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PONZI SCHEME CLAWBACKS: ARE THEY EQUITABLE?

*Caitlyn Crisp**

I. Introduction

In the fall of 2008, when the markets crashed, Bernie Madoff's Ponzi scheme unraveled as an unexpected number of his customers demanded their accounts be liquidated. Madoff became a household name for defrauding his customers out of billions of dollars. The 4,800 customers who had open accounts at the time of Madoff's arrest had $17.3 billion invested with his firm; with the fictitious profits, the customers' account statements showed an aggregate sum of $57 billion.[1] While Madoff was sentenced to 150 years behind bars, this did nothing to recompense his victims for this enormous fraud.[2]

Attorney Irving H. Picard was appointed the bankruptcy trustee for the now defunct Bernard L. Madoff Investment Securities L.L.C.[3] In addition to recovering the assets Madoff possessed at the time of his arrest, Picard pursued over 1,000 avoidance actions, also called "clawback" suits, against investors who "benefitted" by withdrawing more money from their accounts at Madoff's investment firm than they originally contributed.[4] These Madoff scheme "winners" contested Picard's view that they should return their "profits" to achieve a more equitable distribution to investors who were "losers" in the scheme—meaning those who lost some or all of their principal.[5] These defendants in clawback suits argued that they were

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1. Amy J. Sepinwall, *Righting Others' Wrongs: A Critical Analysis of Clawback Suits in the Wake of Madoff-Type Ponzi Schemes and Other Financial Frauds*, SELECTED WORKS OF AMY. J. SEPINWALL (2012) available at http://works.bepress.com/cgi/viewcontent.cgi?article=1009&context=amysepinwall, at 3.

2. *See* Thomas Vecchio and David M. Laigaie, "Clawback Provisions Used to Recover From Ponzi Scheme Investors," THE LEGAL INTELLIGENCER 1 (August 26, 2009).

3. Tally M. Eiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221, 222 (2009).

4. Sepinwall, *supra*, note 1, at 3.

5. *See,* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Sec. LLC), 424 B.R. 122, 136 (Bankr. S.D.N.Y. 2010), aff'd, 654

victims of Madoff's scam as well and had every reason to believe the money they withdrew was rightfully theirs; therefore, they should not be required to give it back. This case brought clawback suits to the public's attention and sparked debate over whether clawbacks are equitable because they help to defray the losses to the scheme's victims, or unjust, given that the blameless "winners" had no reason to know that they had not invested their money legitimately. The law must determine how billions of dollars of lost value is to be allocated among creditors who are entitled to it and equally innocent. One may suggest clawbacks should go even further than currently permitted—should not all investors bear the costs of fraud equally? Because Ponzi schemes rely on a constant influx of funds to keep the fraud going, should those who were induced to invest first be compensated differently from later investors?

This article examines what constitutes a Ponzi scheme, the statutory framework for clawback suits, the arguments pro and con for the legal allowance of these actions, and offers a proposal for changing the clawback laws. It concludes that the current law regarding clawbacks is the best option presently available, but that a comprehensive legal framework dealing specifically with Ponzi schemes would be better. Given that many legal pundits agree "the use of the clawback device is likely to expand in the years ahead . . . as the American public adjusts from decades of perceived abundance to the sobering reality of economic scarcity,"[6] this is an area of the law ripe for analysis and perhaps new legislation.

II. What is a "Ponzi Scheme"?

A "Ponzi scheme is defined as:

> [A] fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than from any "profits" of the underlying business venture. The fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists

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F.3d 229, 230 (2d Cir. 2011).

6. Michael C. Macchiarola, *In the Shadow of the Omnipresent Claw: In Response to Professors Cherry & Wong,* MINN. L. REV. (2010), at *http://www.minnesotalaw review.org/headnotes/in-the-shadowof-the-omnipresent-claw-in-response-to-professors-cherry-wong-2/.*

and inducing further investment.[7]

"Ponzi schemes" owe their name to the infamous fraud perpetrated by Charles Ponzi in the early 1920s. In December, 1919, Ponzi began selling 90-day notes promising a 50% return, representing, in substance, that he had discovered that, through the use of international reply postal coupons, or the manipulation of foreign exchange, or both, he was able to make, within a very short time, 100 percent on all money entrusted to him.[8] A few of Ponzi's early investors withdrew their funds in the months preceding the bankruptcy. The "winning investors" prevailed at the trial and in the appellate courts,[9] which reasoned that these redeeming investors should retain their gains.[10] The Supreme Court reversed, ruling that it would violate the policy of equality in bankruptcy by depleting the available funds before considering losses of all the investors.[11] In rejecting this inequitable result, the Court concluded "equality is equity, which is the spirit of the bankrupt[cy] law."[12] Ponzi's scheme led to the first set of clawback cases in which winning investors were required to return their false profits.[13]

Ponzi schemes have four basic elements: (1) capital from investors, (2) a fraud, (3) payouts to investors requiring new investment to perpetuate the fraud, and (4) high rates of return that induce investment.[14] Ponzi scheme operators assert that the investors' capital is being used to generate profit, when in actuality the capital is being used to pay false profits to other

7. Cunningham v. Brown, 265 U.S. 1 (1924).

8. Lowell v. Brown, 280 F. 193, 196 (D. Mass. 1922) *aff'd*, 284 F. 936 (1st Cir. 1922) *rev'd sub nom*. Cunningham v. Brown, 265 U.S. 1, 44 S. Ct. 424, 68 L. Ed. 873 (1924).

9. Lowell v. Brown, 284 F. 936, 944 (1st Cir. 1922).

10. *Id.* At 944.

11. *Id.* at 13.

12. *Id.*

13. There are eleven published opinions emanating from Ponzi's scheme, two from state courts and nine from federal courts, including two from the Supreme Court—Ponzi v. Fessenden, 258 U.S. 254 (1922) and Cunningham v. Brown, 265 U.S. 1(1924). In *Cunningham*, the Supreme Court approved the trustee's avoidance of the withdrawals investors in Ponzi's fraud made after the *Boston Post* exposed the fraud. The clawbacks in that case derived from the preference avoidance provision. *Id.*

14. Grant Christensen, *Allocating Loss is Securities Fraud: Time to Adopt a Uniform Rule for the Special Case of Ponzi Schemes*, 3 WM. & MARY BUS. L. REV. 309, 315 (2012).

investors.

After a Ponzi scheme is uncovered, the entity through which the fraud was perpetuated has several options: (1) file for bankruptcy, (2) Securities Investors Protection Corporation (SIPC) liquidation in bankruptcy court,[15] or (3) SEC receivership.[16] Alternatively, creditors can file an involuntary petition against the entity under the Bankruptcy Code, petition a state court for the appointment of a receiver to liquidate the schemer's assets, or file individual lawsuits against the schemer.[17] In a bankruptcy case, the court ordinarily ousts management and appoints a bankruptcy trustee to liquidate the schemer's estate. All of these approaches typically provide limited recovery to victims of fraudulent investment schemes. The common problem is that the schemer has few assets left to pay back defrauded investors and creditors. In many cases, the only assets to recompense losing investors are in the pockets of other investors. Therefore, the trustee or receiver must assert legal claims to avoid or "claw back," transfers paid out by the schemer before the Ponzi scheme was uncovered. Such legal claims fall into two categories: (1) preferences and (2) fraudulent transfers. Avoidance actions for *preferences* are available only under the Bankruptcy Code, but *fraudulent transfer* claims may be brought under either the Bankruptcy Code or state laws. In theory, the trustee claws back these assets into the bankruptcy estate then equitably and ratably distributes the funds to the investors. However, the actual legal mechanisms are much less efficient and effective than the theoretical platitudes.

15. The SIPC was chartered by Congress through the Securities Investor Protection Act to restore funds to investors with assets in the hands of bankrupt and otherwise financially troubled brokerage firms. When a brokerage firm is closed because of bankruptcy and customer assets are missing, SIPC returns, within statutory limits, cash, stock, and other securities to customers. http://www.sipc.org/Who/SIPC Mission.aspx.

16. *See,* Spencer C. Barasch & Sara J. Chesnut, *Controversial Uses of the "Clawback" Remedy in the Current Financial Crisis,* 72 Tex. B.J. 922, 925 (2009).

17. See Alex S. Weiner, *Net Equity Only Comes with Net Equality: An Exploration of An Alternative Remedy for Victims of Ponzi Schemes*, 84 Temp. L. Rev. 523, 524 (2012).

III. Potential Clawback Claims

The Bankruptcy Code and case law grant bankruptcy trustees wide latitude to collect assets from certain investors for fair distribution to other investors. Ponzi scheme funds that were distributed as "returns" to select investors are often the largest potential assets of a Ponzi scheme estate. An overview of the laws that permit clawbacks follows.

A. Preference Claims

Transfers in Ponzi cases may be recovered as "preferences." Under § 547 of the Bankruptcy Code, a bankruptcy trustee may avoid payments or transfers to any creditor for an "antecedent debt" made within 90 days of the debtor's bankruptcy if (1) the debtor was insolvent at the time of the transfer and (2) would result in the creditor receiving more than they would have received in a Chapter 7 liquidation had no transfer taken place. A leading treatise on bankruptcy explains the rationale behind preference actions:

> [P]reference law reaches back over a defined period prior to bankruptcy and restructures transactions so as to level out the overall treatment received by similar creditors. This does not imply that the prepetition transfers avoided to accomplish this leveling were immoral or improper when made. Rather, they are avoided because their effect contravenes bankruptcy law concepts as to the economic effects sought in a distribution of assets or income.[18]

Preference law facilitates the fundamental policy behind bankruptcy law—"equality of distribution."[19] When an investment is considered a "debt" preference actions spread the effect of bankruptcy across more investors rather than permitting a windfall for the earlier-paid investors. However, preference law is of limited use in Ponzi schemes because it only looks back 90 days prior to bankruptcy (but if the payment was to an "insider" the "look back" period is one year).[20]

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18. Tally M. Wiener, *On the Clawbacks in the Madoff Liquidation Proceeding*, 15 FORDHAM J. CORP. & FIN. L. 221, 224 (quoting 4 William L. Norton, Jr. & William L. Norton, III, *Norton Bankruptcy Law and Practice* § 66:1 (3d ed. 2009)).

19. Weiner, *supra,* note 17, at 531.

20. 11 U.S.C. § 547(b)(4)(A) & (B).

