Oct. 26, 2010, 02:30 PM), http://www.forbes.com/2010/10/26/suitability-rule-sec-intelligent-investing-finra.html.

34. *See e.g.* Kilby & Moseley, *supra* note 11; Michael Patterson et al., *Preparing For FINRA's KYC and Suitability Rules*, COMPLIANCE REPORTER (June 13, 2011), *available at* http://www.ey.com/Publication/vwLUAssets/CR-Preparing_For_FINRAs_KYC_and_Suitability_Rules/$FILE/CR-clarified-reprint.pdf; Suzanne Barlyn, *Brokerages Wrestle With New Suitability Rules*, WALL ST. J. (Apr. 18, 2011), http://blogs.wsj.com/financial-adviser/2011/04/18/brokerages-wrestle-with-new-suitability-rules/

35. *See* Letter from James Wrona, Associate Vice President and Associate General Counsel, FINRA, to Ms. Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, (Oct. 21, 2010)*, available at* http://www.sec.gov/comments/sr-finra-2010-039/finra2010039-23.pdf

dealer and adviser standards of care and several commentators requested that FINRA postpone any new rulemaking until "the parameters of any SEC rulemaking resulting from the [Dodd-Frank] study are clear."[36] Even though FINRA rejected these arguments, FINRA delayed the implementation of the rule until July 9, 2012, to allow firms additional time to comply with the new requirements.[37]

A. Substantive Concerns about the New Rules

FINRA member firms have raised several substantive concerns about the new rule. First, the new Suitability Rule's focus on individual recommendations raised much contention. In a comment letter to the SEC, one author stated that firms should not be required to justify why a recommendation, in isolation of other recommendations, meets the suitability criteria.[38] Instead, the commentator argued, suitability criteria should be analyzed only for the customer's entire investment portfolio because some "investors … may have several competing investment objectives that are best met by a fully diversified portfolio made up of securities of varying degrees of liquidity, risk, and anticipated holding periods."[39] Other firms expressed concern that the focus on whether individual recommendations are suitable will require them to revisit customer information over and over again, which imposes an onerous requirement on the broker-client relationship where interaction with the customer is less frequent.[40] One commentator even complained that requiring broker-dealers to consider an "inflexible set of factors [when making a recommendation] will lead to a static or formulaic approach that

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36. *Id.* at 2.

37. *Id.*; *see also* Regulatory Notice 12-25*:* Suitability: Additional Guidance on FINRA's New Suitability Rule 1 (May 2012), http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_25.pdf.

38. Letter from Dale E. Brown, President & CEO, Financial Services Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission 3 (Sept. 27, 2010), *available at* http://www.sec.gov/comments/sr-finra-2010-039/finra2010039-21.pdf.

39. *Id.* at 3.

40. *See* Barlyn, *supra* note 34.

could detract from firms' development of more dynamic and individualized approaches to suitability determinations."[41]

The new Suitability Rule's broad definition of "investment recommendations," which now includes recommendations to hold,[42] was also the subject of many comment letters. One firm expressed a concern that recommendations to hold securities for the long term would now be altogether problematic "since firms must be able to demonstrate, at any given moment, that recommended strategies are suitable."[43]

Even though the new rule has not gone so far as to establish a new uniform fiduciary standard for member firms and associated persons, the industry fears that the new rule comes uncomfortably close to doing so.[44] An SEC study recently recommended holding brokers to a fiduciary standard, and SEC Chairman Mary Schapiro has stated that the SEC intends to develop such a standard in the future.[45] Further, FINRA has stated that the Suitability Rule is "not inconsistent with a fiduciary duty [standard]" and that the rule is "actually a material part of a fiduciary duty in the context of advice or recommendations."[46]

B. Procedural Concerns about the New Suitability Rule

More than being concerned about the substance of the new rule however, many member firms have been distressed about the internal changes they will have to implement to meet the requirements of the new rule. Member firms have complained that they now have to amend new account forms to capture

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41. Letter from James McHale, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission 5 (Sept. 14, 2010), *available at* http://www.sec.gov/comments/sr-finra-2010-039/finra2010039-18.pdf.

42. *See supra* notes 9–16 and accompanying text.

43. Barlyn, *supra* note 34.

44. *Id.*; *see also* Melanie Waddell, *FINRA's New Suitability Rule Edges Closer to "Fiduciary": NAPFA Chairman,* ADVISORONE (July 16, 2012), http://www.advisorone.com/2012/07/16/finras-new-suitability-rule-edges-closer-to-fiduci

45. *Id*.

46. Letter from James Wrona to Elizabeth M. Murphy, *supra* note 35.

information for each of the new categories firms must consider while establishing a customer's investment profile under the new Suitability Rule.[47] After all, even though "[c]ompliance with suitability obligations does not necessarily turn on documentation of the basis for the recommendation,"[48] FINRA has stated that "to the degree that the basis for suitability is not evident from the recommendation itself, FINRA examination and enforcement concerns will rise with the lack of documentary evidence for the recommendation."[49] Firms have also complained that they will now have to change their internal systems to store the new categories of information, and ensure that the information is available to brokers throughout the lifetime of an account.[50] Even though many firms already ask for much of the information that is required under the new Suitability Rule, much of this information "doesn't reach a firm's back office technology systems, where it can be routinely analyzed and monitored."[51] Additionally, firms will have to ensure that internal policies and procedures, including supervisory procedures, conform to the new rule requirements.[52]

Member firms complained that these changes will create a lot of work for firm's compliance departments,[53] and carry huge costs.[54] One commentator noted that "the implementation of [the abovementioned] changes will require significant investment of financial, technology and human resources across the industry.[55]

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47. Letter from Bari Havlik, SVP and Chief Compliance Officer, Charles Schwab & Co., Inc., to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 1 (Sept. 9, 2010) , *available at* http://www.sec.gov/comments/sr-finra-2010-039/finra2010039-15.pdf.

48. Regulatory Notice 11-25, *supra* note 2, at 3.

49. *Id*.

50. *See* Letter from Bari Havlik to Elizabeth M. Murphy, *supra* note 47.

51. Barlyn, *supra* note 34.

52. Letter from Bari Havlik to Elizabeth M. Murphy, *supra* note 47, at 2–3.

53. Barlyn, *supra* note 34 ("Compliance departments will … be busy" because "[s]omewhere, somehow, every little step has to be evidenced …").

54. Letter from Bari Havlik to Elizabeth M. Murphy, *supra* note 47, at 3.

55. *Id*.

IV. THE NEW SUITABILITY RULE CODIFIES PRE-EXISTING INDUSTRY STANDARDS

Even though member firms argue that the new rule imposes onerous requirements, upon closer inspection, the new rule does not require firms to undertake any unreasonable obligations. In fact, the new rule simply seems to require that member firms perform suitability analyses under pre-existing industry standards. Focusing on the new suitability factors and the inclusion of "recommendations to hold" in the definition of investment strategies, the following sections will use administrative decisions and case law to highlight that the requirements of the new Suitability Rule are not that new or onerous after all.

A. Regulatory agencies have previously used the new suitability factors to determine the suitability of investments

The new Suitability Rule requires that industry members consider five specific factors, including "a customer's age, investment experience, time horizon,[56] liquidity needs,[57] and risk tolerance[58]" when they make a suitability determination.[59] These factors, however, are not a new development. As FINRA itself explicitly stated in a recent Regulatory Notice addressing the new Suitability Rule, the new suitability factors "largely codif[y] case law indicating that brokers generally should consider various customer-specific factors that NASD Rule 2310 did not explicitly

56. FINRA has defined the term "time horizon" as "the expected number of months, years, or decades a customer plans to invest to achieve a particular financial goal." Regulatory Notice 11-25, *supra* note 2, at 4.

57. Liquidity needs represent "the extent to which a customer desires the ability or has financial obligations that dictate the need to quickly and easily convert to cash all or a portion of an investment or investments without experiencing significant loss in value from, for example, the lack of a ready market, or incurring significant costs or penalties." *Id.*

58. Risk tolerance is defined as "[a] customer's "ability and willingness to lose some or all of [the] original investment in exchange for greater potential returns." *Id.*

59. The old rule only required that firms consider other investments, financial situation and needs, tax status, and investment objectives in making a suitability determination. Regulatory Notice 12-25, *supra* note 37, at 2.

reference."[60] This section will show that regulatory agencies have previously applied each of the new factors to determine whether a firm satisfied the preexisting suitability requirements.[61]

1. Customer's Age

In *In re PaineWebber Inc.*, a registered firm had sold long-term illiquid securities to elderly investors.[62] The Commission found that the transactions were unsuitable and too concentrated given the customers' ages.[63] Similarly, in *In re J. W. Barclay & Co.,* the SEC found that a member firm's registered representatives had engaged in margin trading in the accounts of several customers, who were mostly retired, lacking in investment experience, and had specifically expressed an interest in low-risk investments.[64] The SEC found that the recommendations were unsuitable in part because of the customers' ages.[65] These two opinions, among others,[66] demonstrate that the requirement that member firms and their associated persons consider a customer's age in making investment recommendations is not a novel development or a surprise to anyone in the industry.

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60. *Id.* at n.3.

61. This section will not address cases involving NYSE Rule 405, "Diligence as to Accounts." Although NYSE Rule 405 imposed broader duties on broker-dealers than FINRA Rule 2310, the rule governed only NYSE member firms. *See* NYSE Rule 405, available at http://rules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_5&manual=/nyse/rules/nyse-rules/.

62. PaineWebber Inc., Exchange Act Release No. 7257, 1996 WL 26594, at *14 (Jan. 17, 1996).

63. "The high concentrations of illiquid direct investments in accounts of conservative investors who needed liquidity were unsuitable in light of the customers' age, financial condition and investment objectives." *Id.*

64. J. W. Barclay & Co., Exchange Act Release No. 8202, 2003 WL 1093957, at *2 (March 13, 2003).

65. *Id.*

66. *See, e.g.*, Luis Miguel Cespedes, NYSE Hearing Board Decision 07-24, 2007 WL 4924697 (July 3, 2007) (finding that broker recommended and effected transactions in customers' account which were unsuitable in part because of the customers' age).

2. Customer's Investment Experience

Similarly, regulatory agencies have previously required that industry members consider a customer's prior investment experience before giving investment advice or effecting transactions in a customer's account. In *In re William Floyd Gibbs*,[67] a firm's former branch manager and former registered representative had traded aggressive and speculative securities in the accounts of customers who were retirees, had little investment experience, and were largely dependent on the accounts at issue for their income.[68] The hearing panel determined that the trades were unsuitable and specifically underlined the customers' lack of investment experience as a reason for the panel's finding.[69]

Slightly more than one year later, in *In re Luis Miguel Cespedes*, the NYSE hearing board found that a member firm's former registered representative recommended and effected transactions in customers' accounts that were unsuitable in part because of the customers' lack of prior investment experience.[70] Even though many of the customers had little to no investment experience and did not understand the nature of the recommended investments, the broker had invested the customers' assets in products that were highly volatile and risky.[71]

While these decisions are relatively recent, investment experience is not a recent suitability factor. For example, in a 1996 decision, the NYSE Hearing Panel held that the purchases of real estate partnership units for the accounts of retired customers with a limited educational background and minimal investment experience "were unsuitable in view of the customer[s]

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67. NYSE Disc. Action 2006-41, 2006 WL 1562347 (Mar. 27, 2006).

68. *Id*. at *3.

69. *Id.* at *4.

70. "[The former registered representative] recommended and effected, in over 20 accounts belonging to 20 individual customers, transactions— including transactions on margin—that were unsuitable in view of the customers' investment objectives, investment experience, or financial resources …." *Luis Miguel Cespedes*, NYSE Hearing Board Decision 07-24, 2007 WL 4924697, at *2 (July 3, 2007).

71. *Id.* at *4–12.

investment objectives, investment experience, and the financial resources in the customer[s] account[s].”[72]

These decisions demonstrate that member firms and associated persons were required to consider a customer’s prior investment experience even before the new Suitability Rule came into effect.

3. Time Horizon

In *In re Plase Michael Tansil Former Registered Representative*,[73] the NYSE Hearing Board expressly listed a customer’s time horizon as one of the factors that determine the suitability of a particular investment.[74] The former registered representative of a member firm had engaged in speculative trading in the accounts of customers who had little income and had conservative investor profiles.[75] The Hearing Panel held that the investments were unsuitable, and explained that “risk tolerance, income needs, and time horizon are relevant factors [in the Panel’s decision-making process], and the customer's level of education and financial sophistication may also be considered.”[76]

Prior to the adoption of the new Suitability Rule, FINRA already expressly required that industry members consider a customer’s time horizon to determine the suitability of investments in a variety of specific settings, including when dealing with elderly investors and when making investments in non-traditional Exchange Traded Funds (ETFs) and deferred variable annuities.[77] Specifically, in a 2007 Notice to Members, FINRA emphasized

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72. Larry Allen Trailor, NYSE Hearing Panel Decision 96-107, 1996 WL 681354, at *1–5 (Oct. 2, 1996). For a more complete discussion of this decision, *see infra* notes 81–84 and accompanying text.

73. NYSE Hearing Board 06-43, 2006 WL 4130493 (Sept.18, 2006).

74. Plase Michael Tansil Former Registered Representative, NYSE Hearing Board 06-43, 2006 WL 4130493, at *10 (Sept. 18, 2006).

75. *Id.* at *11.

76. *Id.* at *10.

77. FINRA Regulatory Notice 07-43, Senior Investors, 2007 WL 2685590, at *2–3 (September 2007); FINRA Regulatory Notice 09-31, Non-Traditional ETFs, 2009 WL 1663507, at *3 (June 2009); FINRA Regulatory Notice 09-32, Deferred Variable Annuities, 2009 WL 1701936, at *4 (June 2009).

that "certain products or strategies pose risks that may be unsuitable for many seniors, because of time horizon considerations, liquidity, volatility, or inflation risk."[78] Similarly, in a 2009 Notice to Members, FINRA reminded brokers that "training [for brokers] should emphasize the need to understand and consider the risks associated with [non-traditional ETFs], including the investor's time horizons, and the impact of time and volatility on the fund's performance."[79] Further, regarding deferred variable annuities, FINRA already requires brokers to "make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, [and] investment time horizon …."[80]

To the extent that a customer's investment time horizon will be especially relevant for assessing the suitability of transactions in the accounts of seniors, or when investing in special types of securities, as the above FINRA Notices and Alerts indicate, this requirement of the new Suitability Rule is nothing new to FINRA member firms. Further, as the *Plase Michael Tansil* decision highlights, regulatory agencies previously applied a customer's investment time horizon to assess the suitability of investment recommendations even outside of these specific settings.

4. Liquidity Needs

In *Larry Allen Trailor*,[81] a NYSE hearing panel similarly looked to the customers' liquidity needs to hold a registered representative responsible for making unsuitable recommendations.[82] Here, the registered representative invested the customers' accounts in a real estate limited partnership[83] for which no market existed, and which was mainly "suitable for customers having no short-term need to withdraw their investment principal," even

78. Regulatory Notice 07-43, *supra* note 77, at 3.

79. Regulatory Notice 09-31, *supra* note 77.

80. Regulatory Notice 09-32, *supra* note 77.

81. NYSE Hearing Panel Decision 96-107, 1996 WL 681354 (Oct. 2, 1996).

82. Larry Allen Trailor, NYSE Hearing Panel Decision 96-107, 1996 WL 681354, at *5 (Oct. 2, 1996).

83. The partnership was formed to acquire, lease and sell two shopping malls located in Maryland. *Id.* at 1.

though the customers required liquid investments to cover their short-term living expenses.[84]

One year later, in *Jeffrey Ainley Hayden*,[85] a NYSE Hearing Panel specifically focused on the customers' liquidity needs to find that a former registered representative's investment recommendation was unsuitable.[86] For all of the customers involved in this matter, liquidity was an important investment objective because they had a limited net worth and required investments that could be readily converted to cash.[87] Even though the broker had knowledge of these facts, the broker invested the customers' accounts in risky, illiquid limited partnerships.[88] The Hearing Panel explained that these transactions were unsuitable because there was "no ready market for the partnerships and such markets that did exist generally offered to buy the partnerships at deep discounts from their purchase price,"[89] which contrasted with the customers' desire for liquidity.[90]

Thus, as these decisions show, brokers already had an existing obligation to consider a customer's liquidity needs when they assess the suitability of an investment recommendation, which the new Suitability Rule has simply codified.

5. Risk Tolerance

In *In re Prudential Securities Inc.*,[91] the Commission held that certain investments by a member firm were unsuitable in light of the customers' risk tolerances.[92] Specifically, the firm had engaged in margin trading of the

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84. *Id.* at 5.

85. NYSE Hearing Panel Decision 97-135, 1997 WL 909014 (Dec. 5, 1997).

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.* at 18.

90. *Id.* at 18–19.

91. Exchange Act Release No. 33082, 1993 WL 430273 (Oct. 21, 1993).

92. "PSI sold limited partnerships to a significant number of investors for whom the investments were not suitable in light of the individuals' financial condition or investment objectives, and caused many other investors to purchase securities they

customers' accounts, which the Commission found to be a highly risky investment strategy given that the customers were elderly, had conservative investment goals, and relied on the principal for their living expenses.[93]

Similarly, in *In re Steven E. Muth*,[94] the Commission specifically held that "a broker's recommendations must be suitable for the client in light of the client's tolerance for risk and investment objectives, as determined by his or her financial situation and needs."[95] The brokers recommended high-risk stocks[96] to customers who had modest financial profiles and little investment experience, and were either not working or retired.[97] In finding that the unsuitable recommendations rose to the level of fraud, the Commission emphasized that the customers were "unsophisticated investor[s] who wanted to pursue a more conservative investment strategy and had a more moderate risk tolerance than was set forth on their account forms. None were interested in purchasing extremely risky or highly speculative stocks, on margin or otherwise."[98]

These decisions contradict the securities industry's arguments that the new Suitability Rule factors impose new requirements and require additional investment of resources to comply with the new rule. Rather, as these decisions reveal, for at least the past 20 years, regulatory authorities have used these very factors to determine the suitability of investments and discipline member firms and associated persons for violating previous existing suitability requirements.

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would not otherwise have purchased if they had been adequately informed of the inherent risks of these types of partnership investments." *Id.* at * 2.

93. *Id.* at 12–17. *See also* Scott Epstein, Exchange Act Release No. 59328, 2009 WL 223611 (Jan. 30, 2009) (holding that a broker's recommendations were unsuitable in part because the broker did not adequately ascertain the customers risk tolerances).

94. Exchange Act Release No. 262, 2004 WL 2270299 (Oct. 8, 2004).

95. *See id.* at *25 (Oct. 8, 2004).

96. The stocks at issue "were high-risk stocks, suitable only for investors that had a high risk tolerance and preferred aggressive or speculative investments." *Id*. at 3. One of the stocks was a NASDAQ Consolidated Small-Cap market stock, with a price that declined steadily between October, 2000 and April, 2001. *See id*. The other stock had closing stock price that was unstable, fluctuating from $6.00 to $12.87 per share between October, 2000 and March, 2001. *See id*. at 4.

97. *Id.* at 26.

98. Exchange Act Release No. 262, 2004 WL 2270299 (Oct. 8, 2004).

B. State Courts Have Previously Recognized Fraud Claims Predicated Upon Recommendations to Hold

As outlined in Section III, member firms also expressed concerns over the new Suitability Rule's broad definition of "investment recommendations," which now includes recommendations to hold.[99] However, including recommendations to hold in the new Rule should not be such a controversial alteration to the current suitability paradigm, as claimed by industry commentators. A recommendation to hold affects a customer's account just as much as a recommendation to buy or sell. It seems only natural that the Suitability Rule has now been extended to include recommendations to hold. More importantly however, case law indicates that courts have long since allowed common law fraud claims in instances where the defendant wrongfully induced the plaintiff to hold onto securities. In fact, in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court held that even though federal securities laws do not cover claims based on recommendations to hold, this finding was not meant to leave defrauded plaintiffs who neither purchased nor sold securities without recourse.[100] Instead, the Court emphasized that its holding was mitigated "to the extent that remedies are available to non-purchasers and non-sellers under state law."[101] Given that a number of states have subsequently recognized fraud claims by plaintiffs who were induced not to sell stock, claims based on recommendations to hold are no new development.

For example, in 2001, the Third District Court of Appeal of Florida considered whether a broker's recommendation to hold securities could form the basis of a common law fraud claim.[102] In *Ward v. Atlantic Security Bank*,[103] an investor tried to sell his shares in a mutual fund that was managed by a bank, but the bank ignored his order to sell.[104] Instead, one of the bank's representatives called the investor and convinced him not to sell the securities.[105] Subsequently, the fund's board decided to liquidate the fund,

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99. *See supra* note 42 and accompanying text.

100. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, n. 9 (1975).

101. *Id.*

102. Ward v. Atl. Sec. Bank, 777 So. 2d 1144 (Fla. Dist. Ct. App. 2001).

103. 777 So.2d 1144 (2001).

104. *Id.* at 1145.