B. Defenses to Preference Claims

Transfers are *not* preferences if they were (1) made in exchange for new value (and therefore not payment for an antecedent debt), or (2) "made in the ordinary course of business" in payment of a debt "incurred . . . in the ordinary course of business."[21]

Courts have rejected the ordinary course of business defense for "any creditor being pursued by a trustee of a Ponzi scheme,"[22] rendering this defense of little use. To establish the "new value" defense, a transferee must show that "'(i) the debtor received new value after the transfer, and (ii) such new value remained unpaid.'"[23] Such a defense might be available when an investor receives a payment on his investment and reinvests the payment in the scheme prior to bankruptcy, but only to the extent of the new value.

C. Fraudulent Transfer Claims

In the mid-1980s, bankruptcy trustees began pursuing clawback actions to recover money from innocent investors who had withdrawn more than they invested.[24] Only four of the 190 published opinions regarding Ponzi schemes and fraudulent conveyance arose before 1984, and three of these stem from the Charles Ponzi scheme. Of the 190 published state and federal cases regarding clawback actions, 149 were decided in or after the year 2000.[25] Therefore, this is a relatively new and potentially malleable area of the law.

Fraudulent transfer law was not originally created to deal with Ponzi schemes. Rather, it was intended for situations when an insolvent debtor makes a transfer of assets with the specific intent to avoid satisfying a

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21. U.S.C. § 547 (c)(1) and (2).

22. *See e.g.*, Henderson, 985 F.2d at 1025 (reaffirming the Ninth Circuit's holding that Ponzi schemes are not true businesses, so transfers made in the course of such schemes are not in the "ordinary course of business."); *see also* In re Taubman, 160 B.R. 964, 991 (Bankr. S.D. Ohio 1993) ("Ponzi schemes are not legitimate businesses which Congress intended to protect by enactment of § 547(c)(2).").

23. Wiener, *supra,* note 18, at 224 (quoting 4 William L. Norton, Jr. & William L. Norton, III, *Norton Bankruptcy Law and Practice* § 66:1 (3d ed. 2009)).

24. Sepinwall, *supra,* note 1, at 20.

25. *Id.*, at 7.

liability to a creditor.[26] Courts have extended the use of fraudulent transfer law to permit recovery of funds for the benefit of "losing investors" in Ponzi schemes, reasoning that equity requires that "winning investors" not be allowed to profit from a Ponzi scheme when the "profits" were in actuality a re-distribution of funds from other investors.[27] There are no true "winners" because Ponzi schemes have a zero percent opportunity for success. Rather money is simply pooled and passed around. The notion is that "winning investors" should be on the hook for their "false profits"—returns received in excess of their principal investment—within the allowable "clawback reach-back period."

Avoided transfers can also be recovered from those who received the property from the initial transferee.[28] In the Madoff SIPA proceeding, because many investors received returns on their investments indirectly through hedge funds that invested with Madoff, both the intermediaries and investors are potential defendants for fraudulent transfer actions.[29]

Fraudulent transfer claims are available under both federal and state law. Federal claims are available under Bankruptcy Code Sections 548 and 550. Trustees can also bring claims under state statutes through Bankruptcy Code and state Uniform Fraudulent Transfer Act laws. There is a two-year pre-bankruptcy petition reach-back under Section 548, but there is usually a longer reach-back under state law. In California, for instance, the reach back period is up to seven years.[30] Through fraudulent transfer actions, a trustee can undo both (1) actually fraudulent transfers and (2) constructively fraudulent transfers. "'The purpose of fraudulent conveyance law, whatever its form, is simple: it protects a debtor's unsecured creditors from reductions in the debtor's estate to which they look, generally, for their security.'"[31]

26. *See* Clarence L. Pozza, Jr., Robert J. Morad, & Thomas R. Cox, *A Review of Recent Investor Issues in the Madoff, Stanford, and Forte Ponzi Scheme Cases*, 10 J. Bus. & Sec. L. 113, 131 (2010).

27. Weiner, *supra,* note 17, at 532.

28. 11 U.S.C. § 550.

29. Wiener, *supra*, note 18, at 228.

30. Cal. Civil Code Section 3439, et. seq.

31. Wiener, *supra,* note 18, at 225 (quoting Mark S. Scarberry et. al., *Business Reorganization in Bankruptcy: Cases and Materials* 387 (3d ed. 2006)).

1. Fraud Claims

Federal fraud claims are brought under 11 U.S.C. 548(a)(1)(A), which provides:

> "The trustee may avoid any transfer . . . that was made or incurred on or within two years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."

This provision allows the trustee to recover any funds transferred with actual intent to hinder, delay, or defraud any of the debtor's creditors within two years prior to a bankruptcy filing. Only the debtor's intent is relevant to determine whether there was an intentional fraudulent transfer. Therefore, the transferee's lack of knowledge of the fraudulent scheme is irrelevant to finding fraudulent intent.

Fraud claims can also be brought under state statutes, such as California Civil Code § 3439.04(a) [32] which provides the same standard for fraud under the federal law.

Once the existence of a Ponzi scheme is established, actual intent to defraud is inferred from the operation of the Ponzi scheme itself.[33] A guilty plea in a criminal case for the Ponzi scheme operator also conclusively establishes actual intent.[34] Otherwise, a bankruptcy trustee can utilize the "Ponzi Scheme Presumption," under which, if the court concludes that an

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32. Under California Civil Code § 3439.04(a):

> ""A Transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation . . . without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either: (A) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to business or transaction. [or] (B) Intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due."

33. *See, e.g.,* In re Agric. Research & Tech. Corp., 916 F.2d 528 (9th Cir. 1990); *see also* Gredd v. Bear, Stearns Sec. Corp. (In re Manhattan Inv. Fund, Ltd.), 359 B.R. 510, 517–18 (Bankr. S.D.N.Y. 2007), *rev'd in part*, 397 B.R. 1 (S.D.N.Y. 2007).

34. Johnson v. Neilson (In re Slatkin), 525 F.3d 805, 814 (9th Cir. 2008).

operation was a Ponzi scheme, "actual intent to hinder, delay or defraud creditors" is deemed proven.[35]

2. Constructive Fraud Claims

Constructive fraud claims do not require proof of fraudulent intent—only that the transfer was for less than reasonably equivalent value at a time the debtor was insolvent. A transfer is constructively fraudulent under the Bankruptcy Code if

> "the debtor voluntarily or involuntarily . . . (i) received less than a reasonably equivalent value in exchange. . . ; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in a business or transaction, or was about to engage in a business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; [or](III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured . . . ."[36]

Insolvency is deemed established when the debtor is operating a Ponzi scheme.[37] There is sometimes a question whether this applies to the entire period of "business operations."[38] While some debtors have no legitimate business operations from the beginning, at times there is ambiguity as to when the Ponzi scheme began. In the latter case, the presumption may not be applied and the facts to establish these elements will need to be proven.[39]

A transfer can also be subject to a constructive fraud claim under state law. Federal and state law elements are essentially the same for

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35. Donnell v. Kowell, 533 F.3d 762, 770 (9th Cir. 2008); Barclay v. Mackenzie (In re AFI Holding, Inc.), 525 F.3d 700, 704 (9th Cir. 2008).

36. 11 U.S.C. § 548(a)(1)(B).

37. *See, e.g.,* Cuthill v. Kime (In re Evergreen Sec., Ltd.), 319 B.R. 245, 253 (Bankr. M.D. Fla. 2004).

38. Kathy Bazoian Phelps, Hon. Steven W. Rhodes, Brenda Moody Whinery, & Daniel R. Williams, *Fraudulent Transfer Claims and Defenses in Ponzi Schemes*, 091009 ABI-CLE 2009 1 (2009), at 4.

39. *Id.*, at 6.

constructively fraudulent transfers.[40]

There is some debate over whether profits constitute "value" within the meaning of the statute.[41] Courts almost uniformly hold that amounts recovered by transferees over the amount invested are subject to disgorgement because the debtor's operations were fraudulent, so the transferees lack a basis to maintain that they are entitled to any profits.[42] Many courts have concluded that no reasonably equivalent value is provided in exchange for the payment of fictitious profits, and the fictitious profits are recoverable so as not to permit earlier investors to profit at the expense of later investors.[43]

D. Good Faith Defense

After the trustee has established a prima facie case for fraudulent conveyance, the transferee has one or more affirmative defenses to protect it from liability to the extent of the value given.[44] 11 U.S.C. § 548(c) provides a defense to the initial transferee if the transferee received the transfer (1) in good faith and (2) for value. State laws generally provide this same defense. The burden of proof is on the defendant transferee to show entitlement to protection under section 548(c).[45] While theoretically, this defense can be used against claims for actual and constructive fraud, if a prima facie case of

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40. *See, e.g.*, *supra,* note 32.

41. Phelps, et. al., *supra*, note 38, at 4.

42. Merrill v. Abbott (In re Independent Clearing House Co.), 77 B.R. 843, 860 (D. Utah 1987); see *also* Scholes v. Lehmann, 56 F.3d 750, 757 (7th Cir. 1995) ("A profit is not offset by anything; it is the residuum of income that remains when costs are netted against revenues. The paying out of profits . . . conferred no benefit on the [debtors] but merely depleted their resources faster."). *But see* In re Unified Commercial Capital, 260 B.R. 343, 351 (court should measure what was given against what was received in a transaction, concluding that in some cases, the debtor's use of the investor's funds for some time supports the payment of reasonable contractual interest).

43. *See e.g.,* In re Indep. Clearing House Co., 77 B.R. at 871.

44. Phelps, et. al, *supra* note, at38; see, e.g., *Plokin v. Pomona Valley Imports, Inc. (In re Cohen),* 199 B.R. 709 (718–20 (B.A.P. 9th Cir. 1996).

45. In re Bennett Funding Corp., Inc., 232 B.R. 565, 573 (Bankr. S.D.N.Y. 1999); *Agric. Research*, *supra,* note 33, 916 F.2d at 536.

constructive fraud has been made by proving that the transfer was not for reasonably equivalent value, the reasonably equivalent value prong of the good faith defense will not be met. But if a prima facie case of constructive fraud has been made by proving that the transfer was not for reasonably equivalent value, the reasonably equivalent value prong of the good faith defense will not be met.[46]

1. Good faith

The good faith defense turns on the state of knowledge or awareness of the specific transferee. Lack of good faith does not mean a transferee acted with bad faith. Rather, it means the investor was put on inquiry notice.[47] Courts have held that a defendant transferee lacks good faith if he had knowledge of (1) a fraud or (2) the debtor's insolvency. [48] A transferee may also argue in Ponzi cases that the transferee is put on notice of the fraudulent nature of the debtor merely because the returns are substantially beyond market returns for similar investments[49]— in other words "too good to be true."