105. *Id.*

causing the investor to incur a loss of $300,000.[106] The *Ward* court held that, even though the bank representative's advice not to sell the securities could not satisfy the requirements of a federal 10b-5 claim, the recommendation could still form the basis of a common law fraud claim.[107] Consequently, the court reversed the lower court's decision to grant summary judgment for the bank, and ordered the case to proceed.[108] Similarly, in *Holmes v. Grubman*,[109] an investor brought an action against a broker-dealer firm for inducing the investor not to sell his stock in WorldCom, Inc., the now bankrupt telecommunications company, even though the broker at the firm knew that the WorldCom stock was overvalued.[110] The investor had initially requested his broker to sell his stock in WorldCom, but instead, upon his broker's advice, the investor decided to acquire more stock in the company.[111] Subsequently, the investor had to sell all his stock in WorldCom to meet margin calls, which allegedly caused the investor to incur a loss of almost $200 million.[112] The Georgia Supreme Court rejected the broker-dealer's arguments for barring holder claims,[113] and found that Georgia law allowed holder claims "where, as here, plaintiffs allege that misrepresentations were directed at them to their injury."[114] To explain its reasoning, the court noted that "the actionability of fraud exists regardless of whether plaintiff is induced to act or refrain from action. Lies which deceive and injure do not become innocent merely because the deceived continue to do something rather than begin to do something else."[115]

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106. *Id.*

107. *Id.* at 1146. "The essential elements of a fraud claim are: (1) a false statement concerning a specific material fact; (2) the maker's knowledge that the representation is false; (3) an intention that the representation induces another's reliance; and (4) consequent injury by the other party acting in reliance on the interpretation."

108. *Id.* at 1148.

109. 286 Ga. 636 (2010).

110. *See id.*

111. *Id.*

112. *Id.*

113. *Id.* at 638– 39.

114. *Id.* at 639.

115. 286 Ga. at 637.

Even though *Ward* and *Holmes* are relatively recent cases, fraud claims predicated upon a plaintiff being induced to hold onto stock are not a recent development. More than one hundred and ten years ago, in 1901, the Supreme Judicial Court of Massachusetts held that a plaintiff could recover for damages he incurred because he held onto a company's stock in reliance on fraudulent statements by his broker.[116] The plaintiff gave the broker an order to sell the securities, but the broker induced the plaintiff to hold on to the stock by making false statements about the market value of the stock.[117] Subsequently, the value of the stock declined, causing the plaintiff to incur a loss.[118] The court rejected the broker's argument that the plaintiff must have acted upon the broker's misrepresentation for there to be a valid fraud claim.[119] Instead, the court held that inaction could form the basis for a fraud claim where "by reason of fraud practiced upon him, the plaintiff was induced to recall his order to sell, and, being continuously under the influence of this fraud, kept his stock when, save for such fraud, he would have sold it …."[120] About thirty years later, New York courts recognized holder claims in *Continental Ins. Co. v. Mercandante*, 225 N.Y.S. 488 (Sup. Ct. 1927). In *Mercandante*, the plaintiff insurance company alleged that the defendants had fraudulently induced the plaintiffs to retain certain bonds, which ultimately caused the plaintiffs to incur a large loss.[121] The court concluded that "the plaintiffs cannot be denied redress because their conduct was inaction, rather than action."[122] Rather, because "[t]he defendants intended that their misrepresentations should cause the plaintiffs to keep their bonds, desist from further inquiry, and remain passive" and "[t]he motive for [the defendants] conduct was their own gain,"[123] the court reversed an earlier judgment dismissing the plaintiff's complaint.[124]

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116. Fottler v. Moseley, 179 Mass. 295 (1901).

117. *Id.* at 297.

118. *Id.*

119. *Id.* at 298.

120. *Id.* at 299.

121. Continental Ins. Co. v. Mercandante, 225 N.Y.S. 488, 489–90 (Sup. Ct. 1927).

122. *Id.* at 491.

123. *Id.* at 494.

124. *Id.* at 495.

In many instances, courts have also held that plaintiffs can recover even where the defendants did not expressly recommend that plaintiff refrain from selling stock, but through other misstatements or actions that caused the plaintiffs to hold onto securities. In *Small v. Fritz Companies, Inc.*,[125] shareholders brought a class action for, *inter alia,* common law fraud against a corporation and its officers, alleging that the defendants caused the plaintiffs to hold on to the corporation's stock by misstating the corporation's quarterly earnings.[126] Once it was discovered that defendants had misrepresented their quarterly earnings, the share price of the corporation's stock fell, causing the plaintiff stockholders to suffer massive losses.[127] The court held that California law should allow "a holder's action for fraud or negligent misrepresentation," stating that "[t]his conclusion does not expand the tort of common law fraud, but simply applies long-established legal principles to the factual setting of misrepresentations that induce stockholders to hold on to their stock."[128] Although this case did not involve a specific statement or misrepresentation by a broker, it held that a plaintiff's inaction as a result of the defendant's misstatements is actionable. This again underlines that fraud claims predicated upon a recommendation or inducement to hold do not constitute a novel cause of action.[129]

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125. 30 Cal. 4th 167 (2003).

126. *See id.* at 170.

127. *Id.*

128. *Id.* at 171. The court did hold that the "holder" cause of action should be restricted to plaintiffs who "can make a bona fide showing of actual reliance upon the misrepresentations. *Id.*

129. *See also* Rogers v. Cisco Sys., Inc., 268 F. Supp. 2d 1305, n.13 (N.D. Fla. 2003) (Stating that even though "[t]he federal and Florida securities laws only apply to the purchase or sale of securities and not to representations intended to induce a stockholder to retain their securities …. [s]tate common law recognizes such a claim, in fraud and negligent misrepresentation, called a 'holding claim.'"); Gordon v. Buntrock , Case No. 99 CH 18378 (Circuit Court of Cook County, Illinois, County Department, Chancery Division, July 19, 2004) ("There can be no legitimate argument with the proposition that an investor who holds a security in reliance on false statements concerning the company's financial status can maintain a claim for fraud."); David v. Belmont, 291 Mass. 450 (1935) (affirming that a plaintiff could recover where the defendant securities dealer fraudulently convinced the plaintiff not to sell his stock); Kaufmann v. Delafield, 229 N.Y.S. 545, 546 (1928) ("The claim was based on an inducement to retain. The original misrepresentation is deemed as continuing and the influence of the fraud as recurring (and here there was

V. CONCLUSION

This analysis proves that the new FINRA Suitability Rule does not require member firms or their associated persons to meet an entire new set of requirements. Instead, customers and regulators have successfully brought claims and disciplinary actions under the elements of the new rule's factors, including recommendations to hold securities long before the new Suitability Rule came into effect. In the future, FINRA may establish a more demanding fiduciary duty standard. For now however, the new FINRA Suitability Rule mainly codifies pre-existing industry suitability standards.

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reassurance of promised values), so that the defrauded one may sue for damages occasioned by his own inaction."); Duffy v. Smith, 57 N.J.L. 679 (1895) (holding that plaintiff had a cause of action against defendant who induced the plaintiff to retain stock of a company until the company failed).; Gutman v. Howard Sav. Bank, 748 F. Supp. 254, 263 (D.N.J. 1990) ("[U]nder New York law, a plaintiff may state a common law fraud claim against a defendant whose misrepresentations caused plaintiff to hold securities which plaintiff otherwise would have sold.").

GAMED BY MONTE CARLO?

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With the world at war in the early 1940s, scientists in America were combining their collective genius with components rejected from the Army and Navy to build the first electronic computer, ENIAC. Its unveiling in 1945 to a team of thermonuclear scientists headed by John von Neumann revived the pursuit of thermonuclear weaponry capabilities, which had stalled during the research and development phase at least partly because of the complexity and sheer enormity of the mathematical modeling required.

In the spring of 1946, a group of scientists convened at Los Alamos to discuss the calculations generated by the first model posed to ENIAC. One of the conference attendees, mathematician Stanislaw Ulam, believed that statistical sampling should be revived in light of the new computing capabilities. During a period of convalescence in which he played card games, Ulam became intrigued by trying to estimate the number of successful games, which in turn made him think about mathematics, neutron diffusion, and, of course, how to articulate their research processes using randomly generated numbers. Ulam described his idea to von Neumann. Together they worked on an algorithm for ENIAC that would generate random numbers, creating a new statistical approach perfectly suited for their project.

The method reminded fellow scientist, N. Metropolis, of Ulam's uncle who borrowed money from family, after having gambled away all of his own, because he could not resist the temptation to go to Monte Carlo and play the games of chance; and so the code name "Monte Carlo" was coined.

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Fifteen years earlier Enrico Fermi actually invented, but never named, the method. He built an analog Monte Carlo trolley named FERMIAC to help him research neutrons, which move both randomly and unpredictably, essential characteristics for relevant Monte Carlo analysis. The term "Monte Carlo" has since become a permanent part of scientific lexicon, and its intrigue has drawn interest from other professions looking for a method that could be used to forecast the probability of successful future events.

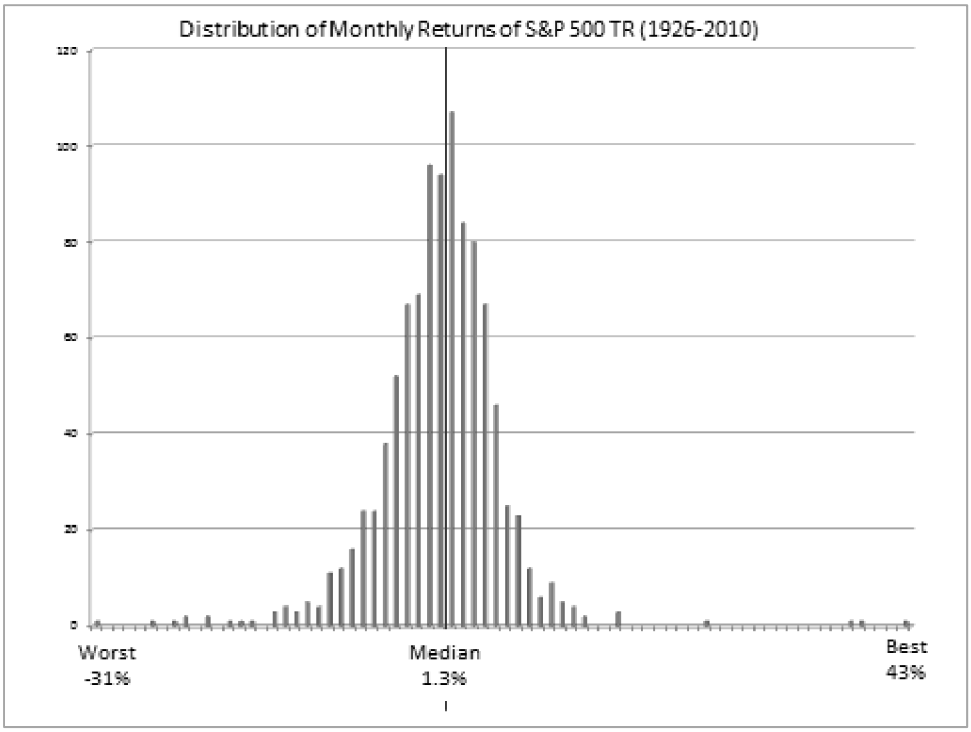
Decades later, the mathematical method wandered from the cloak of cold war secrecy to the investment advisor community. With a decreasing ability to rely on pension income, Americans are carrying a greater share of the responsibility for financing their own retirement. The highly competitive financial services industry was clamoring to serve this need by using advances in technology to estimate portfolio performance behavior, thereby providing guidance to investors regarding how much money they need to save for retirement and other financial objectives. Monte Carlo sounded sexy, and was complicated and used by scientists; so it appeared to be the perfect process to apply to investment portfolios. In November 2004, the NASD acknowledged in Notice to Members 04-86 that investors want "access to additional sources of investment information and tools to make investment decisions;" and they officially acquiesced and permitted "technology [to be used as] a key component of members' attempts to meet … investor demand," albeit with many caveats and conditions.

MONTE CARLO EXPLAINED

On its website, FINRA offers the explanation: "A Monte Carlo simulation generates thousands of probable performance outcomes, called scenarios, which might occur in the future. An investment simulation incorporates economic data such as a range of potential interest rates, inflation rates, tax rates, and so on, combined in random order. As a result, it's designed to account for the uncertainty and performance variation that's always present in financial markets." That explanation may help someone understand the general purpose for Monte Carlo, but it is too vague to shed any light on the actual workings of the modeling. While the mathematical algorithm is complex, the process can be described in simple, straightforward terms.

Conceptually, Monte Carlo as it applies to simulations performed in the financial services industry can be explained with a bunch of ping-pong balls and clear plastic tubes. Using, for example, the S&P 500 for the period 1926 - 2010, assign a return percentage to each tube starting with the lowest return

from the period up to the highest return. There will be tubes that do not correspond to any return during that period. Arrange the tubes in a wide line sequentially from the smallest number on the left to the largest one on the right. Now assign each month's return to a ping-pong ball and place each ping-pong ball in the corresponding tube. Some tubes will have many balls, some only a few, and others will be empty. At the end, the tubes and balls come together to create a basic histogram of the returns, which would look similar to the chart below.



Find the point at which half of the returns are to the left and half are to the right. Mark it with a vertical line to demarcate the median. By tracing a smooth line along the top of the ping-pong balls starting at the worst return on the far left up to the median and then back down to the best return at the far right, a trend line is created. The resulting line would generally appear as a bell curve. Monte Carlo analysis uses return and standard deviation data from the distribution of historic returns to model future returns. In this example, the median (midpoint) is 1.3%, and the arithmetic average (mean) of the monthly return performance is about 0.9%. Two-thirds of the returns (one standard deviation) fell within the range of about -3.2% to 5.1%.

Monte Carlo simulation constructs a hypothetical period performance using randomly generated monthly returns constrained by the assumption that the distribution of future returns will fall within the modeled curve. It randomly selects one of the numbers, not removing it from the population. In this case, 12 draws make up one year, and if multiplied by the number of years, an iteration is created. Depending on the software, it may follow this process hundreds or thousands of iterations.

Following the ping-pong ball analogy, imagine filling up each of the tubes to the trend line. If those balls were emptied into a bingo tumbling cage, the contents of the cage would make up the universe of data. The figurative simulator tumbles the cage and draws one number, putting it back into the cage after noting what it is. For a 20 year period, this would be done 240 times for one iteration or possible sequence of events. Running 1000 iterations would require 240,000 random draws.

The results are then analyzed for failure rates, meaning in the financial services community, the percentage of the iterations in which the portfolio's value failed to meet the ending goal. The average return generated by the simulation is applied to cash flow and other client-specific parameters in a linear projection to forecast an ending portfolio value. The probability may be expressed as: "The portfolio met its goals 80% of the time."

HOW THE FINANCIAL SERVICES INDUSTRY USES MONTE CARLO

Since the NASD first allowed its use on Valentine's Day 2005, brokers have been professing their love for Monte Carlo. The forecasting and probability presentations have been effective sales tools for garnering more assets under management. Brokers could now show investors how, with a comfortable level of probability, they could make their dreams come true, if only the numerous unpredictable and unforeseen events of the future occurred in sync with the reports generated by this new technological advance in financial services known as Monte Carlo analysis.

Typically, an adviser, in talking to a client or prospective client about his investments, promotes the benefits of running financial projections with an advanced software program that uses complex scientific modeling to calculate the probability that the investor's portfolio will be able to fund his financial goals. The fact that the software model is entirely objective and not biased by history will likely be an important sales point, as will the belief that hypothetical projections applying historical data are outdated and much less reliable since historical performance is no indication of future results. A discussion of how the software's analysis is tailored to an investor by

incorporating an array of variables, such as cash flows, taxes, inflation, time horizon, costs and asset mix, is designed to impress even the skeptical.

The financial services industry commonly uses Monte Carlo analysis as a tool to establish the likelihood of achieving specific rates of return over a given time horizon. Clients typically want to know the likelihood that a savings and investment strategy will grow their assets to a target point over a specified time horizon or that a portfolio can distribute funds over a specified time horizon without being depleted.

In preparing to run a Monte Carlo analysis, an adviser collects information about the client and his investments, including what goals the client wishes to fulfill with the portfolio and, hopefully, questions aimed at assessing the client's suitability profile. The adviser creates an asset allocation model and enters it into the Monte Carlo software. Depending on the results, the adviser may go through this process multiple times until the analysis produces a desired probability for success. One or more of the analysis results will be presented to the client in the form of a report, typically with charts and graphs and lists of data. A Monte Carlo report appears not only to take into account all relevant contingencies, but also to establish a success ratio with a mathematical degree of confidence despite the unknowns that the future may bring. The report should include all of the client specific information and assumptions used in the software's computations. Although Monte Carlo models vary, the report does not provide any details regarding the algorithm or how it specifically processes the data inputs.

In the end, what the prospective client sees is a complex and detailed, and therefore convincing, basis for following the adviser's advice. After all, if Monte Carlo simulations are based on math, and math is universal and objective, can it not be assumed to be perfectly reliable? Alas, the devil is in the details, and with details like those inherent in Monte Carlo analysis, there is plenty of opportunity to make innocent but grievous mistakes or even game the system.

MONTE CARLO'S WEAKNESSES

Monte Carlo software is a tool. Tools are neither inherently good nor bad. What matters is how they are used. In order to properly employ a tool, a user must understand what the tool can and cannot do. After all, a tool is only as good as its operator. In the case of Monte Carlo, an adviser needs to understand the software's weaknesses in order to make suitable recommendations and proper disclosures to a client. A non-exhaustive look

at some of the weaknesses follows. Weaknesses that inherently create a potential for liability are discussed later in the Liability section.

Present Economic Environment. Monte Carlo does not adjust its analysis based on current market conditions or trends. The software would not know if the country was experiencing a protracted bear market or was several years into a bull market. Not factoring in the starting climate despite it being a meaningful determinant of short term market behavior can create overstated portfolio values, particularly when a portfolio is in a distribution phase.

End-point Sensitivity. The Monte Carlo algorithm requires investment return and risk data in order to produce its multitude of simulations. Most commonly this data is based on historical returns from a defined period of time. If the historical period chosen ends after the markets have experienced unusually high performance, Monte Carlo's random calculations will be based on artificially high figures. For example, the 50 year average annual return using the S&P 500 Composite Total Return Index for the period ending in 1999 was 13.6%, but fell to only 9.6% for the same period ending 10 years later. Thus, a Monte Carlo analysis using data ending in 1999 would have generated more favorable results than one using data ending in 2010.

Using Monte Carlo Return in Linear Hypothetical. The cash flow models used with Monte Carlo analysis commonly project future values based on a constant application of the average return of the simulations produced by the analysis. It takes the average result and uses it in a linear projection, giving the portfolio an artificial air of stability. If, for example, a simulation produced an 8% return as the average annual return, the planning portion of the Monte Carlo software would use 8% as the annual investment return every year. In reality, returns are not constant. They vary. This discrepancy can understate the impact of distributions and overstate the portfolio balance because lower returning years never occur. The real danger would be experienced if the portfolio started with a bear market.

Garbage In, Garbage Out. Monte Carlo software commonly provides users with the ability to perform analysis on a very client-specific, granular level. This requires the client's financial adviser to customize the analysis by loading a wide range of assumptions into the scenario, such as taxes, expenses, inflation and cash flows. Even if Monte Carlo calculations are performed correctly, the user can dramatically affect the end results with the assumptions upon which the analysis is predicated. Precise numbers based on unrealistic estimates will necessarily generate results that are unrealistic, what-if scenarios.

Randomness v. Serial Correlation. Modern Portfolio Theory assumes that investors are rational and that markets are efficient. Monte Carlo, by contrast, randomly generates returns to simulate future market performance, which would be relevant if markets were inefficient and investors irrational. Using an analytical method that contradicts market and investor behavior is inherently flawed.

Unlike the movement of sub-atomic particles for which Monte Carlo simulation was first used, the financial markets do not move entirely randomly. The stock and bond markets are cyclical, more analogous to weather than neutrons. The primary determinants of tomorrow's weather are the season, the month and the prevailing weather pattern. Employing Monte Carlo to generate a weather forecast for Chicago, using a database of historical weather from the National Weather Service, would likely produce an inaccurate picture of what to expect. It could feasibly forecast for an August day, a high temperature of 100 degrees with snow and a low temperature of 28, or a high temperature of 28 with fog and a low temperature of 72. While streaming together 365 such randomly generated daily forecasts may result in a year that is average in a sense, it would lack the cyclicality of the seasons.

As Monte Carlo is blind to the seasonal influences of weather, so is it blind to asset class correlation and the serial correlation of financial markets. Equity markets experience waves of bull and bear markets, and bond markets move with the cyclicality of interest rates. Asset classes within markets move in relation to each other as well. If large cap stocks fell as a group, it would be highly improbable that mid cap stocks would have a huge rally. More importantly, though, numbers move in relation to their prior movement. They can have positive and negative momentum. One finds a huge upside potential only after a big decline or period of little to no return, not out of the blue on an otherwise average day.

Ultimately, because Monte Carlo uses randomly generated returns, it would project the performance of highly correlated asset classes to be better diversified than they actually are, giving a smoothing effect that overestimates the stability and underestimates the volatility of a portfolio. It would also be statistically unlikely that a randomly generated analysis would include a cyclical bear market since it ignores serial correlation. The result may cause an understatement of the portfolio's failure rate. The greatest problem is the effect on an unsuspecting investor who may not have the risk tolerance necessary to handle the volatility and may therefore abandon his investments at a loss due to anxiety.

To those who exalt the objectivity of using a random method free of the cyclicality of the past, it may seem as though Monte Carlo provides a

categorical improvement over the standard hypotheticals that were accepted by the NASD before it allowed the use of technology like Monte Carlo. The only question a standard hypothetical answers is how the value of a portfolio changes if it replicates either historical averages or the actual historical performance.

If, for instance, the S&P 500 had an average annual return of 12% for the prior 20 years, a standard hypothetical would project a 12% return per year for the following 20 years. Alternately, the hypothetical could show the value of the portfolio at the end of the 20 year period had it been invested at the beginning of the period and experienced each year's individual return in succession as it actually occurred. These projections could then be tailored to include a client's starting portfolio value, time horizon, forecasted cash flow and inflation. The problem, of course, is that it is highly unlikely that any future 20 year period would replicate any preceding 20 year period.

In reality, the weaknesses of Monte Carlo analysis may give it no greater predictive insight than hypotheticals. Worse, the complexity and robustness of Monte Carlo products may give investors an unwarranted confidence in its results.

LIABILITY ISSUES

By its very nature, Monte Carlo carries the potential of promoting a false sense of confidence that the user has the power to forecast returns with a very specific level of reliability. The complexity of Monte Carlo makes it susceptible to being misunderstood by both the adviser and the investor. Clients who rely on the advice of naïve, negligent or unscrupulous Monte Carlo operators may find themselves surprised by actual portfolio performance that is radically different than what their Monte Carlo simulations forecasted. A non-exhaustive look at some of the possible liability issues follows.

Unskilled or Untrained User. Monte Carlo analysis is inherently complex. It is fundamental that an adviser understands what it is, how it works, and what it does and does not do if he or she is to make suitable recommendations with proper disclosures. Moreover, an adviser cannot adequately interpret the results for a client and provide appropriate recommendations or advice without first recognizing the strengths and weaknesses of the analytical engine. If the financial adviser lacks an understanding of Monte Carlo, the potential for an unsuitable recommendation, misrepresentation or material omission looms large.

Inadequate Disclosure. The rule that allows brokers to use investment analysis tools does so only on the condition that brokers comply with comprehensive disclosures, including the fact that the results may vary with each use and over time. The limitations of the tool must be articulated, along with the key assumptions and methodology. The disclosures must be prominent and written clearly in narrative form. Brokers must also present the recommendations in a manner that is fair and balanced, not exaggerated, unwarranted or misleading.

Misrepresented Risk. The financial services industry primarily uses Monte Carlo analysis to demonstrate the probability of realizing an investment return sufficient to support future withdrawals, otherwise stated as the risk of not achieving a particular investment return. Such analysis necessarily favors exposure to assets that are riskier and higher returning, and in so doing turns the definition of risk on its head. Risk under this approach is having too few stocks in a portfolio, thereby depleting the portfolio within an investor's lifetime. In contrast, an investor's risk tolerance is a function of his desire or ability to accept loss or volatility. Moderating this type of risk requires decreasing a portfolio's exposure to riskier, higher returning assets. Clearly, these two types of risk are fundamentally at odds with one another. Implying that the risk expressed by Monte Carlo analysis in any way applies to client specific risk tolerance would be misleading.

Unsuitable Risk. An investor's risk tolerance is a fundamental component of suitability. However, Monte Carlo analysis does not consider client specific risk tolerance. As discussed above, Monte Carlo evaluates the risk of a portfolio missing its objectives, which is decreased by increasing the portfolio's exposure to riskier and higher returning assets. As a result, an investor may be advised to invest portfolio assets in a manner that exceeds his risk tolerance.

Misrepresented Reliability. The complex mathematical nature of Monte Carlo analysis, the robustness of the software and the fact that its output is a simple number that defines the probability of the portfolio's success combine to create an impression for investors that Monte Carlo's results are reliable with a mathematical degree of certainty. In fact, the output is derived from many unknowns, and while it does calculate its results using a large number of possible events, it also includes a number of possible but never seen economic events that do not occur in tandem. An investor needs to understand that a Monte Carlo outcome may not reflect his reality. Instead of allowing or encouraging an investor to falsely believe that Monte Carlo analysis is reliable, advisers must clearly explain Monte Carlo's limitations.

Fallacy of Too Much Sacrifice. Some financial advisers and purveyors of Monte Carlo software characterize portfolios with a high probability of

success as being overly burdensome on the client by requiring them to suffer too much sacrifice. This camp of advisors recommends a success probability of 75 to 90%. If, for example, an advisor runs an analysis and finds that a client's probability is 95%, the advisor recommends that the client save less for retirement and enjoy more spending now or take larger annual distributions during retirement. In the event that an unplanned expense arose during the client's retirement, such as an illness, the portfolio may be impaired beyond its ability to sustain planned withdrawals. The misleading notion that saving too much money simply leaves too much money for heirs and causes undue sacrifice can create great risk in a world of so many unknowns. In providing financial advice, an adviser must consider the client's risk tolerance and not mislead the client to view a high probability of success negatively. A client may view a high probability of success as financial security and peace of mind rather than a burden. The consequences of failure are too important for the adviser to ignore. Consider the analogy to surgery: Even a 90% chance of surviving an operation means a 10% chance of dying.

Quantitative Unsuitability. Monte Carlo software allows advisers to include a wide range of cash flow variables. To support the probability that a portfolio will be able to sustain a lifetime of distributions, it is simple for a financial adviser to include any and all of a client's assets. Advisers, for example, sometimes go so far as to include proceeds from the future liquidation of the investor's home in a client's Monte Carlo analysis, as well as current and future income with bonuses and anticipated inheritances. Advisers may also estimate an unreasonably low income distribution, convincing the client that needs in retirement are much less than in pre-retirement, when that may not be a reasonable position. Quantitatively unsuitable cash flow variables may create a greater probability of success than suitable ones, incentivizing a less than honorable adviser to recommend the investment of assets that the investor cannot afford to lose or to make lifestyle changes on the anticipation of future events that may not come to pass. Monte Carlo's capacity for handling such a variety of cash flow variables does not sanction a wholesale liquidation of everything with a potential market value. Perhaps the client would like to remain in his home and not endure the stress and uncertainty of needing to relocate. Furthermore, a financial adviser must disclose the risk of relying on cash flow estimates being realized for estimated figures when needed.

Deviation from Recommended Allocation. If a financial adviser recommends investments in accordance with Monte Carlo analysis, which assumes a specific asset class allocation, the adviser should ensure that the investments adhere to the allocation. If not, the Monte Carlo analysis is

reduced to impertinence. Yet, financial advisers have, subsequent to such analysis, invested stock allocations in hedge funds, investment grade bond allocations to junk bonds and balanced portfolio allocations to all-equity portfolios.

Mis-mapping Investments to Allocation. Monte Carlo software analyzes diversified benchmarks and does not contemplate the effects of concentration or specific risk. If an adviser does not exercise adequate care to implement the portfolio with investments that closely mimic each respective benchmark, the results may deviate from expectations. Recommendations of investments that are not as diversified as the benchmark will likely result in greater risk than the analysis portrayed and may produce returns that are unsatisfactorily dissimilar from the benchmark. Implementing an allocation to large cap stocks with a banking sector fund would add sector concentration risk, while populating the allocation with a few large cap stocks would expose the portfolio to the specific risks of those equities.

Flawed Inputs. Monte Carlo analysis depends entirely on the data inputs used in its algorithm, among them being average investment returns, standard deviations, inflation, taxes, fees and expenses, contributions, distribution needs and even mortality. Results hinge entirely on these input variables. If, for example, unrealistically high return expectations are used in a Monte Carlo simulator, unrealistically high returns will be generated by the Monte Carlo simulations. As the saying goes, "Garbage In, Garbage Out." Likewise, underestimating taxes or life expectancy can cause similar problems. Flawed inputs may simply reflect user deficiencies due to a lack of understanding or training. Of course, when the Monte Carlo software allows a user to define his own set of inputs, including return distributions, the flaws may be the byproduct of intentional manipulation as well.

Excluding Portfolio Costs. Investment indices are unmanaged, meaning they are theoretical portfolios that do not factor in the fees and expenses of investing the portfolio; however, investing is not free. Investments cost money and investment management costs money. To fairly calculate the probability of success or test sustainable withdrawal rates, the Monte Carlo analysis must consider all relevant costs. Otherwise, an investor would rely on unrealistically optimistic results. Nonetheless, Monte Carlo analysis software generally uses benchmark data unless the financial adviser specifically enters costs into the assumptions.

Unsustainable Withdrawal Rate. Multiple studies within the investment community have researched sustainable rates of withdrawal, generally finding agreement between 4 – 5% based upon audits of historical investment performance. Nonetheless, financial advisers using Monte Carlo software

often propose higher rates of distribution, a hazardous recommendation regardless of the outcome of the Monte Carlo software analysis.

Misleading, Exaggerated or Unwarranted Claims. At least one major purveyor of Monte Carlo software claims that it is absolutely objective, superior to Wall Street standards, and life changing for the financial advisers and clients who use it. Care must be taken not to mislead investors that Monte Carlo is more reliable than it is, or that it offers anything greater than an additional form of financial analysis.

STANDARDS OF CARE

Advances in technology such as Monte Carlo analysis software have provided the financial services community with new abilities to evaluate investor portfolios. While providing more information to clients has its benefits, the tool is complex and lends itself to being misunderstood. Without an understanding of how Monte Carlo works, what it does and does not show and its weaknesses, an investor cannot make an informed investment decision. Instead, he must rely on his adviser's counsel regarding the Monte Carlo findings. A client may be left with an unwarranted sense of confidence and the potential for massive destruction of his portfolio, finding such loss all the more unexpected considering that Monte Carlo analysis involves rigorous calculations and specific success rates. The rules designed to prevent investor harm serve as a resource for recovery when the harm comes at the hand of the investor's adviser.

Depending on the type of investment professional rendering advice, the following standards of care should be evaluated to determine whether an adviser committed a breach. Stockbrokers must comply with, among many other rules, the following ones specifically related to the use of Monte Carlo analysis software and corresponding recommendations.

NASD Rule 2310(a), Recommendations to Customers (Suitability)

"In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other holdings and as to his financial situation and needs." [Note, as of July 9, 2012, FINRA adopted the revised Suitability Rule (2111(a)), which states that "A member or associated person must have a reasonable basis to believe that a recommended

transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation".]

NASD Rule 2210(d)(1), Communications with the Public - Standards Applicable to All Communications with the Public

(A) All member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service. No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would make the communications to be misleading.

(B) No member may make any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. No member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

(C) Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor's understanding of the communication.

(D) Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or project the performance of an investment or investment strategy. [Note: FINRA's revised manual will update 2210 and IM-2210-6 with rules 2210 and 2214 effective February 4, 2013.]

NASD Notice to Members 04-86, Investment Analysis Tools

This Notice to Members ("NTM") alerted the brokerage community in November 2004 to a limited exception to Rule 2210(d)(1)(D), which prohibited making predictions or projections regarding investments or investment strategies. As part of its rule modernization project, the NASD approved IM-2210-6 (effective 14 February 2005) to "allow members to use and provide customers access to investment analysis tools if the members comply with certain disclosure and other requirements." Monte Carlo software fits within the NASD's definition of investment analysis tools, as "an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices."

Footnote 6. "Although each required disclosure need not be displayed on every separate Web page and/or page of a written report generated by the tool, the disclosures must be "clear and prominent" in light of the content, context, and presentation of the tool and/or written report. In addition, if the member provides customers access to an investment analysis tool and written report generated by the tool, the disclosures must be clear and prominent on both the tool and the written report. A member may not provide clear and prominent disclosures on one but not the other. For instance, a member cannot simply refer in a written report to the disclosures made by the tool (and vice versa)."

NASD IM-2210-6, Requirements for the Use of Investment Analysis Tools

(c) Use of Investment Analysis Tools and Related Written Reports and Sales Material

A member may provide an investment analysis tool (whether customers use the member's tool independently or with assistance from the member), written reports indicating the results generated by such tool and related sales material only if:

(1) the member describes the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;
(2) the member explains that results may vary with each use and over time;
(3) if applicable, the member describes the universe of investments considered in the analysis, explains how the tool determines which

securities to select, discloses if the tool favors certain securities and, if so, explains the reason for the selectivity,4 and states that other investments not considered may have characteristics similar or superior to those being analyzed; and

(4) the member displays the following additional disclosure: "IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results."

(d) Disclosures

The disclosures and other required information discussed in paragraph (c) must be clear and prominent and must be in written or electronic narrative form.

The Securities and Exchange Commission views financial planning as investment advice, subject to regulation under the terms of The Investment Advisers Act of 1940. Merely holding oneself out as a financial planner or performing financial planning for a client's investments using Monte Carlo analysis is generally sufficient to trigger investment advisory duties. As with stockbrokers, investment advisors are prohibited from misleading their clients and must make only suitable recommendations. Investment advisors are fiduciaries for the advice they give, so fiduciary standards apply to their relationships with clients.

For financial services professionals who are dually registered, meaning they are registered and regulated both as stockbrokers and investment advisors, both standards of care apply. However, since investment advisors are fiduciaries, their bar is categorically higher than a stockbroker's.

CONCLUSION

Monte Carlo analysis in an imperfect, albeit informative, tool in the financial adviser's toolbox. Simulation results may vary materially according to the knowledge, skill and intent of the adviser, as well as the particular software maker. Given the large number of assumptions and unpredictable data, it is important that investors understand the limitations of the analysis and not base life decisions solely on its findings. If a financial adviser violated a relevant standard of care in giving a client advice regarding Monte Carlo analysis, liability for losses sustained may become the object of consideration in litigation whether the adviser intentionally gamed the system or not.

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Editors' note: Mr. Russell was the winner of the 2011 James E. Beckley Student Writing Competition. The following is a condensed and excerpted version of the article he submitted for the competition.

PERVASIVE FRAUD: DISCLOSURE PRINCIPLES AND THE FRAUD CREATED THE MARKET THEORY OF RELIANCE

Blair Russell[1]

I. INTRODUCTION

The financial meltdown of 2008, in the view of many commentators, represents the most severe economic crisis since the great depression. The result has been a massive increase in securities fraud litigation, namely class action litigation. Many plaintiffs named in these class actions, however, lack a piece of evidence that may ordinarily be necessary to bring a successful action - reliance. Where direct proof of reliance is lacking, one legal theory posits that investors may rely on the fact that the availability of securities on the market is a marker of a plaintiff's justifiable reliance of the security's integrity.

This article discusses the tension that currently exists in the various circuit courts between those that have embraced the "fraud created the market" theory of reliance and those that have, in whole or in part, rejected that theory.

The Third Circuit decision in *Malack v. BDO Seidman, LLP*,[2] highlights the split in circuits regarding the use of presumptions in establishing reliance in 10b-5 claims. Beginning in October 2002 and continuing through January 2005, John Malack and other investors directly purchased notes from American Business Financial, Inc. ("ABF"), a subprime mortgage originator. The notes promised to pay interest well above the prime rate, were issued without the involvement of underwriters or brokers, were non-transferrable,

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1. Bachelor of Science in Finance, California State University Northridge; Chapman University School of Law (2012), *Chapman Law Review*. Active member of the New York American Inn of Court, New York, Member New York State Bar Association, New York County Lawyers Association. Many thanks to Prof. Susana Ripken for her comments on a previous draft.

2. 617 F.3d 743 (3rd Cir. 2010).

could be cashed in only after they matured, and had no market for resale. The notes had been issued pursuant to registration statements and prospectuses that ABF had filed with the SEC in 2002 and 2003.

On January 21, 2005, ABF filed a Chapter 11 petition for reorganization which, in May 2005, was converted to a Chapter 7 liquidation proceeding. Malack and the other investors suffered substantial losses as a result.

In February 2008, Malack filed a putative securities fraud class action against the accounting firm BDO Seidman, LLP, alleging that its audits of ABF were deficient. According to Malack, had BDO done its job properly, it would not have issued ABF clean audit opinions. Malack further alleged that, without clean audit opinions, ABF would not have been able to register the notes with the SEC, the notes would not have been marketable, and Malack and the other investors would not have purchased the notes. Based on these allegations, Malack asserted that BDO violated §10(b) of the 1934 Act and Rule 10b-5.

When the district court denied class certification, holding that Malack did not satisfy the predominance requirement of Rule 23(b)(3)[3] because he did not establish a presumption of reliance under the fraud created the market theory,[4] Malack appealed the denial of class certification to the Third Circuit Court of Appeals.

In a lengthy and far reaching opinion issued on August 16, 2010, the Third Circuit, rejected the fraud created the market theory of reliance and held that, without the presumption of reliance afforded by that theory, the lower court's determination that Malack could not receive class certification would be sustained.[5]

In the context of class action securities litigation, proof of reliance of an alleged misrepresentation that caused the plaintiff's injury (i.e., financial loss) is one of the essential elements that a plaintiff must satisfy.[6] In general,

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3. Malack v. BDO Seidman, LLP., CIV.A. 08-0784, 2009 WL 2393933, at *2 (E.D. Pa. 2009).

4. Malack did not seek certification of a class based on actual reliance. *See id.*

5. 617 F.3d 743, 744 (3d Cir. 2010).

6. Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) (explaining the element of reliance as necessary in a suit pursuant to Rule 10b-5). *See also* 93 A.L.R. Fed. 444 "[I]nvestors rely on the market price of securities as an accurate measure of their intrinsic value; unrebutted, this presumption allows a securities fraud plaintiff to satisfy the reliance element of the Securities Exchange Act." (citing SECURITIES EXCHANGE ACT of 1934, § 10(b), 15 U.S.C.A. § 78j(b); PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, § 101(b), 15 U.S.C.A. § 78u–4(b)(2); 17 C.F.R. §

a plaintiff must prove that, had the misrepresentation not been made, the plaintiff would not have invested or purchased certain securities for sale.[7] Sometimes proof of reliance is difficult, if not impossible to establish in securities actions, due in large part to the fact that requiring a plaintiff to show how he would have acted if a misrepresentation had not been made is subjective.[8] In such cases, the Supreme Court and some circuit courts have endorsed the use of presumptions of reliance to show that a material misrepresentation served as a causal link to the plaintiff's injury.[9]

Some circuit courts have utilized the fraud on the market theory, positing that reliance may be presumed whenever a fraudulent misrepresentation impairs the value of a security to the extent that a plaintiff will be injured, regardless of whether he or she directly relies on any documents or disclosures issued in connection with the securities.[10] Other circuit courts,

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240.10b–5(a, c); In re Citigroup Auction Rate Securities Litigation, 700 F. Supp. 2d 294, Fed. Sec. L. Rep. (CCH) P 95507 (S.D. N.Y. 2009)).

7. 485 U.S. at 243–45 (explaining that "persons who had traded [] shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, *i.e.,* how he would have acted if omitted material information had been disclosed or if the misrepresentation had not been made."). *See also* Peil v. Speiser*,* 806 F.2d 1154, 1161 (3rd Cir. 1986) ("In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock, and purchasers generally rely on the price of the stock as a reflection of its value").

8. 485 U.S. at 245.

9. 485 U.S. at 243–44 ("Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties. The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act. In drafting that Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets." (citations omitted).

10. *Id.* at 241–42. *See also* Malack*,* 617 F.3d at 747 (quoting Peil v. Speiser*,* 806 F.2d 1154, 1160–61 (3d Cir.1986)) ("[I]n an efficient market ... misinformation directly affects the stock prices at which the investor trades and thus, through the inflated or deflated price, causes injury even in the absence of direct reliance.")). *See also* Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 175 (3d Cir.2001) ("[R]eliance may be presumed when a fraudulent misrepresentation or omission impairs the value of a security traded in an efficient market.").

however, have utilized the fraud created the market theory, positing that reliance may be presumed on the basis of the integrity of the marketplace such that investors can rely on the fact that the securities are entitled to be on the market as an indication of their genuineness.[11]

At a time where financial reform has dominated the limelight, and where individuals are increasingly seeking redress for financial fraud, resolution of such questions of law would benefit from unanimity among our courts. Whether the fraud created the market theory is a viable presumption, or whether the fraud on the market theory is the only allowable presumption, is a conflict among the circuits that has developed over the decades since the 1980s. The balance of this article will analyze the competing rationales the circuit courts have adopted over the decades.

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11. Shores v. Sklar, 647 F.2d 462, 471 (5th Cir. 1981) ("The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place."). *See also* Robert Schwinger & Jonathan Cross, *"Fraud Created the Market" Securities Fraud Theory Rejected By The Third Circuit, Widening Circuit Split*, (Aug. 25, 2010), http://www.chad bourne.com/files/Publication /656f9992-3826-4c25-ace3-33ede8de9f6e/Presentation/Publication Attachment/346251ae-732d-448c-83be-38c239759986/Security%20Lit-%20Fraud%20Created%20Market %20ca.pdf, at 1–2. Peter J. Dennin, *Which Came First, the Fraud or the Market: Is the Fraud-Created-the-Market Theory Valid Under Rule 10 B-5?*, 69 FORDHAM L. REV. 2611, 2613-14 (2001) (explaining the fraud created the market theory of reliance as:

> The fraud-created-the-market theory allows a court to presume reliance if the plaintiff has relied on the market itself to prevent the entry of unmarketable securities. In other words, if not for the defendant's fraud, there would be no market for that security to be issued into and subsequently traded upon because the security has no underlying value….The central focus of the fraud-created-the-market theory is the concept of unmarketability. If a security should not have been issued and could not have been issued, if not for the intentional fraud of a party, it is unmarketable, because the security is essentially worthless. Plaintiffs are granted a presumption of reliance by the court because actual reliance on sham disclosure materials is irrelevant. The plaintiff has not relied on disclosure documents to ascertain whether in fact the security is a sham because the very presence of the security and its accompanying disclosure materials indicates that the security is bona fide. As a result, investors rely on such materials to ascertain the fair market value of a security, while relying on the presence of a security in the market as an indication that it is not a sham.