Courts consider whether there were any "red flags" to determine whether a transferee should have been on inquiry notice.[50] Examples of red flags are: (1) statements by the debtor concerning its improprieties and fraudulent conduct,[51] (2) actual knowledge of the debtor's financial problems,[52] (3)

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46. In re Bayou Group, LLC v. Redwood Growth Partners, 396 B.R. 810, 845 (Bankr. S.D.N.Y. 2008), *aff'd in part, rev'd in part*, 439 B.R. 284 (S.D.N.Y. 2010).

47. Sandra S. Benson, *Follow the Money*, 46 SEP TENN. B.J. 12, 14 (2010), at 16.

48. *In re Bayou Group LLC*, *supra,* note 46; Practical Inv. Corp. v. Rellen (*In re Practical Inv. Corp.*) 95 B.R. 935, 941 (Bankr. E.D. Va. 1989); Brown v. Third Nat'l Bank (*In re Sherman*), 67 F.3d 1348, 1355 (8th Cir. 1995). However, these two types of knowledge may not be the only kind of information that would destroy a good faith defense; *In re Bayou Group, LLC ("Bayou IV"),* 439 B.R. 284, 308 (S.D.N.Y. 2010) rejected the proposition that inquiry notice of other issues regarding the transferor's operations is a basis to challenge the defendant's good faith.

49. Scholes v. Lehmann, 56 F.3d 750, 760 (7th Cir. 1995).

50. Benson, *supra*, note 47, at 17.

51. Armstrong v. Collins, No. 01 Civ. 2437 (PAC), 02 Civ. 2796 (PAC), 02 Civ. 3620 (PAC), 2010 WL 1141158, at *27–28 (S.D.N.Y. Mar. 24, 2010).

52. *See* In re Grove-Merritt, 406 B.R. 778, 810 (Bankr. S.D. Ohio 2009).

knowledge of a tax lien filed against the debtor,[53] (4) knowledge of an impending bankruptcy,[54] (5) knowledge of the debtor's commingling of funds,[55] and (6) knowledge that the transfer received was "grossly in excess of the value" the transferee had provided.[56]

Whether the transferee's purported good faith should be evaluated using a subjective test or an objective test has not been uniformly decided. Most courts employ an objective two-part test:[57] (1) were there "red flags" that would have put the typical investor on inquiry notice of a debtor's fraudulent purpose and alerted that investor to conduct some further investigation, and (2) if so, did the investor conduct adequate due diligence to allay concerns about their investment?[58] The purpose of a due diligence inquiry is not to unveil the details of the fraud, but to resolve concerns raised by red flags and establish the credibility of the transferee's good faith reason for redemption.[59] In *In re Bayou Group IV* ("*Bayou IV*"), the court placed a "specific focus on the class or category of the transferee" and noted that whether a transferee is on inquiry notice is informed by "the standards, norms, practices, sophistication, and experience generally possessed by participants in the transferee's industry or class."[60] The *Bayou IV* court found redemptions for funding the purchase of a home, the expenses of a newborn child and private school tuition of an older child, and to comply with ERISA were all good faith defenses.[61] These defenses seem to be more in the nature of equitable justification and demonstrate that subjective interpretation of such defenses does not allow a bright line to be drawn to simplify future claims.

A defendant transferee who fails to conduct a diligent inquiry may still be able to successfully defend if he can show that a reasonably diligent

53. *See* In re Armstrong, 259 B.R. 338, 344 (Bankr. E.D. Ark. 2001).

54. *See* In re McLaren, 236 B.R. 338, 344 (Bankr. E.D. Ark. 2001).

55. *See* Cannon v. J.C. Bradford & Co., 230 B.R. 546, 593–94 (Bankr. W.D. Tenn. 1999) (*reversed on other grounds*).

56. *Agric. Research*, *supra,* note 33, 916 F.2d at 536.

57. Benson, *supra,* note 47, at 16.

58. *Id.*

59. *Id.*

60. Bayou IV, *supra*, note 48, at 313.

61. Benson, *supra*, note 47, at 16.

inquiry would not have disclosed the relevant facts about the Ponzi operator.[62] However, in some cases, courts have required the transferee to have actually made a diligent inquiry when on inquiry notice.[63]

2. For Value

Once a transferee proves good faith, to successfully assert the defense he must also establish he gave value. 11 U.S.C. § 548(d)(2) defines "value" as "property, or satisfaction, or securing of a present or antecedent debt of the debtor…" "Property," in turn, means a reasonably equivalent exchange of consideration. One commentator explains,

> The defendant's assertion of "value" for purposes of section 548(c) is essentially the flip side of the plaintiff's showing of "reasonably equivalent value" under section 548(a)(1)(B). The former looks at value from the perspective of the transferor (i.e., did the debtor receive enough value in exchange for the transfer, while the later looks at value from the perspective of the transferee (i.e., how much did the transferee give?).[64]

In most Ponzi scheme cases, defendant investors can establish "value" by showing that the principal they received from the Ponzi operator was in satisfaction of an "antecedent debt," because their initial investment gave rise to a claim.[65] Therefore, the argument that unequal distribution of the Ponzi operator's assets creates unjust enrichment of certain investors and warrants disgorgement fails as to those "good faith" investors who are entitled to recover up to the amount of principal they invested.[66] However, amounts received above the principal investment cannot be "for value."[67] Courts have evaluated whether value was given in two ways: (1) "on a case-by-case basis, looking at the surrounding circumstances and by focusing on the precise

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62. In re Agric. Research & Tech. Corp., 916 F.2d 528, 536 (9th Cir. 1990).

63. *See e.g.,* In re Manhattan Inv. Fund III, 397 B.R. 1, 22–24 (S.D.N.Y 2007).

64. Phelps, et. al, *supra*, note 38, at 8.

65. Jessica D. Gabel, *Midnight in the Garden of Good Faith: Using Clawback Actions to Harvest the Equitable Roots of Bankrupt Ponzi schemes*, 62 CASE W. RES. L. REV. 19, 24 (2011).

66. *See e.g.,* SEC v. Stanford Int'l Bank, Ltd., 776 F. Supp. 2d 323 (N.D. Tex. 2011).

67. Merrill v. Abott (*In re Independent Clearing House Co*.), 77 B.R. 843 (D. Utah 1987) (*en banc)*.

nature of the transfer"[68] or (2) "by considering whether reasonably equivalent value confers an economic benefit on the debtor."[69]

E. Constructive vs. Actual Fraud: Recovery of Avoided Transfers

For a trustee to recover under a constructive fraud claim, the debtor must have received less than a reasonably equivalent value from the investor in return for the transfer when the debtor's insolvency was imminent. For clawback claims under actual fraud, the debtor must have had actual *intent* to hinder, delay, or defraud creditors.[70]

The general rule is that the trustee's recovery is limited to recovery of fictitious profits from "net winners." Bankruptcy rulings across the circuit courts and the Restatement of Restitution agree "that distribution of principal absent bad faith does not amount to unjust enrichment of an innocent investor."[71] A Ponzi scheme investor who receives more from the schemer than he or she invested is considered to be a "net winner." These fictitious profits are "clawed back" from "net winners" to repay the principal investments of "net losers."[72]

Under the "actual fraud" theory, the entire amount of any transfer made with "actual intent to hinder, delay or defraud creditors" can be avoided, whether or not the debtor received value in exchange, and the trustee does not need to prove that the transfer was for less than fair value.[73] In reality,

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68. In re Fin. Federated Title & Trust, Inc., 309 F.3d 1325, 1332 (11th Cir. 2002).

69. Rubin v. Manufacturers Hanover Trust, 661 F.3d 979 (2d Cir. 1981).

70. Weiner, *supra,* note 17, at 533.

71. *Id.*

72. *See,* In re Bernard L. Madoff Inv. Sec. LLC, 424 B.R. 122, 142 (Bankr. S.D.N.Y. 2010) ("Equality is achieved in this case by employing the Trustee's method, which looks solely to deposits and withdrawals that in reality occurred. To the extent possible, principal will rightly be returned to Net Losers rather than unjustly rewarded to Net Winners under the guise of profits. In this way, the Net Investment Method brings the greatest number of investors closest to their positions prior to Madoff's scheme in an effort to make them whole.")

73. *See* Bayou Superfund LLC v. WAM Long/Short Fund II L.P. (In re Bayou Group, LLC), 362 B.R. 624 (Bankr. S.D.N.Y. 2007); *see also* Sharp Int'l Corp. v. State Street Bank & Trust Co. (In re Sharp Int'l Corp.), 403 F.3d 43, 56 (2d Cir. 2005).

because fraudulent transfer provisions under the Bankruptcy Code and state statutes are subject to the defense of good faith, the trustee will only be able to recover amounts in excess of principal.

Under the theory of constructive fraud, recovery ordinarily is limited to fictitious profits earned by the investor, unless the investor subjectively knew of the fraud.[74] The rationale behind disallowing the trustee from recovering principal is that an investment made into a Ponzi scheme is obtained by the schemer's fraud. Therefore, the investor has a claim of restitution to recover that investment.[75] When the schemer repays principal to the investor, the exchange is for value because this is considered as repayment for the debt owed to the investor as a result of the schemer's fraud.[76] The investor should have a claim of restitution only if he acted in good faith and without knowledge of the fraud.

The good faith defense effectively eliminates any difference in the recoverable amount between the "actual fraud" and "constructive fraud" theories.[77] "Since most Ponzi schemes are built around the obliviousness of investors, the good faith defense habitually surfaces, eliminating any possibility for the redistribution of principal investments under either theory of fraud and recouping net winners at the expense of those who failed to withdraw sufficient funds before the pyramid collapsed."[78]

IV. Impact of Submitting a Claim

Defrauded customers are invited to submit claims to receive distributions from SIPC or the bankruptcy court, but this invitation has been described as a "Trojan Horse."[79] By submitting claims for recovery of net equity, investors submit themselves to the jurisdiction of the Bankruptcy Court and give up their right to a jury trial to defend potential clawback claims.[80] Claims

74. Benson, *supra,* note 47, at 15.

75. Barclay v. Mackenzie (In re AFI Holding, Inc.), 525 F.3d 700 (9th Cir. 2008).

76. Benson, *supra* note 47, at 15.

77. Weiner, *supra*, note 17, at 533.

78. *Id.*, at 534.

79. *See, e.g*., Robert Wayne Pierce, *Madoff—The Trojan Horse and the Lion*, at http://www.secatty.com/Madoff.shtml (last visited Nov. 24, 2012).