II. THE FRAUD ON THE MARKET THEORY

In 1978, Basic Inc. made statements in which the company claimed it was not the subject of any merger discussions, when in fact, the company was actively pursuing a merger with Combustion Engineering.[12] Plaintiff Levinson, relying on these misrepresentations, sold his shares of Basic Inc.[13] Later that year, Basic Inc. merged with Combustion, causing the stock price to go up.[14] As a result, Levinson lost money by selling his shares of Basic stock and filed suit on behalf of a class of investors, claiming that the material misrepresentations made by Basic had caused him and others to sell their stock at an artificially lower price.[15] To show reliance on the misrepresentations made by Basic, Levinson argued for the adoption of a presumption of reliance. The particular presumption that was utilized in *Basic* is known today as the fraud on the market theory, which posits that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company… misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on misstatements."[16] The connection between fraud and the purchase of stock is no different than in cases where there is actual direct reliance on material misrepresentations.[17] Because "in [an efficient] market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock, and purchasers generally rely on the price of the stock as a reflection of its value," there is a causal nexus that supports, indirectly, that a purchaser of

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12. Levinson v. Basic Inc., 786 F.2d 741, 742–43 (6th Cir. 1986) (vacated) 485 U.S. 224 (1988).

13. *Id.*

14. *Id.* at 745; *see also* EDWARD P HALIBOZEK, MERGERS AND ACQUISITIONS: CORPORATE RESTRUCTURING AND SECURITY MANAGEMENT 4 (Elseiver et al. ebh., 2005) (describing generally the concept of mergers and acquisitions as one in which "all mergers and acquisitions occur for the same basic reasons: to improve the immediate, short-term, and/or longer-term financial position of both companies or to provide a strategic advantage to one or both of the companies involved."). For this same reason, the plaintiff in Levinson, had he known a merger would take place, would not have sold his stock.

15. Levinson*,* 786 F.2d at 743. *See supra* text accompanying note 14.

16. Basic Inc.*,* 485 U.S. at 244.

17. *Id.* at 242 (quoting Peil v. Speiser, 806 F.2d 1154, 1160-1161 (1986)).

stock intends to make a profitable trade.[18] Requiring plaintiffs to show how they would have acted if certain representations had not been made imposes an unrealistic burden on plaintiffs pursuing Rule 10b-5 actions.[19] Accordingly, the Court in *Basic* allowed the presumption, as it is consistent with the congressional policy in enacting the 1934 Act.[20]

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18. *Id.* at 244–245. For understanding behind the theories of the "Efficient Market," *see also* Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373 (1984):

> Researchers agree that the efficient capital market model accurately represents the pricing behavior of stocks. The model posits that the price of a security reflects all publicly available information about a firm, and that prices react almost instantaneously and in an unbiased manner to any new information. These two notions are obviously interrelated. If share prices always reflect all publicly available information, then prices must adjust promptly to any new data. As a normative matter, a market that operates in the manner described by the model is economically desirable because investment will be channeled into the most profitable areas and capital will be allocated efficiently. Moreover, capital formation is encouraged by an efficient market. Such a market reduces the risk of ownership, thus reducing the cost of capital. If the market price efficiently reflects all public information, then investors can have more confidence that the variance of prices will be more stable than if the market were inefficient.

Christopher Paul Saari, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). *See generally* J LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE (1973); W SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS (1970).

19. Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988).

20. *Id.* at 246.

Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets:

> No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings *[sic]* about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value.

III. THE FRAUD CREATED THE MARKET THEORY OF RELIANCE

As illustrated in *Shores v. Sklar*,[21] the fraud on the market theory has not been the only theory enabling plaintiffs to establish reliance in Rule 10b-5 claims. In *Sklar*, the plaintiff purchased industrial development bonds that were used to help fund the construction and equipment of a facility for constructing mobile homes.[22] The lease of the premises for this new facility was the sole source of funding for the bonds.[23] The issuer of the bonds retained an attorney, Sklar, to advise as to the legality of the issuance of the bonds.[24] Sklar drafted an offering circular that intentionally and negligently disregarded many facts about the bond issuer, of which he was aware.[25] Sklar was aware, among other things, that the SEC was investigating and had commenced action against the bond issuers and knew that the issuers were ready to default on some notes.[26] Despite having knowledge of these facts, Sklar participated with the defendants to issue the bonds.[27] The plaintiff, however, was unable to show that he relied on any specific statement or omission in the offering circular as a basis for purchasing the bonds.[28] Nevertheless, the court maintained that "because reliance is so difficult to prove when a defendant has failed to disclose a material fact rather than misrepresenting it," presumptions of reliance enable a plaintiff to meet his or her burden of proof.[29] The Fifth Circuit then reasoned that the lack of reliance on the offering circular is only one part of the overall scheme and is not determinative.[30] Because the plaintiff relied on the availability of the

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Id. (quoting H.R. Rep. No. 1383, at 11) (citing Lipton v. Documation, Inc., 734 F.2d 740, 748 (11th Cir. 1984)).

21. 647 F.2d 462 (5th Cir. 1981).

22. *Sklar*, 647 F.2d at 463, 466.

23. *Id.* at 463.

24. *Id.* at 465.

25. *Id.*

26. *See id.* at 466.

27. *See id.*

28. 647 F.2d at 464.

29. *Id.* at 468.

30. *Id.* at 469 (quoting Blackie v. Barrack, 524 F.2d 891, 905 (9th Cir. 1975)) (describing other factors that are more determinative than simply relying on the

bonds on the market as a mark of their genuineness, reliance would be properly established.[31] In support of its conclusion, the court relied on congressional intent behind enacting Rule10b-5.[32] The Fifth Circuit maintained that Congress intended Rule10b-5 to be broader than merely requiring full disclosure in offering circulars,[33] instead enacting Rule10b-5 to provide that the market be free of fraud and protect investors from ethical misdealings.[34] In addition, the court stated, offering circulars are provided to assist investors in the ascertainment of the fair value of their purchases rather than to determine if a security is free from fraud.[35] As such, Rule10b-5 is the basis for an action against elaborate and intentional schemes that deceive or defraud purchasers of securities.[36] Accordingly, the Fifth Circuit adopted the fraud created the market theory, which finds that investor's reliance on the mere fact that the securities were allowed to be on the market is evidence of their genuineness.

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offering circular as "causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.").

31. *See id.* at 469–70.

32. *Id.*

33. *See id.* at 470 ("First, the purposes of the securities acts and rule 10b-5 are far broader than merely providing full disclosure or fostering informed investment decisions. The Supreme Court has held that the acts were designed 'to protect investors against fraud and to promote ethical standards of honesty and fair dealing… The acts reach complex fraudulent schemes as well as lesser misrepresentations or omissions. Full disclosure is only one means, albeit a central one, of achieving these paramount goals.'" (relying on H.R.Rep.No. 85, 73d Cong., 1st Sess., 1-5 (1933))). *See also* Sargent v. Genesco, Inc., 492 F.2d 750, 760 (5th Cir. 1974) ("This court has held that '(t)he basic intent of section 10(b) and rule 10b-5 and indeed, of the Exchange Act, is to protect investors and instill confidence in the securities markets by penalizing unfair dealings.'").

34. *Sklar,* 647 F.2d at 470.

35. *Id.* (explaining that purchasers read offering circulars not as an incentive to determine the integrity of a stock, but rather to help establish their understanding of where the price of a sale will go, either up or down. The integrity of a purchase is relied on more so by its being on the marketplace).

36. *Id.* at 472.

A. OTHER CIRCUIT COURTS ADOPTING THE THEORY:

1. TENTH AND ELEVENTH CIRCUITS

The Tenth Circuit in *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irr. Fuel Authority*,[37] adopted the fraud created the market theory of reliance. The Tenth Circuit explained that, "[w]e find the Fifth Circuit's reasoning in *Shores v. Sklar* to be persuasive. Federal and state regulation of new securities at a minimum should permit a purchaser to assume that the securities were lawfully issued."[38] The Court further stated that securities laws "must be interpreted flexibly and progressively, not technically nor grudgingly, to fairly effectuate their remedial purpose."[39] By advocating the fraud created the market theory of reliance, the Tenth Circuit effectively announced that the goal of Rule10b-5 was to give courts wide latitude to effectuate a goal of progressive remedies against proponents of fraudulent schemes.

Similarly, the Eleventh Circuit has followed the reasoning of the Fifth Circuit. In *Ross Bank South, N.A.*, the Eleventh Circuit ruled that the fraud created the market theory of reliance was, in fact, a valid presumption.[40] The court, however, clarified that this presumption of reliance could only be used

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37. 717 F.2d 1330 (10th Cir 1983).

38. *See id.* at 1333.

39. *Id.* at 1333 (quoting Clegg v. Conk, 507 F.2d 1351, 1361 (10th Cir. 1974)).

40. Ross v. Bank South, N.A., 885 F.2d 723, 732 (11th Cir. 1989) (explaining that the fraud created the market theory from *Shores v. Sklar* could be applied in certain situations, but that the threshold for this presumption is high).

> The burden imposed by the first element is a substantial one. *Shores* is based on the understanding that although it is reasonable to rely on the market to screen out securities that are so tainted by fraud as to be totally unmarketable, investors cannot be presumed to rely on the primary market to set a price consistent with the appropriate risk. Thus, the *Shores* court defined fraudulently marketed bonds as those that could "not have been offered on the market at any price" absent the fraudulent scheme. In other words, the fraud must be so pervasive that it goes to the very existence of the bonds and the validity of their presence on the market. If the plaintiff "proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover."

Id. (quoting Shores, 647 F.2d at 464, n.2; 647 F.2d at 470).

if the plaintiff could show that the securities for sale would never have made it to the market but for the misrepresentations.[41] The Eleventh Circuit heightened the standard to a new level that previous courts had not. The standard requires that plaintiffs have some sort of evidence that the misrepresentations were the sole criterion for a security's basis for placement in the marketplace.

B. COURTS REJECTING THE FRAUD CREATED THE MARKET THEORY

1. FIFTH CIRCUIT DISSENT

A number of courts have questioned the validity of the fraud created the market theory of reliance, noting that the theory does not conform to the principles for which Rule 10b-5 was enacted, as well as arguing that its approach is flawed. The first to questioning of this theory came from justices who sat on the same court that had first ruled in its favor, *Shores v. Sklar*. In the *Sklar* dissent, ten justices found the theory to be flawed.[42] The dissent noted that the theory hinges on a plaintiff's reliance upon the integrity of the marketplace that offers the securities, rather than on a defendant's misrepresentations.[43] Under this approach, a plaintiff is permitted to bring an

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41. *Id.* at 729.

42. *Sklar,* 647 F.2d at 472 (RANDALL, Circuit Judge, with whom BROWN, RONEY, GEE, TJOFLAT, JAMES C. HILL, FAY, ALVIN B. RUBIN, REAVLEY and HATCHETT, Circuit Judges, join, dissenting).

43. *Id.* at 473 stating that:

> The requirements for recovery under Rule 10b-5 in any case hinge upon which category of securities the defrauded plaintiff purchased. If he purchased a security that was entitled to be marketed, he must have relied on the defendants' misrepresentations or omissions in order to recover. If, however, he can show that he purchased a security which was not entitled to be marketed, he can recover in spite of his nonreliance on the defendants' misrepresentations or omissions if he can show that he reasonably relied on the integrity of the marketplace to offer him securities that were entitled to be marketed. This novel theory permits recovery under the Rule to one who has elected not even to seek to read what the seller is obligated by the Rule to disclose, thereby defeating the primary objective of the Rule the making of an informed investment decision.

action without actually having read any information that a defendant is required to disclose, which, the dissent argued, effectively defeats one of the objectives of Rule10b-5.[44] The dissent argued that Congress did not intend for every security brought onto the market to be free from fraud.[45] Rather, the dissent stated, Congress intended merely to ensure the flow of information in securities markets so that individual investors could make sound decisions based upon sufficient disclosures.[46]

2. EIGHTH CIRCUIT

In *In re NationsMart Corp. Sec. Litig.,* the plaintiffs had not read the corporate-issued prospectus or any information relating to the offering of the securities, which, had they done so, may have caused them to act differently.[47] In dismissing the plaintiff's claim based upon on the fraud created the market theory, the Eight Circuit stated that there was no indication and no proof that the alleged securities would not have been offered on the market, but for the defendant's misrepresentations.[48]

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44. *Id.*

45. *Id.* at 482 (explaining that Congress did not intend to create a scheme of investors insurance or to directly regulate the merits of all those investments on the market).

46. *Id.* (explaining that the role of the securities law is to ensure the free flow of accurate information and that individual investors should look out for themselves). *See also* Santa Fe Industries, Inc v. Green, 430 U.S. 462, 477–78 (1977) ("[I]t repeatedly has described the fundamental purpose of the (1934 Act) as implementing a philosophy of full disclosure; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.").

47. In re NationsMart Corp. Sec. Litig., 130 F.3d 309, 322 (8th Cir. 1997) (discussing the belief that the plaintiffs would have acted differently had they taken the time to read the prospectus issued).

48. *Id.* at 322 (explaining the proposition, that in invoking the fraud created the market theory of reliance, a plaintiff would have to prove the securities would not have been allowed on the market but for the defendant's misrepresentations).

3. SIXTH CIRCUIT

In *Ockerman v. MayZima & Co.*,[49] the Sixth Circuit dealt with a case very similar to that of *Shores v. Sklar*. *Ockerman* involved the issuance of bonds to finance the construction of a retirement village.[50] When the project failed, those responsible for the development of the retirement village were unable to amortize the bonds issued to various investors.[51] The defendants had made material misrepresentations in their offering circular, which purportedly exaggerated the value of the retirement village that was to be constructed.[52] Plaintiff claimed he read the offering circular, but sought to represent a class of plaintiffs who did not.[53] In making its decision, the Sixth Circuit recognized that the fraud created the market theory had been relied on by several other circuits in cases where the plaintiffs' actual reliance was not based upon reliance of required disclosures.[54] In dismissing the fraud created the market theory, the Sixth Circuit stated that:

> We need to keep in mind that Rule 10b-5 is concerned with disclosure and the use of the mail, a national security exchange or an instrumentality of commerce-and the prospectus is claimed by plaintiff to be what was used. We see no justification for reading reliance out of Rule 10b-5 and creating a new implied cause of action which amounts to investor's insurance.[55]

4. SECOND CIRCUIT

In a similar case, the Second Circuit denied a private action brought under Rule10b-5 precisely because the plaintiff could not establish direct

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49. 27 F.3d 1151 (6th Cir. 1994).

50. *See id.* at 1153.

51. *Id.*

52. *Id.* at 1154.

53. *Id.*

54. *See id.* at 1158 (citing to several other circuits including the Eleventh Circuit, Tenth Circuit, and Fifth Circuit as all having adopted the fraud created the market theory presumption of reliance).

55. *Ockerman,* 27 F.3d at 1162 (explaining that in the instant matter, the claims of fraud all related to the representations made in the offering circular).

reliance. In *List v. Fashion Park, Inc.*, the defendant omitted material facts about the status of the corporation, which caused a loss to the plaintiff.[56] The plaintiff, however, had not relied on the information concerning the corporation in purchasing the securities.[57] In deciding the case, the Second Circuit felt the need to clarify the reliance requirement of Rule 10b-5 by stating that:

> the test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in (the recipient's) loss. The reason for this requirement, as explained by the authorities cited, is to certify that the conduct of the defendant actually caused the plaintiff's injury. The basic test of 'materiality,' on the other hand, is whether 'a reasonable man would attach importance (to the fact misrepresented) in determining his choice of action in the transaction in question. Thus, to the requirement that the individual plaintiff must have acted upon the fact misrepresented, is added the parallel requirement that a reasonable man would also have acted upon the fact misrepresented.[58]

After clarifying the reliance requirement, the Second Circuit reasoned that there was no causation that would show that the plaintiff would have purchased the securities if the requisite information was known, and thus denied the plaintiff's claims.[59]

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56. 340 F.2d 457, 460 (2d Cir. 1965).

57. *Id.* at 461.

58. *Id.* at 462; s*ee also Sklar*, 647 F.2d at 474–475 (explaining the basis behind the reliance requirement, being applied by the authorities to securities actions). *Sklar* points to a laundry list of authorities that explain the reliance requirement behind Rule10b-5. The reliance requirement is not an issue that has been subject to debate. Indeed, what is subject to interpretation, and what can be learned from the reliance requirement, is the basis for its inclusion in common law fraud. Using this interpretation, courts have tried to decipher whether the fraud created the market theory of reliance is in fact viable, and whether the theory is one that conforms to the intent of Congress.

59. *List,* 340 F.2d at 464. *Sklar*; 647 F.2d at 475 (explaining that there was no evidence that plaintiff would have acted differently had he known of the misrepresentations that were made).

5. SEVENTH AND THIRD CIRCUITS

While the fraud created the market theory has been rejected in certain instances by the circuit courts above, the theory has been expressly rejected in its entirety by both the Seventh and Third Circuits.[60]

In *Eckstein v. Balcor Investors*, Balcor and a class of plaintiffs had admitted that they failed to read the offering prospectus regarding the company. Instead, they argued that the offering prospectus contained material misrepresentations, which, but for the misrepresentations, would have precluded the securities offering from making it to the market.[61] Because the plaintiffs had not read the offering prospectus, they had to predicate reliance not on the prospectus, but rather through the fraud created the market theory.[62] The Seventh Circuit dismissed the theory, reasoning that "the existence of a security does not depend on, or warrant, the adequacy of disclosure. Many [securities are] on the market even though the issuer or some third party made incomplete disclosures. Federal securities law does not include merit regulation."[63] In addition, the Seventh Circuit noted that adverse information may lower the price of securities, but it will not exclude a security from the market.[64] In following this analysis, the Seventh Circuit rejected the fraud created the market theory.[65]

In *Malack v. BDO Seidman, LLP*, the Third Circuit also rejected the fraud created the market theory, making note of several flawed analyses that courts have used in following the theory. The Third Circuit remarked that the assumption that an investor may reasonably rely on a security's availability on the market as a sign of its genuineness is critical to the fraud

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60. Schwinger & Cross, *supra* note 11 (discussing in footnotes that the Third and Seventh Circuit have declined the theory, where other circuit courts have declined it in specific instances).

61. Eckstein v. Balcor Film Investors*,* 8 F.3d 1121, 1123 (1995).

62. *Id.* at 1130 (explaining that plaintiffs were trying to rely on the fraud created the market theory where direct reliance on documents was lacking).

63. *Id.* at 1131–32 (referring to Freeman v. Laventhol & Horwath, 915 F.2d 193 (6th Cir. 1990)).

64. *Balcor*, 8 F.3d 1121 at 1131. *See also* Business Roundtable v. SEC, 905 F.2d 406 (D.C.Cir. 1990).

65. *Balcor*, 8 F.3d 1121 at 1131.

created the market theory.[66] The court commented that those who promote a particular security, however, as well as all the entities involved in issuing securities, cannot possibly or reasonably be relied upon to insure that a particular security is free from fraud.[67] Because one cannot adequately assert that securities are free from fraud by virtue of their being on the market, the Third Circuit struck down reliance under the fraud created the market theory.[68]

IV. CONCLUSION

Adopting the fraud created the market theory as a valid presumption for establishing reliance in a 10-b5 claim, could establish that any investor who purchases a security is entitled to rely on the market as being fraud-free. Clearly, the existing tension between the interpretations of the various circuit courts will continue to exist unless and until the issue is decided by the United States Supreme Court.

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66. *Malack*, 617 F.3d at 748; s*ee also Sklar*, 647 F.2d at 470 (explaining the requirements in using the fraud created the market theory as developed by the Fifth Circuit in *Sklar*).

67. *Id.* at 749 (stating "All of the parties involved in an issuance have a significant self-interest in marketing the securities." (quoting Ross v. Bank South, N.A., 885 F.2d 723, 739–40 (11th Cir. 1989)).

68. *Id.* at 753–55 (explaining, for many reasons, the fraud created the market theory is at odds with the Congressional intent in enacting Rule10b-5, would open the floodgates to frivolous litigation, and among other things, plaintiffs cannot prove that securities availability is a sign of genuineness).

Editor's Note: Mr. Sichtermann received third place honors in the 2011 James E. Beckley Student Writing Competition. Due to the page constraints of the PIABA Bar Journal, the article is not published in full. The following is a condensed and excerpted version of the article he submitted for the competition. As this is an excerpted article, some internal references relate to portions of the submission that are not included in this version.

TRACING A NEW PATH IN FEDERAL SECURITIES REGULATION: RE-EXAMINING THE NEED FOR THE FRAUD CREATED THE MARKET PRESUMPTION IN LIGHT OF THE GREAT RECESSION

Jonathan Sichtermann[1]

I. INTRODUCTION

Events of the 2008–2009 Great Recession illustrate the need for a careful re-examination of United States securities laws. Securities fraud regulation must be altered and strengthened to ensure that investors in the debt market have legal recourse against securities issuers to reduce the risk of similar crises in the future. This article begins with an examination of debt markets in general and the securities statutes as they pertain to the element of reliance in those statutes. An analysis of judicial interpretation of the reliance element in 10-b5 claims reveals glaring weaknesses in securities laws, which allow fraud to go uncompensated. The article next offers a new presumption of reliance, which is based on the highly controversial fraud created the market presumption. Finally, the article concludes by showing how this new presumption would enable the investor from our hypothetical (omitted from these excerpts) to fight issuer fraud and stave off financial calamity.
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1. Deputy Attorney General, Office of the Indiana Attorney General. J.D., *magna cum laude*, Valparaiso University School of Law (2012); B.S., Business Accounting, Purdue University (2009). The views contained in this article are solely those of the Author and do not represent the views of the Office of the Indiana Attorney General.
I would like to thank my parents, Rich and Linda, for their constant love and support. I would also like to thank my Moot Court coach Paul Kelly and teammate Eli Korer for sparking my interest in securities law. We had a great run last year! Finally, I would like to thank Valparaiso University School of Law Professor Bernard Trujillo for introducing me to many of these concepts in Corporate Finance.