80. Wiener, *supra*, note 18, at 231.

submitted by customers who are subsequently named as clawback defendants are not eligible to receive SIPC distributions until the clawback claims against them are resolved.[81]

While an investor can always be sued outside of Bankruptcy Court, submitting oneself to jurisdiction by the Bankruptcy Court makes it easier for the trustee to assert a clawback action. In addition, a jury may be more sympathetic to a clawback defendant than a bankruptcy judge who is well-versed in fraudulent transfer law, and would not think twice about clawing back fictitious profits. It would likely be easier to convince a jury that taking the money back from an innocent investor is not fair. Thus, by submitting a claim in bankruptcy, the investor makes fraudulent transfer recovery more likely.

V. Investors Subject to Clawbacks

Because in practice bankruptcy trustees pursue clawbacks against net winners only to the extent of profits, allowing net winners to keep their principal investments, the net losers are left only what remains of recovered funds, which can amount to pennies for each dollar they invested.[82] There are cases in which clawback actions have been successful against innocent investors for fictitious profits, and cases in which investors' principal investments have been recovered given a lack of good faith, however "'no court has ever sanctioned clawback of principal from an innocent investor.'"[83] This is likely due in large part to the SEC recommendation that net winners should only be subject to the clawback of "returns" on their principal investment.[84]

81. *Id.*

82. Weiner, *supra,* note 17, at 538.

83. *Id.* (quoting Brief of Appellees Jim Letsos et al. at 24–25, SEC v. Stanford Int'l Bank, Ltd., 776 F. Supp. 2d 323 (N.D. Tex. 2011).

84. Brief of Appellees Jim Letsos et al. at 13, SEC v. Stanford Int'l Bank, Ltd., 776 F. Supp. 2d 323 (N.D. Tex. 2011).

VI. Allocating Loss

The trustee is tasked with hearing the arguments by all parties, ascertaining the losses claimed, and reconciling these claims with the remaining or potentially recoverable assets. The trustee then recommends to the court the appropriate method of allocating loss among innocent parties. Courts have explored a variety of methods to allocate loss based on the facts of each case. These remedies all end with allocation of the funds the trustee was able to recover from the "net winners" to the "net losers," apportioned based on each investor's net equity.[85] Investors have argued that net equity should be calculated based on the amounts shown on their statements before the collapse of the scheme.[86] Courts have rejected this approach "on the ground that it is unfair to give credence to documentation that was wholly fictional."[87] Rather, courts have used the "Net Investment Method" which calculates net equity as the amount of money deposited minus amount already withdrawn.[88] In other words, to determine whether an investor is subject to clawbacks and therefore must return funds, courts look at the transfers in the aggregate to calculate whether an investor is a net-winner. "It is, therefore, not necessary in a Ponzi scheme case to analyze each payment, transfer by transfer, to characterize the payments as either principal or profit."[89]

VII. Distribution of Recovered Funds

Courts typically order pro-rata distribution of the total amount recovered based on the net equity of each investor." The justification for the pro-rata standard originates in the Supreme Court opinion surrounding the eponymous name for Ponzi schemes, stating that 'equality is equity' between 'equally innocent victims.'"[90]

Under the current system, some degree of inequality is unavoidable due to the nature of Ponzi schemes and the practical difficulties of recovering and

85. Weiner, *supra*, note 17, at 535.

86. *See,* 7 Bromberg & Lowenfels on Securities Fraud § 19:36 (2d ed.).

87. Weiner, *supra*, note 17, at 535.

88. *Id.*

89. Phelps, et.al., *supra*, note 38, at 5.

90. Weiner, *supra*, note 17, at 539.

redistributing funds. Some theorists argue that the current practice of limiting Ponzi scheme clawbacks to the fictitious profits of net winners should not be the remedy in every case. Rather, these theorists argue, there should be the opportunity to clawback principal investments in some cases.[91]

VIII. Criticism of the Current Approach for Clawbacks

A. Inefficiency

Clawbacks are an imperfect remedy—it's not as simple as putting all the money back in the pot and distributing it equally. The current system for clawbacks is inefficient. As mentioned previously, Mr. Picard has brought more than 1,000 cases on behalf of victims. He has reached settlement deals worth approximately $9 billion, but many of those settlements are being challenged in court, further delaying distribution of these recovered funds to victims.[92] To date, only about $2.7 billion has been distributed to Madoff's victims.[93]

The legal fees generated by bankruptcy trustees can be substantial. Mr. Picard's efforts have cost $554 million in legal and other fees, and–at $850 an hour—Mr. Picard has personally earned $5.1 million. As for the longevity of these suits, they can take years.

B. Allowance of Unjust Enrichment

In the current system, people are not all treated equally because some get to keep all of their principal, while others get back only pennies on the dollars of their principal. Allowing all good-faith investors to retain their principal treats the Ponzi scheme as a true investment. The fact that these good-faith investors pulled their principal out in time or received "returns" was based purely on luck and the whims of the schemer. In making some investors whole by allowing them to keep their principal, courts are permitting a degree of unjust enrichment if other investors are receiving

91. *See generally*, Weiner, *supra,* note 17.

92. *Id.*

93. Aaron Smith, "Judge releases billions in Madoff money," CNN MONEY, August 23, 2012, at *http://money.cnn.com/2012/08/23/news/companies/madoff-ponzi/index.html.*

pennies on the dollar as victims of the same scheme.

As a practical matter, most "net winners" subject to clawback suits will settle outside of court. Because bankruptcy trustees will typically offer settlements at a discount, these net winners may be able to keep some of their "profits" that would legally be subject to clawback. Therefore, under the current system, the full amount of money that could theoretically be put back into the pot will not be.

IX. Advantages of the Current Approach for Clawbacks

The current approach partially accounts for the reliance of "net winners." Subjecting winning investors to clawbacks of "profits" imposes severe financial burdens on innocent victims of the fraud. The investors who in good faith were collecting "profits" had no reason to know that these were not legitimate, and may spent these funds to purchase a house, donate to charity, save for children's education, or save for retirement. Some theorists contend that the time value of money and opportunity costs should be considered before clawing back money from winning investors.[94] "[P]erhaps reaching into the pockets of innocent people to an extent immediately short of capital outlay is as fair of a compromise as courts can justifiably mandate."[95]

X. Alternative Approach: Clawing Back Principal

In the Stanford International Bank Ltd. litigation, the receiver appointed by the SEC took an aggressive stance on clawbacks—he attempted to pursue clawback claims against innocent investors for the return of both principal and fictitious profits.[96] The SEC responded by filing a motion to limit the court-appointed receiver's authority to file clawback claims, arguing his actions "contravene [] Commission practice and [are] supported by neither logic nor the law." In the SEC's view, "[t]he reasoning is simple: Forcing innocent investors to return funds they contributed to the defunct entity does

94. *See generally* Karen E. Nelson, *Turning Winners into Losers: Ponzi scheme Avoidance law and the Inequity of* Clawbacks, 95 MINN. L. REV. 1456 (2011).

95. Weiner, *supra* note 17, at 545.

96. Jeffrey G. Hamilton and Robert G. Richardson, *Clawback Claims Against Innocent Investors: The SEC vs. The Stanford Receiver*, 28 OCT AM. BANKR. INST. J. 12 79, 79 (2009); Pozza, et al., *supra,* note 26, at 120.

nothing more than create new victims to the fraud because it deprives those investors of their actual out-of-pocket contributions."[97]

Despite the fact that the SEC "does not want to be seen as being a party to actions that cause hardship to investors who have done nothing wrong,"[98] it may be appropriate in some cases for principal to be clawed back from "net winners." The receiver in the Stanford estate argued:

> "the failure to file clawback against these innocent investors would unfairly prefer those investors who were lucky enough to redeem their investments before the fraud was discovered . . . all investors, even those investors who redeemed their investments before [the Ponzi scheme was revealed], should share equally in the losses."[99]

This approach would be more akin to putting all the money back in one pot and distributing it pro-rata. The SEC argued that

> "(1) the Receiver's suit in equity was simply an attempt to circumvent the fraudulent transfer rules which make it difficult to recover the proceeds received in good faith by investors as principal and (2) no case law would allow for the pro-rata distribution of receivership assets of a Ponzi scheme when the monies are in the hands of third parties and not already assembled into the receivership estate."[100]

While this approach may be impractical for the rare Ponzi schemes that span many years, such as Madoff's, it could be practically applied to shorter-term Ponzi schemes. Based on how much money is available to be recovered, each investor would be allowed to recover an equal percentage of their principal. This approach would recognize that money was merely moved around from one investor to another. In addition, this approach would "eras[e] distributions that were made at the discretion of the swindler, it would be as if there was never allocation of any kind. This would be a more complete materialization of the commonly held conclusion by the courts that '[e]quity does not permit [a net winner's] zeal to be rewarded.'"[101] The only principal funds that would not be able to be redistributed would be the money that the

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97. Hamilton, *supra*, note 96, at 79.

98. *Id.*

99. *Id.,* at 80.

100. Pozza, et al., *supra*, note 26, at 121.

101. Weiner, *supra,* note 17, at 547 (quoting Lawless v. Anderson (*In re Moore*), 39 B.R. 571, 575 (Bankr. M.D. Fla. 1984).

schemer already spent. As one commentator puts it: "the proposition to clawback principal investments reflects the idea that a hospital would rather attend to two patients with paper cuts than one with a stab wound."[102]

XI. Conclusion

Regardless of theoretical approaches to recovery, none will be practically feasible without comprehensive legislation to address the conundrum—how to be fair. The current approach of litigation, in most cases, costs both the trustee and the investor legal fees amounting to a significant percentage of the sums being sought. The uncertainty of the various defenses including their applicability, the skill of their assertion, and the vagaries of perception by the courts, make these lawsuits akin to a crapshoot. More certainty in result is needed if Ponzi schemes are to be addressed fairly and equitably, because the present state of the law does not permit a truly equitable result. Allowing someone who simply cashed out before the Ponzi scheme was discovered or received "dividends" along the way to retain these amounts, to the detriment of investors who did not cash out, or received fewer or no dividends, is simply not an equitable result. A set of laws that makes it easier for trustees to claw back money into the bankrupt estate and then distribute it out ratably is the only way to make clawbacks truly equitable. Perhaps the good faith defense needs to be eliminated to achieve overall victim fairness. Given the complicated mess that Ponzi schemes leave behind, the current system may be the best we can do absent new and specific legislation.