C. The Reliance Element of a 10b-5 Claim

Plaintiffs must prove they *reasonably relied* on false and misleading statements to establish a securities fraud claim under Rule 10b-5.[2] A plaintiff's unreasonable reliance upon misleading statements is not adequate. Reasonableness depends in part on the investor's sophistication and whether the issuer has given truthful information.[3] In the absence of specific representations from the issuer to plaintiff, the plaintiff might not be able to establish reasonable reliance needed to bring a federal claim.[4] Presumptions are justified because of "considerations of fairness, public policy, and probability, as well as judicial economy."[5] They are particularly appropriate when the plaintiffs would have a difficult time establishing direct proof.[6]

While actual reliance is required in most instances, the United States Supreme Court has allowed plaintiffs to establish presumed reliance in two situations.[7] The first presumption was created in *Affiliated Ute Citizens of Utah v. United States*, and is applicable when the issuer makes material

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2. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) (explaining that "to the requirement that the individual plaintiff must have acted upon the fact misrepresented, is added the parallel requirement that a *reasonable man* would also have acted upon the fact misrepresented"); Mitchell v. Tex. Gulf Sulphur Co., 446 F.2d 90, 102 (10th Cir. 1971); SEC v. Alliance Leasing Corp., 28 Fed. Appx. 648, 2002 WL 10482 (9th Cir. 2002); *see also*, HAZEN, *supra* note 25 at 509 (explaining that private plaintiffs must prove that they relied on fraudulent misrepresentations, but the SEC does not have to prove reliance).

3. Semerenko v. Cendant Corp., 223 F.3d 165 (3d Cir. 2000); Banca Cremi, S.A. v. Alex Brown & Sons, Inc., 132 F.3d 1017 (4th Cir. 1997) (explaining that a sophisticated investor could not reasonably rely on a broker).

4. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 513 (5th ed. 2006) (explaining that "specific disclosure[s] will preclude a fraud action" while general disclosures will not); s*ee also*, Ambrosino v. Rodman & Renshaw, Inc., 972 F.2d 776 (7th Cir. 1992); Chavin v. McKelvey, 182 F.3d 898 (2d Cir. 1999).

5. Basic, Inc. v. Levinson, 485 U.S. 224, 245 (1988).

6. *Id*.

7. *Compare* Levine v. Prudential Bache Props., Inc., 855 F. Supp. 924 (N.D. Ill. 1994), *with* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153–54 (1972) (allowing plaintiffs to presume reliance in the case of a material omission), *and* Basic, Inc., v. Levinson, 485 U.S. 224, 250 (1988) (allowing plaintiffs to presume reliance when they bought securities on an efficient market based on the market's price).

omissions in the offering materials.[8] The second exception to the actual reliance requirement arose from *Basic, Inc. v. Levinson*, when the Court adopted the fraud on the market presumption of reliance at the pleading stage of a securities class actions.[9] The presumption of reliance set forth in *Basic*, "is based on the hypothesis that, in an open and efficient securities market, the price of a company's stock is determined by the available material information regarding the company and its business."[10] Misleading information becomes part of the securities' price and investors rely on that price when buying or selling their securities.[11] Opponents of this presumption argued at the time that the theory "effectively eliminate[d]" the reliance element of a Rule 10b-5 claim, which "long has been an element of common-law fraud."[12] The Court rejected this argument by noting that "modern

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8. 406 U.S. 128 (1972).

9. 485 U.S. at 245 (allowing a presumption or reliance at the pleading stage due to the theory that investors relied on information disseminated in an impersonal market).

10. *Id.* at 241. This hypothesis is known as the Efficient Capital Markets Hypothesis.

11. *See id.* at 244.

> In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between buyer and seller and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.

Id.

12. *Id.* at 243. The presumption of reliance remains controversial today, as commentators argue that the Efficient Capital Markets Hypothesis on which it is premised is not accurate and does not serve as an adequate basis for presumed reliance. A.C. Pritchard, Stoneridge Inv. Partners v. Scientific-Atlanta*: The Political Economy of Securities Class Action Reform*, CATO SUP. CT. REV. 217, 221 (2007) (explaining that the Court's interpretation is more like common law deceit than common law fraud). The Court did not address these concerns in *Basic*, instead noting that "[o]ur task . . . is not to assess the general validity of the theory." *Basic*, 485 U.S. at 242. Since the Court's interpretation of federal securities law is based on common law tort principles, it is appropriate to look at policies underlying those

securities markets [with] millions of shares changing hands differ daily from the face-to-face transactions contemplated by early fraud cases."[13]

The Court justified this new presumption by looking to congressional intent, "common sense[,] and probability."[14] The Court quoted congressional language in pointing out that investors cannot safely trade on securities exchanges unless they can rely on the market to impound information from "competing judgments . . . as to the fair price of a security."[15] The Court again adopted congressional language, finding that "[j]ust as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value."[16]

Judge Posner addressed the fraud on the market theory in 1985 and extolled the virtues of awarding damages based on the Efficient Capital Markets Hypothesis.[17] While Judge Posner acknowledged that in some cases the "net measurable damages from a stock fraud will be zero," damages

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common law torts. The primary tort law policy is "[l]iability should be based on fault;" another is "[t]hose who benefit from dangerous activities should bear resulting losses." VINCENT R. JOHNSON & ALAN GUNN, STUDIES IN AMERICAN TORT LAW 7–8 (4th ed. 2009). In exploring possibilities for new regulatory regimes following the Great Recession, some commentators listed the first of these tort policies as one of the "Five Principles of Effective Government Risk Management." Tom Baker & David Moss, *Government as Risk Manager*, *in* NEW PERSPECTIVES ON REGULATION 94 (2009). Baker and Moss explained that this principle is extremely important because "[s]ound risk management requires placing responsibility on people in a position to do something about the risk." *Id.*

13. *Basic*, 485 U.S. at 243–44.

14. *Id.* at 246–47. The Court also noted that the '34 Act's extensive disclosure requirements were based on the "legislative philosophy [that] [t]here cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." *Id.* at 230 (internal quotations omitted) (citing S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934)).

15. *Id.* at 246 (citing H.R. Rep. No. 1383, at 11).

16. *Id.* (quoting H.R. Rep. No. 1383, at 11).

17. Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 168 (1985) (explaining in a lecture delivered on November 14, 1985 that courts' application of the Fraud on the Market theory was "economically correct") [hereinafter Posner, *Law and the Theory of Finance*].

should nonetheless be awarded.[18] He distinguished securities fraud cases from common law tort cases because there are other interests at stake in securities fraud cases than merely awarding damages to deter negligence.[19] Posner then pointed to several social costs imposed by securities fraud, including the risk that "the prevalence of fraud may make the stock market more volatile, imposing disutility on the risk-averse investor."[20] While the fraud on the market theory applies only to secondary markets, some circuit courts have adopted similar presumptions to cases involving initial distributions, thereby creating the fraud created the market presumption.

D. The Fraud Created the Market Presumption of Reliance

Before the Supreme Court handed down its decision in *Basic*, the Fifth Circuit established the "fraud created the market" presumption of reliance.[21] Under this presumption, a plaintiff can establish the reliance element of a 10b-5 claim by showing that the securities were unmarketable and could not have entered the market, *but for* the defendant's fraudulent

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18. *Id.* at 169 (explaining that damages will net out to zero because people who buy stock at fraudulently inflated prices will be hurt, while those selling at those prices will benefit). In justifying damage awards, Posner pointed to the famous tort case of *Rickards v. Sun Oil Co.*, 23 N.J. Misc. 89 (N.J. Sup. Ct. 1945). In *Rickards*, the defendant negligently sailed his boat into the only bridge connecting an island to the mainland, thus cutting the island off from the mainland. Merchants on the island sued the defendant for damages resulting from lost business, but the court refused to award damages. The net damages to society in that case were zero, just as in a securities fraud case, because merchants on the mainland saw increased business at the expense of the island merchants.

19. *Id.* at 170 (explaining that damages should be awarded in securities fraud cases because other interests are at stake besides efficiency interests and distributive interests).

20. *Id.* Posner also cites two other social costs imposed by securities fraud: "First the managers may have expended real resources in concealing the bad news. Second, and related, if fraud is prevalent, investors will have an incentive to expend more resources on trying to find out the truth about firms, because they have to overcome disinformational efforts of corporate managers." *Id.*

21. Shores v. Sklar, 647 F.2d 462, 469–70 (5th 1981) (establishing the fraud created the market theory of reliance for newly issued securities).

misrepresentations.[22] The Supreme Court has never decided the validity of this presumption and currently the circuits are deeply split over whether this is a valid theory to establish reliance.[23] The circuit split has led to at least two, and possibly three, competing theories of unmarketability and questions remain as to whether any of these theories are viable in light of the Supreme Court's recent *Stoneridge* decision.[24]

To establish the fraud created the market presumption of reliance, a plaintiff must show that the issuer intended to defraud investors by issuing securities "which were not entitled to be marketed."[25] Next, the plaintiff must establish that he "reasonably relied on the securities' availability on the market as an indication of their apparent genuineness."[26] Finally, the investor must establish that the losses were caused by the issuer's fraud.[27] While these are the general elements of the fraud created the market presumption, courts have interpreted the unmarketability element differently.

1. Economic Unmarketability

The most widely accepted theory of unmarketability is that of "economic unmarketability." Economic unmarketability occurs if "no investor would

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22. *Id.* at 471 ("The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market."); *see also* Ross v. Bank South, N.A., 885 F.2d 723, 729 (11th Cir. 1989) (explaining that this presumption is appropriate when the fraud was "so pervasive that absent the fraud the bonds could not have been marketed").

23. *See* T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1984) (adopting the *Shores* reasoning and holding that the plaintiffs established reliance under the fraud created the market presumption); Shores, 647 F.2d at 469–70 (holding that the plaintiffs established the reliance element of their 10b-5 claim under the fraud created the market presumption). *But see* Malack v. BDO Seidman, LLP, 617 F.3d 743, 749 (3d Cir. 2010) (rejecting the presumption because it "lacks a basis in any of the accepted grounds for creating a presumption"); Eckstein v. Balcor Film Investors, 8 F.3d 1121, 1130–31 (7th Cir. 1993) (rejecting the presumption).

24. Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008). This case will be discussed later in the article.

25. *Shores,* 647 F.2d at 469.

26. *Id.* at 469-70.

27. *Id.* at 470.

buy [the security] because, assuming full disclosure, the security is patently worthless."[28] This could be a very difficult standard for plaintiffs to meet, because some courts feel nearly every security has at least some value.[29]

For instance, the bonds in *Ockerman v. May Zima & Co.,*[30] were not economically unmarketable because they were not patently worthless, even though the investors recouped only a fraction of their original investment when the public learned of the issuer's fraud.[31] The court reasoned that the bonds were not economically unmarketable because Ockerman merely alleged "the bonds were not worth the price he paid for them" and not that they were "patently worthless."[32] The Fifth Circuit clarified the test for economic unmarketability in *Abell v. Potomac Insurance Co.*, by holding that "promoters [must know] the enterprise itself was patently worthless."[33] The court found that the fraud created the market presumption is only available if the issuers "knew that the subject enterprise was worthless when the securities were issued, and successfully issued the securities only because of the defendant's fraudulent scheme."[34]

While economic unmarketability is the most widely accepted theory of unmarketability, it is also the most widely criticized. For example, in rejecting the fraud created the market presumption,[35] the Seventh Circuit concluded that a security's presence on the market is not dependent on "the adequacy of disclosure" because many securities are marketed "despite

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28. Ockerman v. May Zima, & Co., 27 F.3d 1151, 1160 (6th Cir. 1994).

29. *See* Ross v. Bank South, N.A., 885 F.2d 723, 736 (11th Cir. 1989) (Tjoflat J., concurring) (explaining that economic unmarketability is a misguided theory because "no matter how great the risk of nonpayment, a bond can virtually always be sold at some combination of price and interest rate").

30. 27 F.3d 1151 (6th Cir. 1994).

31. *Id.* at 1160.

32. *Id.* at 1160–61.

33. 858 F.2d at 1122. In that case, the bondholders alleged that the bonds were economically unmarketable, but the court rejected the argument because the bonds *always* had a legitimate value . . . [and] remained near market value for several years *after*" the issuers released accurate statements. *Id.*

34. *Id.* at 1122–23; *see also* Stinson v. Van Valley Dev. Corp., 714 F. Supp. 132, 138 (E.D.P.A. 1989) (explaining that fraud created the market applies only "where the promoters relied on a sham business and did not intend to start a legitimate one").

35. Eckstein v. Balcor Film Invs., 8 F.3d 1121, 1130 (7th Cir. 1993).

incomplete disclosures."[36] The court further concluded that, even though a security's price might fluctuate because of full disclosure, the security would still enter the market.[37]

Even among circuits that adhere to the economic unmarketability theory, there is disagreement as to what that standard means. Judge Tjoflat of the Fifth Circuit Court of Appeals gave economic unmarketability a different interpretation in a concurring opinion, and explained the theory in terms of "factual unmarketability."[38] A security is factually unmarketable if the security could not have been issued "at *its actual price and interest rate"* without the defendant's fraud.[39] By this standard, plaintiffs would be required to prove only that the securities were unmarketable at the price and interest rate at which they were sold absent the fraud, not that the securities were absolutely worthless.[40] No federal circuit court has adopted this interpretation of economic unmarketability. Case law illustrates the deep division among judges as to the validity of the economic unmarketability standard and what exactly renders a security economically unmarketable. One circuit has declined to address the economic unmarketability test presented to it, opting instead for a legal unmarketability standard that examines whether the security was legally issued.

2. Legal Unmarketability

The Tenth Circuit Court of Appeals avoided the entire discussion of whether a security's presence on the market should serve as an indication of

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36. *Id.*

37. *Id.* at 1131. In support of this proposition, the court cited markets that trade primarily in "penny stocks." The court then concluded that disclosing bad information does not keep securities from the market, which rendered the basic premise of the Fraud created the market presumption false.

38. Ross v. Bank South N.A., 885 F.2d 723, 736 (11th Cir. 1989) (Tjoflat, J., concurring).

39. *Id.* at 735. Judge Tjoflat reasoned that this type of unmarketability is preferable to economic unmarketability because a bond can "always be sold at some combination of price and interest rate" regardless of the risk of nonpayment, which makes economic unmarketability a nearly impossible test to meet. Further, bonds come with a legal obligation to repay the investor, so they can never be truly worthless according to Judge Tjoflat.

40. *Id.*

its value when it adopted the Fraud created the market presumption. Instead, the Tenth Circuit focused on whether a security was legally issued. Legal unmarketability means that the issuer could not have sold the securities absent the fraud because the issuance did not comply with the relevant securities law.[41] This theory of legal unmarketability is even more important in light of the recent economic turbulence.[42]

T.J. Raney & Sons, a securities broker-dealer, distributed Fort Cobb, Oklahoma Irrigation Fuel Authority bonds even though it could not issue bonds under Oklahoma law because it was not a "valid public trust."[43] Raney brought a class action against the Authority and alleged that the bonds were not "lawfully issued according to Oklahoma law" and therefore were not entitled to be on the market.[44] The Tenth Circuit adopted the fraud created the market theory and explained that its holding did not create "investor's insurance," but rather protected investors under Rule 10b-5 in cases where issuers knowingly illegally issued securities.[45] However, the illegality must go to the heart of the securities transaction, not an ancillary matter.[46] The split between legal and economic unmarketability remained unchanged until 2008 when the Supreme Court handed down a decision with the potential to invalidate the fraud created the market presumption entirely.

3. Post-*Stoneridge*: Is there still a place for fraud created the market?

While the fraud created the market presumption may have been controversial prior to 2008, it became even more questionable following a Supreme Court decision that did not directly address the presumption. In

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41. Ockerman v. May Zima & Co, 27 F.3d 1151, 1160 (6th Cir. 1994).

42. Even some prominent free-market advocates now argue that the government response to illegal and fraudulent Wall Street activity was "slow, indecisive and poorly articulated." RICHARD POSNER, A FAILURE OF CAPITALISM 239 (2009).

43. T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Auth., 717 F.2d 1330, 1333 (10th Cir. 1984).

44. *Id.*

45. *Id.*

46. *See* Ockerman v. May Zima & Co., 27 F.3d 1151, 1153 (6th Cir. 1994) (explaining that the plaintiffs did not establish legal unmarketability because the illegality dealt with a failure to obtain required nursing services).

2008, the Supreme Court decided *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc*.[47] This decision, which denied plaintiffs a private right of action against secondary actors, (i.e., the issuer's lawyers, accountants, underwriters), was seen by some as a reflection of "the Court's recent skepticism toward securities class actions" and "a retrenchment from *Basic, Inc. v. Levinson*, which was the high-water mark for the Rule 10b-5 class actions."[48] It appears that the Court will neither expand such private rights of action, nor will it curtail existing precedent in this regard.[49] In refusing to create a private right of action against secondary actors, the Supreme Court was concerned with "the specter of unlimited liability" for corporations.[50] Specifically, it felt that this potentially limitless liability would make U.S. corporations less competitive internationally "because companies would be reluctant to do business with American issuers."[51]

While *Stoneridge* did not directly address the fraud created the market presumption, at least one circuit has applied its reasoning in rejecting the presumption.[52] In *Malack v. BDO Seidman, LLP*, the Third Circuit Court of Appeals reasoned that the fraud created the market presumption was inconsistent with *Stoneridge* because it would "extend § 10(b) liability far beyond its current contours."[53] The Third Circuit also rejected *Basic*'s

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47. *See generally* 552 U.S. 148 (2008).

48. Pritchard, *supra* note 11, at 217.

49. *Id.* at 218 (explaining that the Court's interpretation of *Stoneridge* suggests that the Court will not create new private rights, and will also not lead to judicial reforms of existing private rights such as the fraud on the market presumption or the *Ute* presumption). Specifically, the Court noted that "[c]oncerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the §10(b) private right should not be extended beyond its present boundaries." *Stoneridge*, 552 U.S. 148, 165 (2008).

50. Pritchard, *supra* note 11, at 232.

51. *Id.* at 233.

52. Malack v. BDO Seidman, LLP, 617 F.3d 743, 754 (3d. Cir. 2010) ("Although the *Stoneridge* Court was not specifically considering the fraud created the market theory, we view its instruction as general support for rejecting such new presumptions of reliance.").

53. *Id.*

justifications for extending a presumption: common sense, probability, and legislative intent.[54]

The Third Circuit explained that "common sense" does not justify the fraud created the market presumption because a security's mere availability on the market is not an indication of its genuineness.[55] For it to be a reasonable indication of a security's genuineness, "there must be some entity involved in the process of taking the security to market that acts as a bulwark against fraud. Yet the entities most commonly involved in bringing a security to market do not imbue the security with any guarantee against fraud."[56] The court explained that the "security's promoter, . . . the underwriter, the auditor, and legal counsel—the very entities often charged with fraud—cannot be reasonably relied upon to prevent fraud."[57] The court also rejected the claim that a security is genuine based on SEC regulation because the SEC "does not conduct 'merit regulation.'"[58]

The Third Circuit also rejected *Basic*'s "vague invocation of probability" because the fraud created the market presumption is not justified by the same economic theory as the similarly named fraud on the market presumption.[59]

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54. *Id.* at 749–50 (rejecting *Basic*'s "common sense" argument); *id.* at 751–52 (rejecting *Basic*'s "probability" argument); *id.* at 752–53 (rejecting *Basic*'s argument that the presumption is supported by congressional intent).

55. *Id.* at 749.

56. Malack v. BDO Seidman, LLP, 617 F.3d 743, 749 (3d Cir. 2010).

57. *Id.* "If we were to credit the Fraud created the market theory based on the entities involved in the issuance 'we [would have to] believe that an initial investor may reasonably rely on clearly self-interested (perhaps dishonest) parties to make decisions that are at least burdensome and at most economically irrational.'" *Id.* at 750.

58. *Id.* at 750. The SEC "seeks to confirm that the issuer adequately disclosed information pertaining to the security. . . In addition to the review of the adequacy of the disclosures, the SEC will examine the clarity and also will conduct a 'plain English' review of those portions of the registration statement that are subject to the SEC's plain English disclosure requirements." *Id.* (quoting THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 3.7).

59. *Id.* at 751.

> Stripped of its fortuitously similar name—which may have bolstered its credibility with some courts—the Fraud created the market theory gains no support from the universally accepted Fraud on the Market theory. The later is ultimately grounded in the efficient market hypotheses, which while imperfect, has a basis

The Third Circuit further reasoned that adoption of this theory would "eliminate[] the need for proving reliance in *any* securities fraud cases and would create investor insurance."[60] Finally, the Third Circuit concluded that this theory runs counter to the congressional intent of promoting informed decision-making because the theory allows investors to recover monetary damages even when they may have failed to conduct their own due diligence before purchasing the securities.[61] Effectively, an investor would "stand[] to lose nothing by blindly purchasing" a security, since its mere presence on the market is a reasonable indication of its genuineness.[62] Having thus laid out the arguments for and against the fraud created the market presumption, it is time to analyze the presumption and determine if it is truly a valid extension of Rule 10b-5 presumed reliance.

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> in economics. The same cannot be said for the former. The Fraud created the market theory has no underlying economic justifications and any attempt to ride the coattails of the Fraud on the Market theory is easily rejected.

Id.

60. *Malack*, 617 F.3d at 752. Essentially, the court was arguing that the fraud created the market presumption would lead to moral hazard, which occurs "when responsibility is uncoupled from control." Baker & Moss, *supra* note 12, at 95. Some commentators, in examining new regulatory regimes, have noted the need to avoid moral hazards. *Id*. Accordingly, any new regulatory regime must adhere to three basic principles: "mak[e] sure that enough of the loss continues to fall on the insured person to maintain the prevention incentive . . . condition[] insurance coverage on a commitment to engage in specific loss-prevention efforts; and insist[] that some control over the loss be shifted along with the risk." *Id.* at 95–96.

61. 617 F.3d 753.

62. *Id.* The court argues that "under *Shores*, any incentive to read disclosures essentially disappears since plaintiffs would receive the full purchase price for their securities without having to read disclosure information."

III. ANALYSIS

A. Impacts of the Fraud Created the Market Presumption

To determine the effects of this new presumption, one must first determine if it complies with congressional intent.[63] Next, does the presumption strike the proper balance in imposing liability?[64] Finally, does the presumption carry unintended consequences such as creating moral hazard?[65]

1. The Presumption Comports with Congressional Intent

When Congress enacted the '33 and'34 Acts, it sought to promote informed decision making by investors and protect the integrity of the markets.[66] To achieve these goals, the Securities and Exchange Commission has promulgated various regulations that require issuing entities to disclose information to help investors make informed investment decisions.[67] To promote the goal of informed decision making, the Court has limited the instances in which plaintiffs can presume reliance.[68] However, when the

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63. *See infra* Part III.A.1.

64. *See infra* Part III.A.2.

65. *See infra* Part III.A.3.

66. *See supra* Part II.B (explaining the '33 and '34 Acts and describing Congress's intent in enacting these statutes).

67. *See supra* notes ***** (describing Rule 10b-5 and the elements plaintiffs must establish to proceed under a securities fraud claim under the '34 Act). Issuers must make certain disclosures to comply with Rule 10b-5 and plaintiffs must rely on these disclosures in order to establish a securities fraud claim. *See supra* note ****. This reliance element serves Congress's goal of promoting informed decision making. *See supra* Part II.C (describing Rule 10b-5's reliance element).

68. *See* text accompanying notes 7–23 (explaining that actual reliance is preferred and that the Supreme Court has only recognized presumed reliance in two situations). To date, the Court has allowed plaintiffs to proceed only on a presumption of reliance when the issuer made material omissions in the offering materials or when the plaintiff relied on the integrity of an open and efficient securities market when he or she purchased the securities. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153–54 (1972) (holding that plaintiffs could presume reliance when the defendant made material omissions); Basic, Inc., v.

Court has recognized a presumption, it has done so in an effort to protect the other congressional aim—to protect the integrity of the markets.[69]

Critics of the fraud created the market presumption argue that the presumption runs contrary to the goal of informed decision making.[70] The Third Circuit in *Malack* noted that if the plaintiffs could establish reliance based purely on the security's presence on the market, plaintiffs would not need to read any disclosures or prospectus materials.[71] According to the court, this would allow plaintiffs to engage in securities transactions without taking any actions to inform themselves of the risks of the transactions.[72]

While this presumption arguably runs against the congressional goal of promoting informed decision making, it promotes the goal of protecting the integrity of the market. The fraud created the market presumption, or some refinement thereof, would allow plaintiffs to proceed on securities fraud claims involving newly created debt securities in particular, which could give investors more confidence in the debt markets in general.

Levinson, 485 U.S. 224, 250 (1988) (holding that plaintiffs could presume reliance if they purchased their securities based on information disseminated on an open and efficient market).

69. *See supra* note ** (explaining that the *Basic* Court accepted the fraud on the market presumption because investors must be able to rely on the market to impound information about a security's value). According to the Court, if investors cannot rely on the market to properly impound information from diverse sources, the investors cannot safely purchase securities, and the stock market would suffer as a result. *Basic*, 485 U.S. at 246 (justifying the *Basic* holding on congressional intent as evidenced in H.R. Rep. No. 1383).

70. *See* text accompanying note 61 (explaining that the Third Circuit in *Malack* rejected the fraud created the market presumption of reliance because it is contrary to the congressional intent of promoting informed decision making).

71. Malack v. BDO Seidman, LLP, 617 F.3d 743, 753 (3d Cir. 2010).

72. *See supra* notes 60–61 and accompanying text (explaining that plaintiffs could avoid doing their own due diligence when purchasing securities because under the fraud created the market presumption they would "stand to lose nothing by blindly purchasing" a security (quoting *Malack*, 617 F.3d at 753).

2. The Fraud Created the Market Presumption Imposes Burdens on the Party Best Able to Prevent the Fraud

The '33 and '34 Acts draw heavily from principles of tort law.[73] Therefore, a new presumption of reliance should also have some grounding in tort principles. The fraud created the market presumption has just such a basis in tort law. One of the basic principles of tort law is that the law should impose liability and burdens on the party best able to pay.[74] Furthermore, the law should impose burdens on wrongdoers.[75]

The Third Circuit in *Malack*, however, ruled in favor of the defendants.[76] The court reasoned that investors must conduct their own due diligence and cannot rely on parties such as a "security's promoter, . . . the underwriter, the auditor, and legal counsel" to prevent fraud.[77] The court's analysis, however, seems flawed. The '33 and '34 Acts are designed to prevent fraud in the securities markets in the first instance and thereby ensure the integrity of the markets.[78] Thus, investors should be able to rely on an issuer's compliance with SEC rules as a reasonable indication of the security's genuineness. If an issuer is complying with the SEC's disclosure requirements and providing

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73. *See* Basic, 485 U.S. at 243 (critics argued that the fraud on the market presumption should not be adopted because it does not conform with common law tort law); *see also* Pritchard *supra* note 12, at 3 (explaining that the court's interpretation of the fraud on the market presumption is more like the tort of deceit than the tort of fraud); Posner, *Law and the Theory of Finance*, *supra* note 17, at 169 (comparing a 10b-5 cause of action to tort cases, but arguing that differences in the economy and society require slightly different approaches from common law tort approaches).

74. JOHNSON & GUNN, *supra* note 12, at 7–8 (listing this as a prominent tort law principle); *see also* Baker & Moss, *supra* note 12, at 94 (arguing that this principle should be incorporated into new regulatory regimes).

75. JOHNSON & GUNN, *supra* note 12, at 7–8.

76. Malack v. BDO Seidman, LLP, 617 F.3d 743, 756 (3d Cir. 2010) (holding that plaintiffs could not proceed on the Fraud created the market presumption).

77. *Id.* (explaining that these people cannot be trusted to prevent fraud and provide reliable information). The Third Circuit further explained that investors cannot "rely on clearly self-interested (perhaps dishonest) parties to make decisions that are at least burdensome and at most economically irrational." *Id.* at 750.

78. *See supra* Part II.B (explaining that both of the Securities Acts were designed to prevent fraud in the securities markets following the Great Depression).

truthful information in those disclosure documents, an investor could reasonably assume that the documents are not fraudulent.

Instead of forcing investors to bear the burdens of fraudulent activity, as the Third Circuit did in *Malack*, courts should force defendants who engaged in fraudulent activity to bear the burdens and liability of their own actions. This conforms to the basic tenants of tort law and also ensures that those parties best able to prevent fraud in the future are those who bear the losses if such fraud is not prevented.[79] Not only does this conform to the basic tenants of general tort law, it also conforms to the specific intent of Congress. In enacting the securities acts, Congress intended to protect innocent investors. It did not intend for fraudulent issuers to use pleadings requirements as a shield to avoid liability for their otherwise fraudulent acts. The "security's promoter, . . . the underwriter, the auditor, and legal counsel" are in a position to ensure that no fraudulent activity occurs in the course of issuing a security.[80] If any of those parties see fraudulent activity, they have the ability to prevent it or report it to those who can prevent it. Investors, however, do not have a similar ability to prevent fraud. At most, they can try to analyze complex documents and hope to catch fraudulent misrepresentations that the issuing entity has already made. While a few courts find this level of skilled review by public customers to be the preferred course of action,[81] it is often not feasible. Oftentimes, the potential investors may be misled by professionals, have limited expertise, or have limited time to examine the merits of a security. They may often also lack access to the information necessary to determine whether the representations contained in public documents are, in fact, accurate.

3. Opponents of the Presumption Argue That it Creates a Moral Hazard

Some industry advocates contend that a broad fraud created the market presumption may create problems that outweigh its benefits. Potentially, the use of presumptions could create circumstances that incentivize a party to

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79. *See* JOHNSON & GUNN, *supra* note 12 (explaining that tort law should place the burden on those best able to pay and on those who caused the wrong).

80. Malack v. BDO Seidman, LLP, 617 F.3d 743, 749 (3d Cir. 2010). Here, I am quoting Malack's language but arguing that the analysis is incorrect.

81. *See* SEC v. Alliance Leasing Corp., 28 Fed. Appx. 648, 2002 WL 10482 (9th Cir. 2002); Levine v. Prudential Bache Props., Inc., 855 F. Supp. 924 (N.D. Ill. 1994).

ignore the inherent risks of a transaction because they would not bear the costs of that risk. In economic theory, such a situation is known as a moral hazard. Critics of the fraud created the market presumption argue that its usage would create moral hazard because investors could invest in any security they choose and not have to worry about losses. If they lose money they could simply go to the courts and ask to be bailed out.[82] This would insulate them from the risks of the securities that they purchase.

Concerns that the fraud created the market presumption would lead to moral hazard situations can be mitigated by carefully tailoring the presumption. First, the presumption should be available only to investors who purchased private placement bonds, not stocks traded on an efficient market. Second, liability should be limited to recessionary damages. Finally, the fraud created the market presumption must be based on the bond's legality, not its underlying economic value. (Mr. Sichtermann elaborates on each of these proposals in the full version of his article.)

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82. *See* Malack v. BDO Seidman, LLP, 617 F.3d 743, 753 (3d Cir. 2010) (explaining that investors could purchase any security without doing any due diligence and turn to the courts if their investment failed to produce the desired results); Baker & Moss, *supra* note 12, at 95–96 (explaining moral hazard).

REGULATORY RESOURCES FOR INVESTOR ADVOCATES

Steven B. Caruso

In this section of the PIABA Bar Journal, we will share with our readers summaries of a number of publications and notices that have been recently issued by various federal, state and self-regulatory organizations on topics that may be of interest to investor advocates.

FEATURED REGULATORY SPOTLIGHT

U.S. Securities & Exchange Commission
SEC Recommends Improvements to Help Investors in Municipal Securities Market
July 31, 2012
Source: *http://www.sec.gov/news/studies/2011/913studyfinal.pdf*

In July of 2012, the U.S. Securities & Exchange Commission released a comprehensive report, that was entitled *Report on the Municipal Securities Market*, which includes recommendations to help improve the structure of the $3.7 trillion municipal securities market and enhance the disclosures provided to investors.

This Report commences with an overview of the municipal securities market, the regulatory structure and the roles of key market participants. Next, the Report focuses on two key areas of concern in the municipal securities market: disclosure and market structure. Finally, the Commission provides a number of recommendations for potential further consideration, including legislative changes, Commission rulemaking, Municipal Securities Rulemaking Board ("MSRB") rulemaking and enhancement of industry "best practices."

For practitioners who represent investors in securities arbitration proceedings, however, there are several specific portions of this Report that may prove to be invaluable in those particular circumstances where municipal securities are, in whole or in part, at issue.

These specific portions of the Report include those that focus on the following:

Overview of Disclosure Practices & Issues, which describes, in detail, the rules that have been developed as a result of the antifraud provisions of federal and state securities laws, Exchange Act Rule 15c2-12, Commission

interpretive guidance, MSRB rules, and voluntary guidelines published by various industry groups;

- and -

Recommendations for Improved Municipal Disclosures that are applicable to all municipal securities in general, and specifically those municipal securities that either contain and/or are linked to embedded derivative securities and/or indices.

FINANCIAL INDUSTRY REGULATORY AUTHORITY

Investor Alert
Exchange-Traded Notes: Avoid Unpleasant Surprises
Issue Date: July 10, 2012

In this Investor Alert, FINRA informs investors of the features and risks of exchange-traded notes (ETNs) and provides a step-by-step checklist to help investors determine if an ETN is right for them.

Regulatory Notice 12-30
SEC Approves Increase in Simplified Arbitration Threshold
Issue Date: June 22, 2012

In this Regulatory Notice, FINRA discusses an amendment to the Code of Arbitration Procedure which will provide for an increase in the limit, for simplified arbitration cases, from $25,000 to $50,000.

Regulatory Notice 12-29
New Rules Governing Communications With the Public
Issue Date: June 14, 2012
Effective Date: February 4, 2013

In this Regulatory Notice, FINRA discusses the SEC's approval of amendments to the rules that govern communications with the public including the applicable definitions of sales & advertising materials, correspondence and retail/institutional communications. For example, among the revisions, FINRA Rule 2210(a)(2) has redefined "correspondence" as "any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period."

The new amendments also modify the review, approval, and recordkeeping requirements. Of particular import is the retention of the requirement that all firm communications be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service, as well as the prohibition against any communication that omits any material fact if the omissions, in light of the context of the material presented, would cause the communication to be misleading.

Regulatory Notice 12-25
Additional Guidance for New Suitability Rule
Issue Date: May 18, 2012

In this Regulatory Notice, FINRA provides additional guidance in light of questions that have been raised regarding the implementation of the new suitability rule, Rule 2111, which became effective on July 9, 2012. Among the topics for which additional guidance has been provided are: the obligation to act in a customer's best interests; the scope of the terms "recommendation," "customer" and "investment strategy;" the use of a risk-based approach to documenting suitability; information-gathering requirements; reasonable-basis and quantitative suitability; and the institutional-customer exemption.

Investor Alert
It Pays to Understand Your Brokerage Account Statements & Trade Confirmations
Issue Date: February 23, 2012

In this Investor Alert, FINRA guides investors through the key elements of their account statements and trade confirmations and details, in plain language, the key elements of account statements and "red flags" that can help investors spot and avert problems.

Regulatory Notice 12-05
Verification of Emailed Instructions to Transmit or Withdraw Assets from Accounts
Issue Date: January 26, 2012

In this Regulatory Notice, FINRA discusses the increasing number of reports of incidents of customer funds having been stolen as a result of instructions emailed to firms from customer email accounts that have been compromised and reviews the applicable policies and procedures that firms should establish under the rules which must include "a means or method of customer confirmation, notification or follow up that can be documented."

Regulatory Notice 12-03
Heightened Supervision of Complex Products
Issue Date: January 17, 2012

In this Regulatory Notice, FINRA provides guidance to firms about the supervision of complex products, which may include a security or investment strategy with novel, complicated, or intricate derivative-like features (such as structured notes, inverse or leveraged exchange-traded funds, hedge funds, and securitized products, such as asset-backed securities). The Notice not only identifies characteristics that may render a product "complex" for purposes of determining whether the product should be subject to heightened supervisory and compliance procedures, but it also provides examples of heightened procedures that may be appropriate given the fact that retail investors often find it difficult to understand the essential characteristics of complex products and their risks.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Investor Alert
NASAA Warns of Potential Dangers of Crowdfunding Investment Opportunities
Source: *http://www.nasaa.org/12835/nasaa-warns-of-potential-dangers-of-crowdfunding-investment-opportunities/?pfstyle=wp*

In this Investor Alert, NASAA advises investors to approach crowdfunding investment opportunities with great caution. Crowdfunding is an online money-raising strategy that began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and other creative people finance their projects. Through the Jumpstart Our Business Startups (JOBS) Act, small businesses and entrepreneurs will be able to tap into the "crowd" in search of investments to finance their business ventures.

Investor Alert
NASAA Cautions Investors not to Stumble When Interest Rates Fall Flat
Source: *http://www.nasaa.org/10146/nasaa-cautions-investors-not-to-stumble-when-interest-rates-fall-flat/?pfstyle=wp*

In this Investor Alert, NASAA cautions investors, particularly senior investors who may be tempted to turn away from their slower growing, but safe investments, to alternative investments, without understanding the risks and terms, that, in the current low interest rate environment, they should beware of risky or outright fraudulent investments promising higher yield or returns.

U.S. SECURITIES & EXCHANGE COMMISSION

Investor Bulletin
International Investing
July 2012
Source: *http://www.sec.gov/investor/alerts/internationalinvestingbulletin.pdf*

In this Investor Bulletin, the SEC's Office of Investor Education & Advocacy provides guidance to investors on the various ways that individual investors may obtain information about international investments—including special factors to consider when investing internationally.

Investor Bulletin
New Measures to Address Market Volatility
July 2012
Source : *http://www.sec.gov/investor/alerts/circuitbreakersbulletin.htm*

In this Investor Bulletin, the SEC's Office of Investor Education & Advocacy provides guidance to investors on recent safeguards approved by the SEC to address market volatility in U.S. equity markets.

Investor Bulletin
Municipal Bonds
June 2012
Source : *http://www.sec.gov/investor/alerts/municipalbonds.htm*

In this Investor Bulletin, the SEC's Office of Investor Education & Advocacy provides guidance to investors on municipal bonds including the various types of municipal bonds that are available in the marketplace, the risks that are associated with them and where investors can access information on municipal bonds.

RECENT ARBITRATION AWARDS

John S. Burke

Donald H. Brown v. Fidelity Brokerage Services LLC
FINRA Case No. 10-05727

Claimants asserted the following causes of action: (1) negligence; (2) breach of fiduciary duty; (3) fraudulent concealment; (4) elder abuse; (5) conversion; (6) violations of State and Federal Securities Laws; and, (7) violations of FINRA, NASD and NYSE Rules. The causes of action relate to Claimant's investments in KMP stock and PTR stock.

In the Statement of Claim, Claimants requested: (1) the difference between the value of 8,640 shares of KMP stock as of the date of the filing of the Statement of Claim and the proceeds of Fidelity's sales of KMP stock which Mr. Brown received in connection with the 2008 margin calls; (2) dividends paid on 8,640 shares of KMP stock from the date of Fidelity's margin sales to the date of the hearings; (3) dividends paid on 1,600 shares of PTR stock from the date Fidelity transferred these shares to Mrs. Brown's estate to the date of the hearings, less any amounts Mr. Brown ultimately received or was due to receive from the estate related to these dividends; (4) the value of the 1,600 shares of PTR stock as of the date of the filing of the Statement of Claim, less any amounts Mr. Brown ultimately received or was due to receive from the estate related to these shares; (5) the $ 97,126.65 Mr. Brown was required to pay to Mrs. Brown's estate per the Order of the Probate Court, less any amounts Mr. Brown ultimately received or was due to receive from the estate related to this $ 97,126.65 payment; (6) all dividends (to the date of the hearings) and appreciation (as of the date of the filing of the Statement of Claim) on the additional KMP shares which Mr. Brown would have purchased on margin in 2008, as was his custom and practice, had Fidelity never frozen his account, which was to be proven at the hearing; (7) attorneys' fees and costs incurred in the arbitration proceeding; (8) attorneys' fees and costs incurred in connection with the probate of Claimant's Fidelity account; (9) reimbursement of all filing fees, forum and hearing fees;
(10) Punitive damages in an amount determined by the Panel; and (11) such other and further relief as the Panel deemed just and proper. At the close of the hearing, Claimant requested $ 520,451.00 in compensatory damages.

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent requested that the relief requested

in the Statement of Claim be denied in all respects and that the costs of this proceeding be assessed against the Claimant.

At hearing, Respondent made an oral motion to dismiss all claims. The Claimant made an oral objection to Respondent's motion to dismiss. After deliberation, the Panel granted the motion in part, and dismissed with prejudice, Claimant's asserted causes of action for: fraudulent concealment; elder abuse; conversion; violations of State and Federal Securities Laws; and violations of FINRA, NASD, and NYSE Rules. The Panel denied the motion to dismiss Claimant's asserted causes of action for negligence and breach of fiduciary duty.

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant as follows:

1. compensatory damages in the amount of $350,000.00;
2. interest on the amount of $350,000.00 at the legal rate of the state of California from the date of service of the award until the date the award is paid in full;
3. $240,000.00 in attorneys' fees; and
4. $32,000.00 in costs, inclusive of expert witness fees in the amount of $17,000.00 and reimbursement of the nonrefundable portion of Claimant's filing fee in the amount of $ 250.00.

Claimants' Counsel: Thomas C. Frost, Esq. and Mary C. Scott-Hattendorf, Esq., Shustak Frost & Partners, San Diego, California.

Respondent's Counsel: Peter S. Fruin, Esq. and Joel M. Everest, Esq., Maynard, Cooper & Gale, PC, Birmingham, Alabama.

Claimant's Expert: C. Thomas Mason III of Tucson, Arizona

Concurring Arbitrators: Thomas Erique DuVoisin (Public Chairperson); Steven A. Fox (Non-Public)

Dissenting Arbitrator: Thomas L. Marshall (Public)

This case is significant because Claimant, an 82-year-old investor received a total award of $622,000 from two arbitrators. The third arbitrator dissented on damages issues, remarking that he would award $197,000 in compensatory damages and $100,000 in attorney fees and costs. The losses occurred as a result of the Fidelity advisor mistakenly opening Claimants and Claimant's wife's joint Fidelity account as "Joint Tenants in Common" rather than "Joint Tenants with Rights of Survivorship." The Fidelity advisor was aware that the account was aware that a TD Ameritrade account registered as "Joint Tenants with Rights of Survivorship" was being transferred into the Fidelity account. At hearing, it was established that the Fidelity account opening form was improperly written, as there is no legal form of ownership in California known as "Joint Tenants in Common." When Claimant's wife died a few months after the account was opened,

Fidelity "froze" half of the account, denying Claimant access to deposits or withdrawal of funds into or out of account to meet margin calls. Fidelity proceeded to sell off substantial quantities of quality stocks to pay off margin calls.

The Panel awarded attorney fees despite finding that there was no contractual or statutory basis to do so. The Panel determined that it had the authority to award attorney fees in this case because both parties requested the award of attorney fees. The Claimant sought attorney fees in his Statement of Claim. Respondent did not make a written request for attorney fees, but orally requested attorney fees upon closing, and presented the Panel with an itemized statement of fees for services rendered in support of its request. While the dissenting Arbitrator disagreed as to the amount of attorney fees, the Panel was unanimous in finding that it had authority to award attorney fees.