102. Weiner, *supra*, note 17, at 547.

EXPUNGEMENT STUDY OF THE PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION[1]

Scott Ilgenfritz

INTRODUCTION

In the context of the securities industry, the term "expungement" refers to the process by which an individual stockbroker licensed through the Financial Industry Regulatory Authority, Inc., ("FINRA") can seek to have removed from his or her public regulatory record maintained through the Central Registration Depository ("CRD") information concerning a complaint or complaints made by investors which arise from the conduct of the broker.[2]

PIABA has undertaken this study of expungement requests in securities arbitration proceedings filed between January 1, 2007 and December 31, 2011, by investors against securities broker/dealers and/or individual brokers. PIABA requested that the Securities Arbitration Commentator ("SAC") search its database for arbitration awards in investor disputes with securities industry members that mention the term "expungement" and to extract from each award and place on spreadsheets specific types of data as requested by PIABA.[3]

The most alarming statistic arising from an analysis of the SAC data is the very high percentage of cases resolved by settlement or stipulated awards in which expungement relief has been granted. For the time period January 1, 2007 through May 17, 2009, expungement was granted in 89% of the

1. PIABA is an international, not-for-profit, voluntary bar association of lawyers who represent claimants in securities and commodities arbitration proceedings and securities litigation. The mission of PIABA is to promote the interests of the public investor in securities and commodities arbitration, by seeking to protect such investors from abuses in the arbitration process, by seeking to make securities arbitration as just and fair as systemically possible and by educating investors concerning their rights.

2. Broker/dealers that are members of FINRA may also seek expungement of customer complaint information.

3. The analysis, opinions, and conclusions expressed in this study are those of PIABA only. SAC has not participated in the preparation of the text of this study. SAC's role with respect to this study has been limited to providing arbitration award data to PIABA for its review and analysis.

cases resolved by stipulated awards or settlement. For the time period May 18, 2009 through December 31, 2011, expungement relief was granted in 96.9% of the cases resolved by settlements or stipulated awards.

The data also revealed that one individual associated with a brokerage firm during the Review Period requested expungement relief 40 times, and arbitration panels granted expungement relief to that individual 35 times.

The purposes of PIABA's study include the following:

(1) PIABA has analyzed the data provided by SAC with respect to arbitration awards rendered in cases initiated by investors against broker/dealers and/or brokers for cases filed during the five year time period between January 1, 2007 and December 31, 2011, which mention the term "expungement" to determine whether any trends with respect to expungements can be discerned;

(2) To provide context of the above-described analysis, PIABA provides an overview of the Central Registration Depository ("CRD") system, Notices to Members issued by the National Association of Securities Dealers, Inc. ("NASD"), Regulatory Notices issued by FINRA, and rule changes adopted by NASD and FINRA with approval of the Securities and Exchange Commission ("SEC") with respect to the CRD system and expungements;

(3) PIABA discusses issues identified as a result of the analysis of the expungement data, expresses conclusions or opinions with respect to those issues, and expresses ideas about how the issues reflected in the expungement data should be addressed.

THE CENTRAL REGISTRATION DEPOSITORY SYSTEM

FINRA maintains the qualification, employment and disclosure histories of 5100 broker/dealers and approximately 660,000 of their securities employees in the electronic CRD system.[4] FINRA and the North American Securities Administrators Association ("NASAA") established a CRD system in 1981. In 1999, the CRD system was transformed from a paper-based system under which paper registration forms were submitted to the NASD and entered by it, to a web-based system in which the vast majority of

4. *See* FINRA Dispute Resolution Expungement training materials at p. 5. The FINRA Dispute Resolution Expungement training materials are available at http://www.finra.org/ArbitrationAndMediation/Arbitrators/Training/WrittenMaterials/index.htm.

registration forms are filed online via the Internet.[5] FINRA's predecessor, NASD[6], has described the CRD system as follows:

> The CRD system is an online registration and licensing system for the U.S. securities industry, state and federal regulators, and self-regulatory organizations ("SROs"). The CRD system contains broker/dealer information filed on Forms BD and BDW and information on associated persons filed on Forms U-4 and U-5. The CRD system also contains information filed by regulators via Form U-6. The CRD system contains administrative information (*e.g.*, personal, organizational, employment history, registration, and other information) and disclosure information (*e.g.*, criminal matters, regulatory disciplinary actions, civil judicial actions, and information relating to customer disputes) filed on these forms.
>
> NASD operates the CRD system pursuant to policies developed jointly with the North American Securities Administrators Association (NASAA). NASD works with the SEC, NASAA, other members of the regulatory community, and member firms to establish policies and procedures reasonably designed to insure that information submitted to and maintained on the CRD system is accurate and complete. These procedures, among other things, cover expungement of information from the CRD system in narrowly defined circumstances.[7]

Thus, for each associated person licensed by NASD or FINRA, the CRD system contains disclosure information with respect to the associated person having been named in a criminal matter, having been the subject of a regulatory disciplinary action, having been named in a civil judicial action, and having been named in an investor arbitration proceeding.

For many years, there was an anomaly in the reporting requirements with respect to customer complaints. Until May 18, 2009, the questions on the Form U-4 and Form U-5 only required the reporting of two categories of customer complaints: (1) written or oral customer-initiated, investment-related complaints involving alleged sales practice violations for damages in

5. *See* FINRA Dispute Resolution Expungement training materials at 6.

6. FINRA was formerly known as National Association of Securities Dealers, Inc. On July 30, 2007, NASD acquired the member regulation, enforcement, and arbitration operations of the New York Stock Exchange and changed its name to FINRA.

7. NASD Notice to Members 04-16, which is available at http://www.finra.org/Industry/Regulation/Notices/2004/P003233.

the amount of $5,000 or more; and (2) customer-initiated, investment-related, arbitration or civil litigation claims in which the broker was named as a respondent or defendant and was alleged to have been involved in one or more sales practice violations. Thus, if a registered representative was the subject of an oral or written investment-related complaint by a customer alleging one or more sales practice violations and seeking damages of $5,000 or more, which was conveyed to the broker/dealer employing the registered representative, that customer complaint had to be reported to NASD or FINRA. Likewise, if a registered representative was named as a respondent or defendant in an investment-related arbitration or civil action filed by a customer in which the customer alleged the registered representative's involvement in one or more sales practice violations, the broker/dealer employing the registered representative had an obligation to report to NASD or FINRA the filing of the arbitration proceeding or civil action. However, prior to May 18, 2009, if a registered representative was identified by name in a customer-initiated arbitration proceeding or civil action or otherwise identified as the person involved in one or more sales practice violations, but the registered representative was not named as a respondent or defendant, there was no requirement to report to NASD or FINRA the filing of the arbitration proceeding or civil action.

Investor advocates and others complained to FINRA about this anomaly. On March 6, 2009, FINRA filed a proposed rule change with the SEC for comment, review, and approval.[8] The rule amendments included in the proposed rule change addressed the above-described anomaly by incorporating two additional questions into the Forms U-4 and U-5. One of those questions required the reporting to FINRA of a registered representative being the subject of (without being named as a respondent or defendant) an investment-related, customer-initiated arbitration claim or civil action within the past twenty-four months in which the customer alleged one or more sales practice violations and requested compensatory damages of $5,000 or more.[9] On May 13, 2009, the SEC approved FINRA's proposed

8. *See* Exchange Act Release No. 59916 (May 13, 2009) (SEC Order Approving SR-FINRA-2009-008).

9. FINRA maintains on its website at www.finra.org a public disclosure database concerning broker/dealers and brokers called "BrokerCheck". FINRA's BrokerCheck database for registered representatives includes employment history, licensure and registration information, and disclosure information, including customer complaints. FINRA's BrokerCheck database is available at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

rule change described above[10] In May, 2009, FINRA announced the SEC's approval of the proposed rule change.[11] FINRA announced that the amendments with respect to the reporting of customer complaints on Forms U-4 and U-5 became effective on May 18, 2009. Additional questions on the Forms U-4 and U-5 applied to arbitration claims or civil actions filed on or after May 18, 2009.[12]

PIABA chose to base this study on arbitration awards which mention "expungement" in customer-initiated proceedings filed between January 1, 2007, and December 31, 2011, in part, to analyze the effect that the amendments announced in Regulatory Notice 09-23 have had on expungements. The May 18, 2009, effective date is approximately at the midpoint of the five year time period for which PIABA obtained arbitration award data from SAC.

REGULATORY BACKGROUND CONCERNING EXPUNGEMENTS

After the inception of the CRD system in 1981, the NASD generally honored court-ordered expungements.[13] In NASD Notice to Members ("NTM") 01-65, the NASD also stated, "Arbitrator-ordered expungements that met certain requirements also were honored until January 1999."[14] NASD did not describe in NTM 01-65 what those "certain requirements" were. In the same notice, NASD recognized that most customer/broker disputes are resolved in arbitration or are settled without any ruling by a finder of fact. NASD further noted that neither of those customer claim resolution methods results in a document that explicitly identifies the basis for granting expungement relief, because arbitrators are not required to

10. Exchange Act Release No. 59916 (May 13, 2009) (SEC Order Approving SR-FINRA-2009-008), 74 Fed.Reg. 23750 (May 20, 2009) (Order Approving File No. SR-FINRA-2009-008).

11.Regulatory Notice 09-23 is available at http://www.finra.org/Industry/Regulation/Notices/2009/P118706.

12. *See* FINRA Regulatory Notice 09-23 at p. 4.

13. *See* NASD Notice to Members 01-65, p. 564, which is available at http://finra.complinet.com/en/search/search.html?rulenumber=01-65.

14. *Id.*

provide the reasoning for a decision or award, and arbitrators typically do not do so.[15]

The reference in NTM 01-65 to arbitrator-ordered expungements that met certain requirements being honored until January, 1999, relates to NASD Regulation imposing a moratorium on arbitrator-ordered expungements effective January 19, 1999.[16] The moratorium was the result of a disagreement between NASD Regulation and NASAA concerning arbitrator-ordered expungements. At that time, the CRD system was operated pursuant to an agreement between NASD Regulation and NASAA. NASD Regulation had taken the position that expungement of information from the CRD system ordered by an arbitrator and contained in an award should be given the same treatment as a court-ordered expungement. NASAA disagreed because it was the opinion of NASAA that under some state laws information submitted to the CRD system was a state public record, and such state laws did not recognize the authority of arbitrators to remove a state public record.[17]

Later in 1999, NASD Regulation issued Notice to Members 99-54 ("NTM 99-54") in which it recognized that information on the CRD system "has important investor protection implications, provided it is complete and accurate." NASD Regulation further stated, "Therefore, such information should not be expunged without good reason (*e.g.*, a finding that expungement relief is necessary because information on the CRD system is defamatory in nature, misleading, inaccurate, or erroneous)."[18]

In NTM 99-54, NASD Regulation sought comment on an approach that would establish standards which would have to be satisfied before NASD Regulation would expunge information from the CRD system based on an arbitrators' award.[19] In this notice, NASD Regulation also posed the following question:

> **Should consent awards (*i.e.*, those containing expungement directives) be treated differently than awards issued after full**

15. *Id.* at p. 566 and fn. 8.

16.*See* NASD Notice to Members 99-09 ("NTM 99-09") at p. 47, which is available at http://www.finra.complinet.com/en/search/search.html?rulenumber=99-09.

17. *Id.*

18. *See* NASD Regulation Notice to Members 99-54 at p. 2, which is available at http://www.finra.org/Industry/Regulation/Notices/1999/P004218.

19. *Id.* at p. 2.

> **consideration of the merits of the dispute?** (emphasis in the original)[20]

NASD Regulation requested comments on whether the establishment of standards as outlined in the notice would provide a basis for NASD Regulation to treat stipulated awards with expungement directives in the same manner as awards containing expungement directives after a full hearing.[21]

NASD Regulation noted the widely accepted authority of arbitrators to award equitable relief. It stated its belief that arbitrators ordering expungement of information from the CRD system which is determined to be defamatory, misleading, inaccurate, or erroneous is equitable relief within the authority of the arbitrators. However, as of the issuance of NTM 99-54, the NASD's Code of Arbitration Procedure and its arbitrator training materials did not address the granting of equitable relief in the form of expungement of information from the CRD system.[22]

NTM 01-65 also included a discussion of stipulated awards which result from a settlement between the parties and do not involve any findings of fact as to the merits of the investor's claim. In the discussion of stipulated awards, the NASD stated:

> [C]oncerns had been raised about the possibility of negotiated arrangements wherein a firm may agree to settle a claim filed by a customer against an associated person and the firm, provided the customer agrees to the inclusion of a directive to expunge all information about the claim from the associated person's CRD record. In some cases, a customer claim/allegation may have merit and, therefore should be reported on the uniform registration forms, included in the CRD system for use by regulators and broker/dealers, and made available to investors through NASD Regulation's PDP [Public Disclosure Program]. Expungement may be inappropriate under these circumstances.[23]

At the conclusion of the foregoing quotation, the NASD appended a footnote, which stated the following:

> **NASD Regulation is aware of allegations that firms have pressed customers/claimants into accepting expungement as a condition**

20. *Id.*

21. *Id.* at pp. 2-3.

22. *Id.* at p. 3.

23. NASD NTM 01-65 at 567.

> **of settlement of arbitration proceedings. While we believe that the proposed rules would address these concerns, NASD Regulation would consider this practice to be a possible violation of Rule 2110.**[24] (Emphasis added)

In addition to the discussion in 01-65 described above, NASD stated:

> "Stipulated" (or consent) awards or settlements are a source of particular concern because typically there has been no hearing on the merits, no independent fact finder involved in the negotiations, and no rationale provided for the expungement. While there may be legitimate reasons for the expungement, those reasons generally are not provided in a stipulated award or a settlement. Therefore, NASD Regulation is proposing that any approach dealing with the expungement of customer dispute information must address both expungement orders in arbitration awards after a hearing on the merits and "stipulated" or consent awards in which the parties agree to expungement as part of the settlement and then present the settlement to the arbitrator for inclusion in an award.[25]

Thus, as early as 1999, NASD Regulation had concerns about whether stipulated or consent awards containing expungement relief should be treated differently than awards issued after a hearing on the merits. NASD reiterated those concerns in NTM 01-65. Significantly, NASD Regulation took the position that it would consider respondents conditioning the settlement of arbitration proceedings on customer claimants' agreement to expungement relief to be a possible violation of the just and equitable principles of trade under Rule 2110.

The standards for granting expungement relief proposed by NASD Regulation in NTM 01-65 were factual impossibility or clear error, the claim being without legal merit, and the claim being defamatory in nature. The notice stated that NASD Regulation believed that it would be proper to include expungement relief in stipulated awards only in cases that involve factual impossibility or a party being mistakenly named.[26]

NASD's next effort to establish standards for the granting of expungement relief came with the filing of proposed Rule 2130 in a submission to the SEC on November 19, 2002.[27] NASD Rule 2130, entitled

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24. *Id.* at p. 570, fn 14.

25. *Id*. at p. 566.

26. *Id.* at 567.

27. SEC Order Granting Approval of Proposed Rule Change and Amendment No. 1, Thereto, and Notice of Filing Order Granting Accelerated Approval to Amendment

"Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System", established requirements to be met by member firms or associated persons to obtain the expungement of information from the CRD system arising from a customer complaint. First, the rule required that member firms and associated persons must obtain an order from a court of competent jurisdiction directing expungement or confirming an arbitration award containing expungement relief. Second, member firms and associated persons that petitioned a court for expungement relief or sought judicial confirmation of an arbitration award containing expungement relief were required to name NASD as an additional party and serve NASD with all appropriate documents, unless NASD waived that requirement. Third, the rule set forth three affirmative judicial or arbitral findings that might result in NASD waiving the obligation to name it as a party in a petition to a court for expungement relief or confirmation of an arbitration award granting such relief:

> (A) The claim, allegation, or information is factually impossible or clearly erroneous;
>
> (B) The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or
>
> (C) The claim, allegation, or information is false.

Fourth, NASD reserved the discretion under extraordinary circumstances to waive the obligation to name NASD as a party to a petition filed in court if the expungement relief and accompanying findings providing the basis for that relief are meritorious and expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.[28]

In its order approving Rule 2130, the SEC noted that, "Currently, it is possible that respondents may agree to pay damages as a quid pro quo for expungement and obtain court confirmation of the expungement."[29] NASD took the position that the proposed rule would reduce, if not eliminate, the

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No. 2, Thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information From the Central Registration Depository System, 68 Fed.Reg. 74667 (December 24, 2003), Exchange Act Release No. 48933 (File No. SR-NASD-2000-168 (Dec. 16, 2003, 68 Fed.Reg. 74667 (December 24, 2003). NASD Rule 2130 has been incorporated into the FINRA Manual as Rule 2080.

28. *Id.*

29. 68 Fed.Reg. 74667, 74670 (Dec. 24, 2003).

risk of expungement of information critical to investor protection and regulatory interests as a condition in settlement negotiations. NASD believed that any concern about members or associated persons "buying clean records" would be addressed by the requirement in the rule of an "affirmative determination" of one of the grounds specified in the rule by the arbitrators.[30] The SEC expressed its agreement with NASD's position that the "affirmative" determination requirement would provide sufficient regulatory protection and would not allow the "buying of clean records".[31]

Rule 2130 became effective on April 12, 2004, and applied to any request filed with a court of competent jurisdiction to expunge customer dispute information from the CRD system, which was based upon an arbitration proceeding or civil action filed on or after April 12, 2004.[32]

In June, 2004, NASD issued NTM 04-43[33] to provide guidance to member firms and associated persons with respect to the use of affidavits obtained from customers in connection with stipulated awards or settlements to obtain expungement of customer dispute information under Rule 2130. In NTM 04-43, NASD stated that it had recently become aware of situations in which respondents appeared to be settling customer claims, at least in part, for monetary compensation provided to the customer in return for an affidavit from the customer absolving one or more of the respondents from the wrongdoing alleged in the statement of claim.[34] NASD cautioned member firms and associated persons that paying consideration for affidavits from customers as part of settlement negotiations, the content of which is untrue and contradicts the allegations in the statement of claim, exposed member firms and associated persons to a variety of sanctions, including a potential disciplinary proceeding for violation of NASD rules, including Rule 2110.[35] NASD concluded NTM 04-43 by stating:

> NASD believes that abusing NASD's dispute resolution system by negotiating settlements with customers in return for exculpatory affidavits that the member or associated person knows or should

30. *Id.*

31. *Id.* at 74671.

32. *See*, NASD Notice to Members 04-16, at p. 211, which is available at http://www.finra.org/Industry/Regulation/Notices/2004/P003233.

33. NASD Notice to Members 04-43 is available at http://www.finra.org/Industry/Regulation/Notices/2004/P003014.

34. *Id.* at p. 544.

35. *Id.*

> know are false or misleading contravenes Rule 2110, which requires members and their associated persons, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade.[36]

Thus, with the issuance of NTM 04-43, NASD put member firms and associated persons on notice that it was a prohibited practice and a violation of NASD rules for member firms and associated persons to bargain for as part of settlement negotiations a contrived affidavit from the customer claimant which contradicts the allegations of the statement of claim for the purpose of obtaining expungement relief. Bargaining for such an affidavit from a customer claimant could clearly result in the "buying of a clean record" and would make a mockery of any "affirmative determination" of one of the three grounds in Rule 2130 by a panel of arbitrators.

NASD issued NTM 04-44 along with NTM 04-43.[37] NTM 04-44 provided guidance to member firms and associated persons concerning impermissible confidentiality provisions in settlement agreements, impermissible complaint withdrawal provisions, and procuring false or misleading affidavits as a condition to settlement.[38] Impermissible confidentiality provisions include those that prohibit, limit, or discourage customer claimants or other persons from disclosing settlement terms or facts giving rise to the dispute in response to inquiries from regulatory agencies.[39] Impermissible complaint withdrawal provisions included conditioning a settlement on a customer claimant withdrawing a pending complaint filed with NASD or another regulatory agency.[40] NASD notified member firms and associated persons that these two practices, as well as the procurement of false or misleading affidavits from customer claimants as a condition of settlement, were violations of Rule 2110.[41]

With NTM 04-43 and NTM 04-44, NASD made it clear that practices designed to "game" the expungement system established by Rule 2130 or to prevent or discourage regulatory inquiry concerning settlement of customer disputes constitute violations of NASD rules, including Rule 2110.

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36. *Id.* at p. 555.

37. NASD Notice to Members 04-44 is available at http://finra.org/Industry/Regulation/Notices/2004/P003011.

38. *Id.* at pp. 558-559.

39. *Id.* at 558.

40. *Id.* at 559.

41. *Id.* at 558.

Despite the approval and implementation of Rule 2130, FINRA determined that there were still problems that needed to be addressed with respect to requests to expunge customer dispute information under the rule. There was no requirement that arbitrators hold a recorded hearing session regarding the propriety of expungement. There was no requirement that in cases involving settlements, arbitrators review the settlement documents and consider them when determining whether expungement was appropriate. There was no requirement that arbitrators base their granting of an award of expungement on one of the three grounds set forth in Rule 2130. There was no requirement that arbitrators provide a written explanation of the reasons for a finding that one or more of the Rule 2130 grounds for expungement apply to the facts of the case. There was no requirement that all forum fees pertaining to a request for expungement relief be assessed against the party requesting that relief.