The Award also is significant because many broker-dealers continue to use account opening forms that include an option to designate an account as a "joint tenants in common" account, an ownership designation which is inherently inaccurate and confusing. Securities accounts may be designated for ownership purposes as "tenants in common" or "joint tenants with rights of survivorship," among other designations. The use of the inaccurate designation "joint tenants in common" confuses these two designations, a problem which may be compounded by inadequate training of registered representatives.

Ronald Davi, Nicole Davi Perry vs. Oppenheimer & Co., Inc.
FINRA Case No. 10-03067

Claimants asserted the following causes of action: (1) breach of fiduciary duty; (2) breach of contract; (3) negligence; (4), gross negligence; (5) failure to supervise; (6) breach of the anti-fraud provisions of the securities laws of Connecticut, C.G.S.A. Section 336-29, and New Jersey, N.J.S.A. Section 49:3-71; (7) breach of Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. Section 78j(b), and Rule 10b-5 promulgated thereunder; and, (8) fraud. The causes of action relate to Auction Rate Securities (ARS), including, New Jersey St Edl Facs Auth Re NJ XLCA due 7/1/35, New Jersey St Edl Facs Auth Re NJ FGIC 3.35% due 7/1/37, New Jersey St Tpk Auth Tpk Rev NJ MBIA 3.6% due 1/1/30, Salem County NJ Pollutn Ctl Fin NJ XLCA 3.5% due 11/01/33, and Harris Cnty Tex Health Facs DE TX MBIA due 6/1/24 ("Harris County Bonds").

In the Statement of Claim, Claimants requested rescission of the purchase of the remaining ARS and to recover the consideration paid for the

remaining ARS, together with the loss of its investment opportunities or interest at the legal rate from the date of payment, less the amount of income or distribution, in cash or kind, received on the remaining ARS, plus attorneys' fees, costs, and punitive damages. Alternatively, Claimants sought damages for the decline in market value of the remaining ARS and loss of investment opportunity or interest suffered from receiving short-term rates on long term debt. Prior to hearing Claimant Davi withdrew his claim. At the hearing, Claimant Perry requested rescission, money damages in the amount of $ 1,226,424.00, and attorneys' fees in the amount of $ 150,000.00.

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent requested that the Panel dismiss the Statement of Claim with prejudice, with no award of damages, rescission, losses or consequential damages.

Award: The Panel's award ordered the Respondent to repurchase Perry's New Jersey St Tpk Auth Tpk Rev NJ MBIA 3.6% due 1/1/30 ARS, for the amount of $ 5,975,000.00. The Panel also found Respondent liable to Claimant for attorneys' fees in the amount of $134,108.00. The Panel awarded attorneys' fees pursuant to the Connecticut Uniform Securities Act.

Claimants' Counsel: Glenn S. Gitomer, Esq., McCausland, Keen & Buckman, Radnor, PA.

Respondent's Counsel: Michael J. McAllister, Esq., Satterlee Stephens Burke & Burke LLP, New York, NY.

Claimant's Expert: Eddie O'Neal of Securities Litigation & Consulting Group, Fairfax, VA

Respondent's Expert: Stephen Behnke of Bates Group LLC, San Francisco, CA

Arbitrators: David S. Billet (Public Chairperson); Martin H. Jaffe (Public); John J. Witkowski, Jr., (Non-Public)

This case is significant because of the significant size of the recessionary damages made pursuant to state securities law. The Panel followed the Connecticut Uniform Securities Act in also awarding substantial attorney fees in Claimant's favor.

Donald A. Hausfeld and Judith A. Hausfeld vs. Morgan Keegan & Company, Inc.

FINRA Case No. 10-04056

Claimants asserted the following causes of action: (1) breach of fiduciary duty; (2) negligent supervision; (3) negligence; (4) fraud; (5) breach of contract; (6) violation of Georgia Securities Act; and (7) misrepresentations and omissions.

In the Statement of Claim, Claimants requested (1) compensatory damages in the amount of $500,000.00; (2) rescissionary and/or statutory damages; (3) punitive damages; (4) interest; (5) costs; (6) attorney fees; and (7) other and further relief as this Panel may deem just and proper. At the close of hearing, Claimants requested compensatory damages in the amount of $628,900.71, expenses in amount of $31,000.00; attorney fees in amount of $209,423.93; and unspecified punitive damages.

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent requested that the Panel reject Claimants' Statement of Claim in its entirety, attorneys' fees, and costs and assess FINRA hearing fees against Claimant.

Award: The Panel found Respondent liable and ordered Respondent to pay Claimants as follows:

1. Compensatory damages in the amount of $231,352.00, plus interest pursuant to Georgia law at the rate of 7% per annum accruing from November 12, 2004 until April 27, 2012;
2. Claimants attorney's fees pursuant to the state of Georgia law OCGA § 10-5-14 in the amount of $139,749.00; and
3. Claimants costs in the amount of $31,000.00.

Claimants' Counsel: Jeffrey Erez, Esq., Sonn & Erez, PLC, Fort Lauderdale, Florida

Respondent's Counsel: Carl Burkhalter, Esq. and Josh Jones, Esq., Maynard Cooper & Gale PC, Birmingham, Alabama.

Claimant's Expert: P. Richard Evans, CFP, Forensic investments, LLC, Indianapolis, Indiana

Respondent's Experts: Kjell Eckdahl, Applied Financial Analytics LLC, Emeryville, California; John West, West Consulting, LLC, Memphis, Tennessee

Arbitrators: David L. Maislen (Public Chairperson); Jay M. Vogelson (Public); Marvin J. Klein (Non-Public)

This case is significant because the panel rejected two attempts by Respondent to exclude evidence from the hearing. First, prior to hearing, Respondent filed a Motion in Limine to Exclude Regulatory Evidence claiming that Claimants should be precluded from presenting irrelevant evidence at the final hearing related to certain regulatory matters. In opposing the motion, Claimants asserted that the regulatory documents should be admissible as public records under the Federal Rules of Evidence. Respondent argued in reply that the possible relevance of specific documents or other evidence does not make the regulators' allegations, or the mere existence of those regulatory actions, relevant to this matter. Subsequently, at the final hearing, the Panel denied the motion.

Respondent also filed a second Motion in Limine to Exclude Evidence Relating to Purported Mismanagement of Funds asserting that certain claims asserted by Claimants are derivative rather than individual claims and that, under FINRA rules, such claims cannot be brought in arbitration. Claimants responded that their claims are for misrepresentations and omissions, not for mismanagement, and as such the evidence should not be excluded. Respondent replied that certain claims are derivative and Claimants are prohibited from bringing them before a FINRA panel. Subsequently, at the final hearing, the Panel denied the Respondent's motion.

Barry Rosenfeld v. Citigroup Global Markets Inc.
FINRA Case No. 10-05587

Claimants asserted the following causes of action: (1) negligence/unsuitability; (2) false claims; (3) breach of fiduciary duty; (4) breach of contract; (6) respondeat superior; and, (7) negligent or reckless failure to supervise. The causes of action relate to the overconcentration of equities. In the Statement of Claim, Claimant requested compensatory damages in the amount of $1,000,000.00, disgorgement of profits generated, lost opportunity damages, rescission, costs, punitive damages, pre-judgment interest at the legal rate of 9% per annum from date of purchase, attorney's fees, and such other relief as this Panel deemed proper and appropriate. At the close of the hearing, Claimant requested total damages in the amount of $1,022,621.00.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent requested that the Statement of Claim be dismissed with prejudice, and that costs be assessed against Claimant. At the close of the hearing, Respondent requested that the Panel grant expungement of the Central Registration Depository (the "CRD") record of non-party broker.

Award: The Panel found that Respondent was liable for negligence/unsuitability, breach of fiduciary duty, breach of contract, respondeat superior, and negligent failure to supervise and was ordered to pay to Claimant compensatory damages in the amount of $310,000.00, plus interest per annum at the statutory rate in the state of Florida from December 9, 2010 until paid in full. Respondent was also found liable to pay to Claimant attorneys' fees pursuant to *Hosier vs. Citigroup Global Markets Inc.* (CV 11-00971, U.S. District Court, Colorado) in the amount of $110,000.00. In addition Respondent was ordered to pay Claimant costs in the amount of $2,700.00 and expert witness fees in the amount of

$12,000.00. Respondent's request for expungement of the CRD record of non-party broker was denied.

Claimants' Counsel: Robert J. Pearl, Esq., The Pearl Law Firm, P.A., Naples, Florida.

Respondent's Counsel: Sean J. Coughlin, Esq., Bressler Amery & Ross, New York, New York.

Claimant's Expert: Sean Kelly

Respondent's Expert: Anthony Raimondi

Arbitrators: William S. Glickfield (Public Chairperson); Don Muyskens (Public); Oliver J. Janney (Public)

This case is significant because the Panel found authority for awarding attorney fees from the execution of a Uniform Submission Agreement by Respondent. The arbitration involved Respondent's liability for overconcentration of equities in the account of a disable Claimant suffering from chronic illness. At hearing the Panel rejected Respondent's defense that "everybody lost in the market" during the 2008-2009 financial crisis. In awarding attorney fees, the Panel found authority in *Hoiser v Citigroup*, a Colorado Federal District Court that had ruled that Citigroup's signing of a Uniform Submission Agreement in a case in which the Statement of Claim sought attorney's fees resulted in Citigroup agreeing to have the issue of attorney fees decided by the arbitration panel.

Barbara G. Snyder, Eric P. Snyder v. Goldman, Sachs and Company,
FINRA Case No. 09-07024

Claimants asserted the following causes of action: (1) unsuitable investments and investment strategy; (2) breach of fiduciary duty/breach of duty of fair dealing; (3) breach of contract; (4) intentional misrepresentation/fraud; (5) negligence; (6) negligent misrepresentation/omissions; (7) violation of § 10(b) of the Securities Act of 1934 and Rule 10(b)5 of the Securities Exchange Commission (15 U.S.C.A. § 78j and C.F.R. § 240.10b-5); (8) violation of the Tennessee Securities Act (T.S.A. § 48-2-121); (9) failure to supervise; and, (10) respondeat superior/agency. The causes of action concerned Respondent's failure to disclose the nature and extent of risk involved in: (1) trading options in CBL & Associates Properties, Inc. ("CBL"); and, (2) investing on margin in the GS Vintage Fund V.

In the Statement of Claim, Claimants requested; (1) compensatory damages of not less than $10,000,000.00; (2) pre-award interest accruing from the date of filing of the Statement of Claim; (3) disgorgement of all commissions, margin interest, and fees; (4) lost income and opportunities; (5) punitive or treble damages; (6) attorneys' fees; (7) costs and forum fees; and,

(8) such other relief as determined at the hearing. At the final hearing, Claimants' expert presented testimony on the calculation of damages as a range from $5,500,000.00 to $14,800,000.00, the exact amount to be determined by the Panel

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses. At the beginning of the evidentiary hearing, Respondent made an oral motion in limine to exclude documents that Claimants produced on damages after the 20-day document exchange date. Claimants responded that Respondent was not prejudiced as the documents were submitted to correct Claimants' damage calculation, and Claimants' expert would testify to this information. At the final evidentiary hearing, after the conclusion of Claimants' case-in-chief, Respondent made an oral motion to dismiss with prejudice pursuant to Rule 12504(b) of the Code of Arbitration Procedure (the "Code") and request for an award of attorneys' fees and costs. Respondent also made an oral Motion for Expungement of the Central Registration Depository ("CRD") records for non-party associated.

Award: The Panel dismissed the Claimants' claims in their entirety, with prejudice. The Panel also awarded Respondent its attorney fees in the amount of $500,000.00 pursuant to Tennessee Securities Act. Finally, the Panel recommended expungement of the non-party associated persons CRD records.

Claimants' Counsel: Martin Q. Ryan, Esq., David A. Baugh, Esq., and Daniel A. Hetzel, Esq., Baugh, Dalton, Carlson & Ryan, LLC, Chicago, Illinois.

Respondent's Counsel: David G. Russell, Esq. and John W. Mitchell, Esq., Parker, Hudson, Rainer & Dobbs, LLP, Atlanta, Georgia.

Arbitrators: Michael J. Ahlstrom (Public Chairperson); Clare R. Goldfarb (Public); Jeannie B. Wright (Non-Public)

This case is significant because of the significant award of Respondent's attorneys' fees and the motion practice at the beginning and close of the evidentiary hearing. At the beginning of the evidentiary hearing, Respondent made an oral motion in limine to exclude documents that Claimants produced on damages after the 20-day document exchange date. Claimants responded that Respondent was not prejudiced as the documents were submitted to correct Claimants' damage calculation, and Claimants' expert would testify to this information. The Panel granted Respondent's motion and excluded the documents at issue.

After the conclusion of Claimants' case-in-chief, Respondent made an oral motion to dismiss with prejudice pursuant to Rule 12504(b) of the Code of Arbitration Procedure (the "Code") and requested an award of attorneys' fees and costs. Respondent argued that Claimants as a matter of law failed to

provide evidence to sustain a legal cause of action against Respondent. In response, Claimants argued that if they had shown any evidence to sustain a claim against Respondent then Respondent's motion to dismiss should be denied and Claimants asserted they had given such evidence.

In granting Respondent's motion to dismiss the Panel explained that Claimants' allegations of breach of fiduciary duty, breach of duty of fair dealing, fraud, negligence, and unsuitability of retirement plan were clearly erroneous. The panel did not accept Claimants claim that Respondent had a duty to recommend to Claimants a collar for their CBL stock to hedge against a loss. When CBL stock price did decrease, Claimants suffered a huge financial loss. The Panel specifically found that: Claimant was an experienced stock trader who was aware of the risk of holding a concentrated position of CBL stock and was responsible for his own actions; Claimants desired a high rate of return on their investments and were aware of the risk; Claimants authorized or ratified the actions of Respondent; Claimants did not follow Respondent's recommendation to sell the CBL stock; Respondent violated no laws; Claimants proved no damages; and Respondent did not cause Claimants' loss, rather the loss was caused by Claimants' own actions and the stock market collapsing in the fall of 2008. As a result, the Panel granted Respondent's motion to dismiss with prejudice and awarded attorney fees and costs to be paid by Claimants.

Claimants filed a motion to reconsider the order, arguing that a motion to dismiss is most analogous to a motion for directed verdict, motions for directed verdicts should only be granted in limited circumstances, and a directed verdict cannot be granted when a party has presented evidence in support of the elements for each claim. Claimants also argued that there is no legal basis to punish Claimants with an award of attorneys' fees in the absence of a contractual or statutory basis for such an award. In response to the motion to reconsider, Respondent asserted that the FINRA rules do not provide for or allow for a motion to reconsider a merits-based decision; and, even so, Claimants misstated the standard for dismissal after a claimant rests in a non-jury trial by advising the Panel that the standard for a claimant to survive a motion for dismissal only requires a showing of a prima facie case and that all reasonable inferences must be made in favor of the opponent of the motion while disregarding contrary evidence. In reply, Claimants argued that Rule 12609 of the Code contemplates the filing of post-hearing motions and specifically provides that the Panel may reopen the record upon motion of any party at any time before an award is rendered. The Panel denied the motion to reconsider.

In awarding attorney's fees the Panel noted that both parties had sought attorney fees and costs in the proceedings. They awarded attorney fees in the

amount of $500,000 based on the statutory authority of the *Tennessee Securities Act and Wing v JC Bradford*, 678 F. Supp. 622 (N.D. Miss. 1967).

Bobby L. Hayes, Bobby L. Hayes Living Trust v. Banc of America Securities LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated
FINRA Case No. 11-00432

Claimants asserted the following causes of action: (1) breach of written and oral contracts; (2) fraud: (3) breach of fiduciary duty; (4) negligence; (5) failure to supervise and control; and (6) state securities violations.

In the amended Statement of Claim, Claimants requested: (1) compensatory damages in an amount not less than $883,122.50; (2) lost opportunity cost in an amount according to the proofs; (3) rescission of the LCM investment; (4) costs; (5) punitive damages according to proofs; (6) interest at legal rate; (7) attorney's fees; and (8) other and further relief as the Panel deemed just and proper. Prior to the arbitration hearing, Claimants dismissed Respondents McCandless and Groth.

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

Award: The Panel found that Respondent Merrill Lynch was solely liable and ordered Respondent to pay Claimants rescissionary damages in the amount of $1,134,791.24 which included rescissionary damages in amount of $883,122.50, and interest in amount of $251,668.74 pursuant to Nevada statute. The panel also ordered Respondent Merrill Lynch to pay Claimants attorney's fees in the amount of $218,344.00, costs in amount of $23,500.00 and reimbursement of the filing fee.

Claimants' Counsel: Thomas C Bradley, Esq., Sinai, Schroeder, Mooney, Boetsch, Bradley, & Pace, Reno Nevada.

Respondent Banc of America's Counsel: Aquilino Magliocco of Banc of America Securities LLC, New York, New York.

Respondent Merrill Lynch's Counsel: Rodney Acker, Esq. of Fullbright & Jaworski, Los Angeles, California.

Claimants' Expert: Dr. Craig McCann of Securities Litigation & Consulting Group

Respondent's Expert: Dr. Allen Ferrell of Harvard Law School

Arbitrators: James F. Zotter (Public Chairperson); Martin J. Kotowski (Public); Richard B. Bullock (Non-Public)

This case is not only significant because of the award of compensatory damages, interest, attorney fees, and costs pursuant to Nevada statutory authority, but also because of the discovery work achieved in presenting this case to the panel.

In the summer of 2007, Claimant's broker recommended an investment that he described as a conservative fixed income investment that Respondent was underwriting and offering to only it's most elite investors. In reality, it was an investment in the bottom tranche of a Collaterized Loan Obligation known as LCM VII Ltd. The broker failed to understand that the bottom tranche of the investment would bear the first losses and was, therefore, unable to disclose the true risks of the investment. Specifically, he never explained that if the LCM VII investment lost a small fraction of value, the Claimant would lose his entire investment including his principal.

Claimant's expert determined that in late 2006, Respondent began acquiring loans to place in the LCM VII portfolio. Respondent warehoused these loans until the LCM VII deal was fully subscribed in July 2007. Before the deal had closed, Claimants expert testified, the 400 million dollar LCM VII portfolio of loans had declined in value by $20 million. Thus, the LCM VII portfolio was now worth only about $380 million by July 31, 2007.

When the investment was set to close on July 31, 2007, Respondent had already pre-sold hundreds of millions of dollars' worth of investments in LCM VII. Claimant's argued at hearing that Respondent had an important decision to make. One option was that it could disclose the fact the loan portfolio was worth only $380 million, absorb the $20 million that the portfolio lost in July 2007, and sell the loan portfolio to LCM VII at fair market value instead of cost. The LCM VII investors, like the Claimant, would then be purchasing an investment that was not underwater on day one. The second option was for Respondent to conceal the losses, value the loan portfolio based on its acquisition cost, and secretly pass the losses onto the investors in the bottom tranches of LCM VII. Respondent chose this second option.

Claimant testified that he would never have made the investment had he been told the truth. As result of the Respondent's misconduct, Claimant lost his entire investment in LCM VII of $883,122.50.

CASES & MATERIALS

Birgitta Siegel

COMMENCING ARBITRATION

Waterford Investments Services, Incorporated, v. Bosco et.al.,
682 F.3d 348 (4th Cir. 2012)

The Fourth Circuit Court of Appeals held that the Appellant investment firm must arbitrate investors' claims arising out of misconduct by a broker who was not licensed through Appellant during material times. The Court found that there was there was no type of contractual arrangement between Appellant and the broker. Addressing this novel situation, the Court concluded that because Appellant had at least the 'power' to "indirectly control" the broker, the latter was Appellant's "associated person" under FINRA Rule 12100(r)[1] for purposes of compelling arbitration. Therefore, pursuant to FINRA Rule 12200,[2] which allows customers to compel arbitration against member firms and their associated persons, and the federal presumptions that favor arbitration, the Court held that Appellees were entitled to compel arbitration against the Appellant firm.

Background

Appellees ("Investors") are individuals who invested most of their life savings with registered representative George Gilbert and his employer Community Bankers Securities LLC ("CBS"). Between 2005 and 2009, Gilbert handled the Investors' accounts exclusively through CBS. Sometime prior to 2009, the Investors sustained significant losses in two Ponzi schemes (unidentified in the decision), which were sold to them by Gilbert and CBS.

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1. FINRA Rule 12100(r) defines a "person associated with a member," *inter alia,* as "a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member." 682 F.3d at 353.

2. "The FINRA Code provides that a customer can compel arbitration of a dispute "between a customer and a member *or associated person of a member*" when the dispute "arises in connection with the business activities of the member or the associated person." FINRA Rule 12200." 682 F.3d at 353 (*emphasis added*).

Various customers filed FINRA arbitrations against CBS by late 2009, whereupon CBS suddenly ceased operations.

Enter Waterford Investment Services, Inc. (Waterford"), a FINRA member firm that the United States Magistrate Judge ultimately concluded was a de facto successor in interest to CBS under Virginia law. As of January 2010, many of the CBS customers, including the Investors in this case, had transferred to Waterford upon Gilbert's request. Gilbert described Waterford as a "sister company" of CBS. 682 F.3d at 352.