FINRA addressed these problems in March, 2008, with a proposed rule change, proposing the adoption of Rule 12805 as an addition to the Code of Arbitration Procedure for Customer Disputes and Rule 13805 of the Code of Arbitration Procedure for Industry Disputes.[42] Rule 12805 contains express provisions addressing each of the problems in the expungement process identified above. In its order approving Rules 12805 and 13805, the SEC made note of a number of important statements and positions of FINRA, and the SEC made several statements of consequence with respect to the expungement process.

FINRA advised the SEC that while arbitrators may order expungement after a hearing on the merits in a customer's case, it is more common for arbitrators to order expungement at a party's request to facilitate a settlement. FINRA advised the SEC that the terms of the settlement could require a customer to consent to or not oppose ordering of expungement relief in a stipulated award. In determining whether to grant expungement in conjunction with a settlement or a stipulated award, FINRA expected arbitrators to review the settlement agreement regarding the amount paid and other terms and conditions of the agreement which might raise concerns about whether expungement relief was appropriate. However, apparently, arbitrators frequently did not review the terms of settlement agreements before granting expungement relief.[43]

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42. *See* Exchange Act Release No. 58886 (October 30, 2008), 73 Fed.Reg. 66086 (November 6, 2008) (File No. SR-FINRA-2008-010).

43. 73 Fed.Reg. 66086 at p. 66087.

One of the arguments made by commenters on the proposed rule change was that arbitrators would hear only the position of the party requesting expungement if customer claimants did not participate in the expungement hearing. In response to this argument, FINRA assured the SEC that it would take appropriate steps to ensure that arbitrators perform the essential fact-finding that is required by Rule 12805, whether or not a customer appears at the expungement hearing.[44]

Another argument made in comment letters submitted with respect to the proposed rule change was that the rule should deter excessive expungement relief, particularly in situations involving settlements or the agreement not to oppose expungement relief as a condition of the payment of settlement consideration to the customer. In response to this argument, FINRA stated, as it had many times before, that expungement relief should be an extraordinary remedy.[45] In approving the proposed rule change, the SEC made specific note of FINRA's repeated position that expungement relief is to be an extraordinary remedy and FINRA's position that expungement should be granted only when the information to be expunged has "no meaningful regulatory or investor protection value".[46] The SEC also stated that it believes FINRA should review expungement requests to ensure that expungement is an extraordinary remedy.[47]

The SEC made the following significant statements in support of its decision to approve the proposed rule change:

> **[T]he Commission believes that having accurate and complete information in the CRD is vital; information that has regulatory value or that could assist investors in protecting themselves should not be removed from CRD.**
>
> * * *
>
> **The Commission believes that the training and education FINRA provides in conjunction with the proposed rule change will be critical to the implementation and proper application of the rules. Proper training of arbitrators should help make expungement the extraordinary remedy that it was meant to be and should convey to the arbitrators the importance of their role in maintaining the integrity of the CRD.**

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44. 73 Fed.Reg. 66086 at p. 66088.

45. *Id.* (citations omitted)

46. 73 Fed.Reg. 66086 at p. 66089. (citations omitted)

47. 73 Fed.Reg. 66086 at p. 66090.

* * *

> **Given the importance of CRD for regulators and to customers who want to get information about registered persons or member firms before they do business with them, the Commission urges FINRA in its regulatory role to monitor how this rule is applied by arbitrators to assure that it is achieving its goals, and to propose additional changes if needed.**[48] (Emphasis added)

With Regulatory Notice 08-79 ("NTM 08-79), FINRA announced the SEC's approval of Rules 12805 and 13805 with an effective date of January 26, 2009.[49] In NTM 08-79, FINRA stated the following:

> Accurate and complete reporting in CRD, including the reporting of required customer dispute information, is an important aspect of investor protection.
>
> * * *
>
> The new procedures ensure that arbitrators have the opportunity to consider the facts that support or weigh against a decision to grant expungement. The procedures add transparency to the process and safeguards designed to ensure that the extraordinary relief of expungement is granted only under appropriate circumstances.[50]

ANALYSIS OF DATA CONCERNING EXPUNGEMENT REQUESTS AND ARBITRATORS' RULINGS ON THOSE REQUESTS FOR ARBITRATION PROCEEDIGNS FILED BETWEEN JANUARY 1, 2007, AND DECEMBER 31, 2011

In preparing this study, PIABA reviewed data that it requested SAC to provide with respect to all arbitration awards entered in cases filed between January 1, 2007 and December 31, 2011 (the "Review Period"), which mention the term "expungement".[51] PIABA requested that SAC identify each arbitration proceeding by docket number and caption in the order in

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48. *Id.*

49. *See* Regulatory Notice 08-79 at p. 1, which is available at http://www.finra.org/Industry/Regulation/Notices/2008/P117541.

50. *Id.* at p. 2.

51. SAC provided data concerning and access to only awards that mention the term "expungement". The awards examined do not include all awards in cases tried on the merits or all awards resulting from cases resolved by settlement.

which the cases were filed for two time periods: from January 1, 2007 through May 17, 2009; and from May 18, 2009 through December 31, 2011. For each case, PIABA requested that SAC also provide the following information:

(a) The venue of the proceeding;
(b) The date the claim was filed;
(c) The date the award was issued;
(d) Whether or not the broker was named as a party;
(e) Whether expungement was granted or denied;
(f) If expungement was granted, the Rule 2130/2080 basis or bases on which expungement was granted;
(g) Which party prevailed in cases that were tried; and
(h) Identify cases concluded by stipulated awards or settlements.

For each case in which expungement requests were granted, PIABA requested data concerning the amount of compensatory damages claimed and the amount awarded.

SAC provided the requested data for the two time periods on the spreadsheets attached to this study. Each set of spreadsheets is accompanied by a report key to facilitate the interpretation of the data reported on the spreadsheets.

PIABA requested that FINRA provide to it the total number of customer-initiated cases against member firms and/or associated persons in each year. FINRA provided the following information for customer-initiated cases in each of the five years in the Review Period:

2007 – 1,895
2008 – 3,677
2009 – 5,247
2010 – 3,752
2011 – 3,064

PIABA's analysis of the awards in which expungement was requested in cases filed in 2007, 2008, and 2009 on or before May 17, 2009, resulted in the statistics set forth in the charts below:[52]

52. The term "Respondent" in the charts is abbreviated "Resp." The term "Claimant" in the charts is abbreviated "Cl." The term "Expungement" in the charts is abbreviated "Exp."

2007

STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
38	5	43	88.4	11.6

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		40
Resp. Prevails Exp. Denied		32
Cl. Prevails Exp. Granted		6
Cl. Prevails Exp. Denied		33
Total Cases Resp. Prevails		72
Total Cases Cl. Prevails		39
Percentage of Cases Resp. Prevails Exp. Granted		55.6
Percentage of Cases Resp. Prevails Exp. Denied		44.4
Percentage of Cases Cl. Prevails Exp. Granted		15.4
Percentage of Cases Cl. Prevails Exp. Denied		84.6

2008

STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
53	6	59	89.8	10.2

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		44
Resp. Prevails Exp. Denied		32
Cl. Prevails Exp. Granted		13
Cl. Prevails Exp. Denied		49
Total Cases Resp. Prevails		76
Total Cases Cl. Prevails		62
Percentage of Cases Resp. Prevails Exp. Granted		57.9
Percentage of Cases Resp. Prevails Exp. Denied		42.1
Percentage of Cases Cl. Prevails Exp. Granted		21
Percentage of Cases Cl. Prevails Exp. Denied		79

JANUARY 1, 2009-MAY 17, 2009
STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
39	5	44	88.6	11.4

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		48
Resp. Prevails Exp. Denied		23
Cl. Prevails Exp. Granted		7
Cl. Prevails Exp. Denied		38
Total Cases Resp. Prevails		71
Total Cases Cl. Prevails		45
Percentage of Cases Resp. Prevails Exp. Granted		67.6
Percentage of Cases Resp. Prevails Exp. Denied		32.4
Percentage of Cases Cl. Prevails Exp. Granted		15.6
Percentage of Cases Cl. Prevails Exp. Denied		84.4

SUMMARY OF EXPUNGEMENTS FOR THE TIME PERIOD JANUARY 1, 2007-MAY 17, 2009

STIPULATED AWARDS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
130	16	146	89	11

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		132
Resp. Prevails Exp. Denied		87
Cl. Prevails Exp. Granted		26
Cl. Prevails Exp. Denied		120
Total Cases Resp. Prevails		219
Total Cases Cl. Prevails		146
Percentage of Cases Resp. Prevails Exp. Granted		60.3
Percentage of Cases Resp. Prevails Exp. Denied		39.7
Percentage of Cases Cl. Prevails Exp. Granted		17.8
Percentage of Cases Cl. Prevails Exp. Denied		82.2

PIABA’s analysis of the awards in which expungement was requested in cases filed in 2009 on or after May 18, 2009, 2010, and 2011 resulted in the statistics set forth in the charts below:

MAY 18, 2009-DECEMBER 31, 2009
STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
133	6[53]	139	95.7	4.3

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		81
Resp. Prevails Exp. Denied		41
Cl. Prevails Exp. Granted		22
Cl. Prevails Exp. Denied		63
Total Cases Resp. Prevails		122
Total Cases Cl. Prevails		85
Percentage of Cases Resp. Prevails Exp. Granted		66.4
Percentage of Cases Resp. Prevails Exp. Denied		33.6
Percentage of Cases Cl. Prevails Exp. Granted		25.9
Percentage of Cases Cl. Prevails Exp. Denied		74.1

2010

STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Case Exp. Denied
202	6[54]	208	97.1	2.9

53. During this time period, there were three cases in which expungement was granted to one registered representative and expungement was denied to another. Each of these three awards was treated as two separate awards for calculating the total stipulated awards/settlements and for the purpose of calculating percentages.