Indeed, CBS and Waterford were mired in overlapping interests and operations, though they were separate corporate entities. By 2009, a non-party, AIC, Inc., owned 90% of both CBS and Waterford. In addition, CBS and Waterford shared a significant number of directors and key officers during the relevant time. Some officers acted in different capacities for each firm, while others held exactly the same position for both firms (e.g., both firms shared the same Chief Financial Officer and the same Vice President of Operations). Though Waterford and CBS had different Compliance Officers, they shared the same Compliance Manager, who Gilbert testified was one of only two people to whom he reported. Many key officers of both companies shared a small office in Richmond, Virginia, which also served as the main office for CBS.

Both firms shared the same trading desks, office resources, expenses and more. When CBS ceased operations, Waterford absorbed its most productive brokers within days and simply continued the CBS business in almost seamless fashion, albeit under the name of Waterford.

The Investors/Appellees filed their FINRA arbitration against Waterford, CBS, and Gilbert, as well as various officers and directors of both firms. Appellees alleged misrepresentations, failures of due diligence, and other improprieties in connection with the "Ponzi scheme securities" sold to them. Waterford sought to enjoin the arbitration, and argued that it was not obligated to arbitrate these claims because the Investors were not its customers during the time in question. In ruling on summary judgment motions, the U.S. Magistrate issued a detailed report and recommendation in favor of the Investors. Among other conclusions reached, the Magistrate determined that the broker, Gilbert, was an "associated person" of Waterford for purposes of FINRA Rule 12200. The district court adopted the Magistrate's report in full. Waterford appealed. *Id*. at 352.

The Fourth Circuit Decision

In its *de novo* review, the Court first reviewed seminal decisions reflecting the strong federal policy in favor of arbitration. The Court continued by addressing the Federal Arbitration Act's requirement that an arbitration agreement be "in writing." Though the Investors/Appellees did not have customer agreements containing arbitration clauses for the dispute against Waterford, the Investors were entitled to rely upon the text of FINRA Rule 12200 for their threshold showing of a written agreement. "This provision 'constitutes an "agreement in writing" under the Federal Arbitration Act, 9 U.S.C. § 2, which binds ... [a FINRA] member, to submit an eligible dispute to arbitration upon a customer's demand.' Accordingly, a court applies 'the federal policy favoring arbitration' when interpreting this provision, 'generously constru[ing] [the parties' intentions] as to issues of arbitrability' and '[resolving] any ambiguities as to the scope of the arbitration clause' in favor of arbitration." *Id.* at 353 (quoting *Wash. Square Secs., Inc. v. Aune,* 385 F.3d at 432, 435-36) (alterations in original).

The parties agreed that the Investors were customers of their broker, Gilbert, and that the dispute arose out of their business dealings with him. Also not in question was the fact that member firms must arbitrate claims brought by customers of their associated persons. The crux of the dispute centered on whether Gilbert was an "associated person" of Waterford during the time in question, when Gilbert maintained his securities license through CBS, not Waterford. Gilbert had no contractual relationship with Waterford during this period. *Id.* at 353-54.

FINRA Rule 12100(r) defines an "associated person" as one who "is engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member." Waterford argued that prior to 2010, it never controlled Gilbert directly or indirectly. Thus, said Waterford, Gilbert was not its associated person during the time complained of and the Investors could not compel arbitration under FINRA Rule 12200.

The court then turned to case law to examine the extent of "control" required under the "control person" statute of § 20(a) of the Securities and Exchange Act, 15 U.S.C. § 78t(a)(every person who "directly, or indirectly controls any person" is liable for violations of the Act). In the context of determining liability, a court gives 'heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof.'" *In re Mut. Funds Inv. Litig.,* 566 F.3d 111, 130 (4th Cir.2009) (quoting *Rochez Bros., Inc. v. Rhoades,* 527 F.2d 880, 890–91 (3d Cir.1975)), *rev'd on other grounds, Janus Capital Grp., Inc. v. First Derivative Traders,* ——U.S. ——, 131 S.Ct. 2296, 180 L.Ed.2d 166

(2011); *see also* 17 C.F.R. § 230.405 (defining "control" in the governing regulations as the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person"). In accordance with the foregoing authorities, and as found by the district court judge in the case at hand, the Fourth Circuit concluded that "indirect control under the FINRA Code required 'the power and ability to exercise power' but 'not that the power actually be exercised.'" 682 F.3d at 354 (citations omitted).

Finally, the Court considered whether Waterford had the requisite power to control Gilbert during the time in question, and not whether Waterford actually exercised such power. Because key Waterford officers and directors held similar functions at CBS and were empowered to control Gilbert, and because the two companies were entangled by pervasive sharing of personnel and resources, the Court decided that Waterford had at least the power to control Gilbert. In light of such compelling facts, and the strong federal presumption favoring arbitration, the Court held that Gilbert was arguably an associated person of Waterford. The Investors were thus entitled to arbitrate their claims against Waterford pursuant to FINRA Rule 12200. *Id.* at 355-57.

Ross Sinclaire & Assoc. v. PREMIER SENIOR LIVING, LLC, et al., 2012 WL 2501115 (N.D. Cal., June 27, 2012)

This decision is one of the most recent in a series of cases finding that an advisory/issuer client of an underwriter/brokerage firm can, in certain situations, compel arbitration under FINRA Rule 12200, despite the lack of a traditional arbitration agreement.

Background

Plaintiff Ross Sinclaire & Associates ("RSA") is a FINRA member firm that provides a range of underwriting and retail brokerage services. Defendant Premier Senior Living LLC consists of a single member, Aldo Baccala, who in turn is the sole shareholder and president of two affiliates of Premier Senior Living, LLC. Defendants include the LLC and its affiliates (collectively referred to as "PSL"). PSL owns and operates senior healthcare facilities throughout the southeastern United States.

RSA and the PSL Defendants entered a preliminary agreement whereby RSA would assist PSL in its refinancing of various mortgages and raising

capital for improvements and operating expenses. The terms of the formal Letter Agreement provided that RSA would act "as sole underwriter and placement agent ... in connection with the sale and placement (the "Transaction(s)") of taxable Variable Rate Demand Notes and/or other securities (the "Bonds")...." *Id.* at *1. RSA also agreed to provide advisory services necessary for PSL's placement and sale of the Bonds. Thereafter, RSA allegedly helped negotiate the complex financing of the Bonds, including terms of a hedge/ interest rate swap that was incorporated within a Letter of Credit required by RSA. The Letter of Credit was issued by Wachovia Bank, whose credit rating plummeted around the time of the 2008 market crisis. Thereafter, as a partial result of the decline in Wachovia's credit rating, PSL bondholders began to tender their bonds, and were unwilling to hold the investments at existing rates.

PSL (Defendant) filed a FINRA arbitration against RSA, alleging millions in damages as a result of RSA's improper advice throughout negotiations of PSL's financing structure. RSA moved the district court to enjoin the arbitration. PSL moved to compel arbitration, alleging it was entitled to compel arbitration as a "customer"[3] of RSA under FINRA Rule 12200, which provides in pertinent part that a member firm must arbitrate under the FINRA Code if:

> [r]equested by the customer; [t]he dispute is between a customer and a member or associated person of a member; and [t]he dispute arises in connection with the business activities of the member or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company.

The District Court

Upon observing the lack of a "traditional" arbitration agreement between the parties, the court gave RSL the benefit of all reasonable doubts and applied a motion for summary judgment standard. Substantial discovery was conducted on the question of whether PSL was a "customer" of RSA within the meaning of FINRA rules.

RSA contended it provided only "arms length" underwriting to PSL. PSL contended that RSA provided a "negotiated sale underwriting," whereby it purchased and sold the Bonds. In addition, RSA allegedly provided

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3. FINRA defines a "customer" merely as one who is not a 'broker" or a "dealer." *See* FINRA Rule 12100(i).

substantial advice about all components of the financing, including applicable interest rates, and credit ratings. *Id.* at *10.

The exact question presented in this case was one of first impression for the district court. Judge Rogers wrote that "no case in this district has addressed the situation here, that is, a situation where the connection between the purported customer and the FINRA member is undisputedly direct, but the "customer" is a purchaser of services related to the issuance and sale of securities rather than an investor in securities." *Id*. at *7. Recent circuit court decisions, however, provided the district court with guidance. For example, the decision in *UBS Fin. Services, Inc. v. W. Virginia Univ. Hospitals, Inc.,* 660 F.3d 643 (2d Cir.2011) addressed the issue of whether an underwriting client who also received advisory services from the underwriter was entitled to compel FINRA arbitration under Rule 12200. After a thorough examination of evidence adduced, the district court concluded that "RSA plainly acted as the 'broker' for the PSL Defendants by 'effecting a transaction in securities,' *to wit,* structuring the Bonds and then purchasing and selling them, for a fee paid by the PSL Defendants…..RSA structured the transaction from the outset to act as underwriter….and *advisor*." *Id*. at *10 (emphasis added).

Accordingly, the district court granted Defendant PSL's motion to compel arbitration, denied Plaintiff RSA's motion for preliminary injunction, and stayed the court action during the pendency of the arbitration.

POST –ARBITRATION PROCEEDINGS TO CONFIRM/VACATE AN AWARD

Goldman Sachs Execution & Clearing, L.P., FKA Spear, Leeds & Kellogg, L.P. Appellant/Cross-Appellee v. The Officical Unsecured Creditors' Committee Of Bayou Group, LLC, et.al.,
2012 WL 2548927 (2d Cir. 2012)

The United States Court of Appeals for the Second Circuit affirmed confirmation of a $20.5 million FINRA arbitration award against Goldman Sachs, and rejected the firm's contention the arbitrators acted in "manifest disregard" of the law.

Background

In 1999, Appellant Goldman Sachs Execution & Clearing, L.P. ("Goldman') became the sole clearing broker and prime broker for the hedge fund known as the Bayou Fund, LLC. In 2003, the Bayou Fund LLC opened additional accounts at Goldman for four additional Bayou hedge funds operated within the Bayou family of funds. In 2005, all the Bayou Funds were exposed as a massive Ponzi scheme. Bankruptcy followed in 2006. The bankruptcy trustee appointed Appellant – The Official Unsecured Creditors' Committee of Bayou Group LLC (the "Committee") – to represent the interests of the unsecured creditors. In 2008, the trustee further authorized the Committee to prosecute claims it might have against Goldman. *Id*. at *1.

By agreement between the parties, the Committee pursued their claims against Goldman through FINRA arbitration rather than through available bankruptcy procedures. The Committee sought to recover various funds transferred and conveyed by the Bayou Funds to the Goldman accounts. First, the Committee alleged that Goldman failed to conduct due diligence on the Bayou Funds, and that Goldman acted as an "initial transferee," pursuant to 11 U.S.C. § 550(a), for $6.7 million in fraudulent transfers into the "new" Bayou Funds in 2004 and 2005. Second, the Committee sought recovery of $13.9 million of alleged fraudulent conveyances by the original Bayou fund to the four new Bayou Funds in March 2003. Overarching allegations included those that Goldman was jointly and severally liable as one that knew or should have known of potential fraud, given its access to the Bayou Funds' trading records (showing losses), and Bayou Funds' marketing materials (showing profits). *Id*. at *2.

On June 27, 2010, the FINRA Panel awarded the Committee over $20.5 million, representing the full amount of compensatory damages claimed. District Court Judge Rakoff denied Goldman's petition to vacate, and granted the Committee's petition to confirm the award. Judge Rakoff also applied the federal prejudgment interest rate, rather than the New York statutory rate, finding the former more appropriate for claims arising under bankruptcy law. Goldman appealed. The Committee cross-appealed solely on the issue of prejudgment interest.

Second Circuit Decision

On appeal, Goldman argued the arbitration award was rendered in manifest disregard of the law and must be vacated. Though the Federal

Arbitration Act does not mention "manifest disregard" as a basis to vacate an award, the circuit courts have split in recent years as to whether the judicial doctrine remains a viable basis for vacatur in the wake of recent Supreme Court decisions. The Second Circuit affirmed the validity of the "manifest disregard" doctrine in rare situations, and explained:

> Although the Supreme Court's decision in *Hall Street Associates, L.L.C. v. Mattel, Inc.,* 552 U.S. 576, 585 (2008), created some uncertainty regarding the continued viability of the manifest disregard doctrine, we have concluded that "manifest disregard remains a valid ground for vacating arbitration awards." *T. Co. Metals, LLC v. Dempsey Pipe & Supply, Inc.,* 592 F.3d 329, 339-40(2d Cir. 2010).
>
> Our review under the manifest disregard standard, however, "is 'highly deferential' to the arbitrators, and relief on such a claim is therefore 'rare.'" [citations omitted] We cannot "vacate an arbitral award merely because [we are] convinced that the arbitration panel made the wrong call on the law." *Wallace v. Buttar,* 378 F.3d 182, 190 (2d Cir. 2004). Indeed, an arbitral award must "be enforced, despite a court's disagreement with it on the merits, if there is a *barely colorable justification* for the outcome reached." *Id.* (internal quotation marks omitted).

Id. at *1.

As a threshold matter, the Court must therefore consider "first, 'whether the governing law alleged to have been ignored by the arbitrators was well defined, explicit, and clearly applicable,' and, second, whether the arbitrator knew about 'the existence of a clearly governing legal principle but decided to ignore it or pay no attention to it.'" *Id*. at *2 (quoting *Jock v. Sterling Jewelers Inc*., 646 F.3d 11, 121 n.1 (2d Cir. 2011) (quoting *Westerbeke Corp. v. Daihatsu Motor Co*., 304 F.3d 200, 209 (2d Cir. 2002)).

Turning first to the issues concerning the alleged fraudulent transfer of $6.7 million to Goldman in 2004-2005, the Second Circuit noted that Goldman did not contend whether the transfers were fraudulent, or even contend whether the firm should have known of the fraud. For purposes of the appeal, Goldman thus accepted those allegations as true. Instead, Goldman's sole argument was that, as a matter of law, it could not be an "initial transferee" under the Bankruptcy Code, and thus the arbitrators had manifestly disregarded the law.

The Court rejected Goldman's argument. Fatal to Goldman's effort was the fact that on-point, recent precedent from the jurisdiction favored the Committee's position, and discredited Goldman's position. Specifically, in *Bear, Stearns Securities Corp. v. Gredd*, 397 B.R. 1 (S.D.N.Y. 2007), the

district court allowed a bankruptcy trustee to recover from Bear Stearns the deposits made by a debtor hedge fund operating a Ponzi scheme to its margin account in the year prior to filing for bankruptcy. In contrasting other precedents where institutions acted as a "mere conduit" of funds earmarked for transfer to third parties, the *Gredd* court concluded that Bear Stearns had sufficient "dominion and control" over the transferred funds so as to establish transferee liability. Although Bear Stearns "was not able to use the transfers to make a separate profit," it was nevertheless entitled to" use the funds to protect itself from suffering losses due to the hedge fund's short trading." *Id.* at *2 (*citations omitted*). As with Bear Stearns in *Gredd*, Goldman maintained significant control over the Bayou Fund deposits, and held a security interest for the payment of all Bayou Funds' obligations. Furthermore, Goldman had several discretionary rights over the Bayou Funds, including the rights to: (1) require the debtor to deposit cash or collateral with the broker to assure performance of contractual commitments; (2) require the debtor to maintain certain positions or margins; (3) lend any of the debtor's securities held at Goldman margin accounts; and (4) liquidate securities or other property in the accounts to ensure minimum maintenance requirements were satisfied. 2012 WL 2548927 at *3.[4]

The Court also commented that not only did the *Gredd* decision favor the Committee's position, but Goldman failed to provide any on-point, clear authorities in support of its arguments. Thus, Goldman failed to show the existence of any clear and applicable law that the arbitrators could have 'manifestly disregarded' in the first instance. *Id.* at 3.

As concerned the fraudulent conveyances of $13.9 million made between the Bayou accounts, the Court similarly found that Goldman failed to present applicable authorities to support its case. Instead, the Court explained, Goldman relied on non-controlling decisions from other jurisdictions, one inapposite trial court decision, and raised factual questions that were not reviewable under the Federal Arbitration Act. *Id.* at *3.

The Second Circuit affirmed the District Court's entry of judgment for the Committee in all respects.

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4. The Second Circuit found it unnecessary to either endorse or reject the district court's decision in *Gredd*. A finding that *Gredd* cast considerable doubt on Goldman's argument necessarily sufficed to show the lack of clear, on-point, unambiguous law in Goldman's favor. *Id.* at *3.

CLAIMS UNDER FEDERAL SECURITIES LAWS

Securities & Exchange Commission v. Morgan Keegan & Company, INC., 678 F.3d 1233 (11th Cir. 2012)

Oral misrepresentations and omissions by firm's brokers to four investors concerning ARS securities are part of the "total mix" of material information, and thus are actionable in this SEC enforcement action. Morgan Keegan's written risk disclosures were distributed in a "weak" manner and could not trump the materiality of oral misrepresentations at the summary judgment stage.

The District Court Proceedings

The SEC brought this civil enforcement action against Morgan Keegan for misrepresentations and omissions of risks associated with the firm's sales of roughly $647 million of auction-rate securities between January 2, 2008 and March 19, 2008. By misrepresenting in some instances that the ARS securities were "cash equivalents" with no liquidity risks, Morgan Keegan allegedly violated §§ 10(b) and 15(c)(1) of the Securities Exchange Act, §17(a) of the Securities Act, and SEC Rule 10b-5. The SEC also sought an order compelling Morgan Keegan to repurchase all ARS the firm sold prior to March 20, 2008. In its motion for summary judgment on all counts, Morgan Keegan challenged only the 'materiality' question, contending that the misrepresentations and omissions were immaterial as a matter of law. The trial court entered summary judgment for Morgan Keegan, concluding that "the oral statements of four brokers out of hundreds would not lead a rational jury to believe that Morgan Keegan, as a whole, misrepresented the risks of ARS investments to its customers." *SEC v. Morgan Keegan & Co.,* 806 F.Supp.2d 1253, 1265 (N.D.Ga.2011). The SEC appealed.

The Eleventh Circuit

On May 2, 2012, the Eleventh Circuit vacated the district court's order and remanded for further proceedings. The sole issue before the court concerned the materiality requirement under the claims alleged.[5] In its

5. To prove violations of § 10(b), Rule 10b–5, or § 15(c) (1), the "SEC must show

comprehensive review of relevant Supreme Court decisions, the Eleventh Circuit explained that materiality is an 'objective' inquiry into the significance of the misrepresented fact to "a reasonable investor". There is no bright line test conferring materiality only upon a finding of a certain number of adverse events or misrepresentations/omissions. Rather, the test for materiality centers on whether a reasonable investor would find that the misrepresented/omitted fact altered the "total mix" of information made available to him. *See id*. at 1245-46.

Next, the Eleventh Circuit applied the foregoing law, and analyzed the specific, "threshold question of whether, in an SEC enforcement action, a misstatement or omission by an individual broker to an individual investor may be included in the analysis of the "total mix" of information available to the hypothetical reasonable investor." *Id*. at 1247. Morgan Keegan argued that the SEC must show the firm misled the public as a whole, and not just a small number of individual investors. The Court rejected Morgan Keegan's argument in light of precedent explaining that the "materiality" standard examines the total mix of information available to a hypothetical reasonable investor, not just to the public at large." *Id*. at 1248. More specifically, the Court found "no statutory or precedential support for Morgan Keegan's argument that some threshold number of investors must be misled before finding its brokers' misrepresentations "material" in an SEC enforcement action." *Id.* at 1249. Thus, the SEC's evidence that four brokers misrepresented and omitted facts concerning the risks and liquidity of ARS investments would be sufficiently material at least to a hypothetical reasonable investor seeking liquid, short-term investments.

Once it determined the SEC had adequately demonstrated the materiality of oral misrepresentations, the Court examined whether Morgan Keegan's written risk disclosures rendered the oral misrepresentations immaterial as a matter of law. The Court answered this question in the negative. Morgan Keegan had somewhat conflated defenses of a private plaintiff's "lack of justifiable reliance" on oral statements contradicted by written disclosures (a

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(1) a material misrepresentation or materially misleading omission, (2) in connection with the purchase or sale of a security, (3) made with scienter." *SEC v. Morgan Keegan*, 678 F.3d. at 1244 (citations omitted). To prove violations of §17(a)(1), or violations of §§17(a)(2)(3), the SEC must show a material misrepresentation or materially misleading omission, (2) in the offer or sale of a security, (3) made with scienter or negligence respectively. *Id.* Unlike private actions under §10(b), the SEC need not prove an investor's "justifiable reliance" on the misrepresentation/omission. (There is no private right of action under §17(a) of the Securities Act.)

defense that is inapplicable to SEC enforcement actions, as the SEC does not have to prove "justifiable reliance"), with the narrow question of materiality that was in fact before the Court. Even if the justifiable reliance contentions were relevant to an SEC enforcement action, such questions concerning conflicts between written disclosures and oral misrepresentations are fact intensive to each case, and not questions that are often decided as a matter of law. In any event, Morgan Keegan produced no evidence that it provided written risk disclosures "directly to customers." *Id.* at 1253. Though some relevant disclosures were found deep within an unspecified portion of Morgan Keegan's website, the delivery of such disclosures was non-effective. Morgan Keegan also did not present evidence that anyone ever visited the ARS page within its website.

The only documents given directly to customers were the trade confirmations generated after the alleged oral misrepresentations were made; the confirmations merely directed customers to the home page of the firm's website without providing any disclosure of liquidity risks. Morgan Keegan also argued that the 10 day notice on the back of the confirms, wherein customers are told to notify the firm if they object to a trade, was adequate disclosure for materiality purposes. However, the Court found this argument unavailing because – without more meaningful disclosure of the risks relevant to the ARS, "customers would have no reason to investigate whether to use the ten-day provision to rescind the transaction." *Id.* at 1253.

The Eleventh Circuit vacated the judgment and remanded to the district court, noting in closing comments that its opinion was narrow and limited to the issue of materiality.