54. During this time period, there was one case in which expungement was granted to one registered representative and expungement was denied to another. This case

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		91
Resp. Prevails Exp. Denied		56
Cl. Prevails Exp. Granted		18
Cl. Prevails Exp. Denied		69
Total Cases Resp. Prevails		147
Total Cases Cl. Prevails		87
Percentage of Cases Resp. Prevails Exp. Granted		61.9
Percentage of Cases Resp. Prevails Exp. Denied		38.1
Percentage of Cases Cl. Prevails Exp. Granted		20.7
Percentage of Cases Cl. Prevails Exp. Denied		79.3

2011

STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
133	3	136	97.8	2.2

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		54
Resp. Prevails Exp. Denied		30
Cl. Prevails Exp. Granted		10
Cl. Prevails Exp. Denied		34
Total Cases Resp. Prevails		84
Total Cases Cl. Prevails		44
Percentage of Cases Resp. Prevails Exp. Granted		64.3
Percentage of Cases Resp. Prevails Exp. Denied		35.7
Percentage of Cases Cl. Prevails Exp. Granted		22.7
Percentage of Cases Cl. Prevails Exp. Denied		77.3

was treated as two separate awards for calculating the total stipulated awards/settlements and for the purpose of calculating percentages.

SUMMARY OF EXPUNGEMENTS FOR THE TIME PERIOD MAY 18, 2009-DECEMBER 31, 2011

STIPULATED AWARDS/SETTLEMENTS

Exp. Granted	Exp. Denied	Total Stipulated Awards/ Settlements	Percentage of Cases Exp. Granted	Percentage of Cases Exp. Denied
468	15	483	96.9	3.1

CASES TRIED ON THE MERITS

Resp. Prevails Exp. Granted		226
Resp. Prevails Exp. Denied		127
Cl. Prevails Exp. Granted		50
Cl. Prevails Exp. Denied		167
Total Cases Resp. Prevails		353
Total Cases Cl. Prevails		217
Percentage of Cases Resp. Prevails Exp. Granted		64
Percentage of Cases Resp. Prevails Exp. Denied		36
Percentage of Cases Cl. Prevails Exp. Granted		23
Percentage of Cases Cl. Prevails Exp. Denied		77

ISSUES ARISING FROM THE EXPUNGEMENT DATA AND PROPOSALS TO ADDRESS THOSE ISSUES

The data set forth on the SAC spreadsheets, the foregoing statistics, and a review of the stipulated awards identified on the SAC spreadsheets reveal some expected and some alarming trends.

An expected result of FINRA's amendment of the Form U-4 effective May 18, 2009, requiring associated persons not named as parties in a customer's arbitration claim to report the claim, is in an increase in expungement requests and an increase in non-named brokers seeking expungements. The amount of the increase, however, is dramatic. For the pre-NTM 09-23 time period, January 1, 2007 through May 17, 2009, expungement requests in cases resolved by stipulated awards or settlement and cases tried on the merits totaled 511. For the time period May 18, 2009 through December 31, 2011, expungement requests in cases resolved by stipulated awards or settlements and cases tried on the merits totaled 1,053.[55] For the time period January 1, 2007 through May 17, 2009, there were only 20 cases in which non-named associated persons sought expungement. For the time period May 18, 2009 through December 31, 2011, there were 407 cases in which non-named associated persons sought expungement, a twenty fold increase.[56]

FINRA has repeatedly stated that expungements should be an extraordinary remedy and that a respondent prevailing on the merits or obtaining a dismissal of a customer claimant's claim are not by themselves an appropriate ground for expunging the proceeding from the CRD system.[57] The relatively high percentage of cases reported in the SAC data in which the respondents prevailed and expungements were granted suggests that these pronouncements may not be getting through to arbitrators. For the time period January 1, 2007 through May 17, 2009, arbitration panels granted expungements in 60.3% of such cases. For the time period May 18, 2009 through December 31, 2011, arbitration panels granted expungement relief in 61.9% of such cases.

The most alarming statistic arising from an analysis of the SAC data is the very high percentage of cases resolved by settlement or stipulated awards in which expungement relief has been granted. For the time period January 1, 2007 through May 17, 2009, expungement was granted in 89% of the cases resolved by stipulated awards or settlement. For the time period May 18, 2009 through December 31, 2011, expungement relief was granted in 96.9% of the cases resolved by settlements or stipulated awards.

In cases resolved by settlement, expungement is far from being an extraordinary remedy. To the contrary, it is, indeed, extraordinary for expungement relief not to be granted in cases resolved by settlement. It appears that NASD's and FINRA's attempts to mandate narrow grounds for

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55. Part of this increase may be attributable to a greater number of customer-initiated cases filed in 2009 after May 17, 2009, as compared to before May 18, 2009, and the greater number of customer-initiated cases filed in 2011 as compared to 2007.

56. FINRA is in the process of drafting a proposed rule change for submission to the SEC proposing a rule or rules establishing procedures for non-named associated persons to seek expungements. If the SEC approves the proposed rule change, expungement requests will likely increase even more dramatically.

57. *See*, *e.g.*, NTM 01-65 at p. 566; FINRA Dispute Resolution Expungement Training Materials at p. 18.

granting expungement relief and to require arbitrators to hold hearings to receive evidence with respect to expungement relief, to review the terms and provisions of settlement agreements and the amounts paid, and to weigh the evidence and the competing interests regarding the granting or denial of expungement relief have failed with respect to cases resolved by settlement. The apparent result is that the accuracy and completeness of disclosure information concerning customer claims in the CRD system has been adversely affected by the rubber stamping of expungement relief by arbitration panels in cases resolved by settlement. The high percentage of expungement relief granted in cases resolved by settlements or stipulated awards may be attributable to a number of factors, including the following: (1) inadequate training of arbitrators; (2) arbitrators' failure to appreciate the importance of the integrity of the disclosure information in the CRD system; and (3) respondents and their counsel demanding or requesting as part of settlement negotiations that claimants and their counsel either agree to expungement relief or agree not to oppose expungement relief.

Respondents and their counsel should only be making requests for expungement relief when the facts of the case clearly fall into one of the three Rule 2080 categories. There may be ethical issues with respect to respondents' counsel requesting that claimants agree to expungement relief or agree to not oppose expungement relief. For example, under Rule 4-3.4 of the Florida Rules of Professional Conduct, a lawyer shall not "request a person other than a client to refrain from voluntarily giving relevant information to another party unless the person is a relative or an employee or other agent of a client . . .."

Arbitrators must appreciate the critical importance of the integrity of the disclosure information in the CRD system. Particularly in cases involving expungement relief arising from settlements when the claimant nor his counsel appear at the expungement hearing, arbitrators must ensure that adequate inquiry is made with respect to the one-sided presentation made to them and must critically assess any settlement agreement which provides for payment of more than a nuisance value settlement.

For the cases filed during the Review Period, which were resolved by settlements or stipulated awards and in which expungement relief was granted, the awards in those cases reveal the following information. In the vast majority of those cases, claimants did not oppose expungement, agreed to expungement, or withdrew their claims against the associated person. The awards do not reflect whether the claimants not opposing expungement, agreeing to expungement, or withdrawing their claims against the associated person was a condition of settlement or was requested as part of settlement negotiations. However, the frequency with which claimants do not oppose expungements, agree to expungement, or withdraw their claims strongly suggests that respondents are demanding or requesting such from claimants.

Arbitrators do not appear to be applying FINRA Rules 2080 and 12805 to make expungement relief an extraordinary remedy as FINRA and the SEC have repeatedly stated it should be, particularly with respect to cases resolved by settlement. Arbitrators do not appear to appreciate the importance of the accuracy of disclosure information in the CRD system to investor protection.

Under the current procedures of FINRA Dispute Resolution, motions seeking expungement relief are filed with FINRA in the arbitration proceeding with respect to which the expungement relief is sought. The FINRA case administrator for that proceeding then mails a copy or copies of the motion for expungement relief to the arbitrator or arbitrators presiding in that proceeding. FINRA does not review or critically assess motions seeking expungement relief. A filed motion for expungement relief is then set for a telephonic or in person hearing before the presiding arbitrator or arbitrators to rule on the motion. It is not until a brokerage firm or broker files an action in court seeking confirmation of an arbitration award granting expungement relief that FINRA undertakes a review of the arbitration award, the motion seeking expungement relief, or any settlement agreement.

At present, the training required by FINRA for arbitrators to be able to rule upon a motion seeking expungement relief is limited. Arbitrators must take an online training course, which takes approximately one hour, and pass a test concerning the materials included in the online training course.

FINRA needs to propose a rule change with respect to respondents and their counsel bargaining for in settlement negotiations or conditioning a settlement upon an investor's agreement to not oppose expungement or an agreement to expungement. Changes need to be made with respect to the content and thoroughness of the training arbitrators are required to complete before they can rule upon a motion seeking expungement relief. Changes should also be made with respect to the procedures applicable to motions seeking expungement relief.

As the SEC suggested in its order approving Rules 12805 and 13805, FINRA should use its authority to review expungement requests, particularly those associated with settlements, to ensure that expungement is an extraordinary remedy. Member firms do not pay substantial sums to claimants when investors' claims are clearly erroneous, factually impossible, or false or when their associated person was not involved in wrongdoing.

FINRA should file a proposed rule change making it a violation of FINRA Rule 2010 for respondents, as part of settlement discussions, to negotiate for claimants to agree to not oppose expungement relief, to agree to expungement relief, or to withdraw their claims against associated persons.

FINRA has already advised member firms and associated persons that conditioning settlement on claim withdrawal is a violation of Rule 2010. At a minimum, FINRA should issue a regulatory notice advising member firms and associated persons that bargaining for claimants to agree to expungement or to agree not to oppose expungement in settlement negotiations constitutes a violation of Rule 2010.

FINRA needs to significantly improve the training arbitrators receive concerning requests for expungement relief. That training should include an emphasis on the critical importance of the integrity of the disclosure information on the CRD system. FINRA should also attempt to ensure that arbitrators make the necessary inquiry during expungement hearings, particularly those arising from settlements at which neither claimants nor their counsel appear. That required inquiry should include the following:

(1) Asking an associated person whether he or she has other customer complaints pending, and if so, the number;
(2) Examining the associated person's CRD;
(3) Inquiring of the associated person whether he or she is or has been the subject of any regulatory proceedings and if so, the outcome;
(4) Inquiring whether the associated person has previously requested expungement relief and if so, the number of times it was granted or denied; and
(5) Inquiring whether in the settlement with the claimant having the claimant agree to not oppose expungement, agree to expungement relief, or withdraw his or her claim against the associated person was bargained for or required.

Finally, for FINRA to fulfill its mission of investor protection, the procedures applicable to motions for expungement relief need to be changed. FINRA needs to play a more active role in arbitrators' rulings on motions for expungement relief. FINRA needs to review and critically assess all motions for expungement relief, particularly those made in cases resolved by settlement. FINRA also needs to review and critically assess settlement agreements. A proposed rule change should include the requirement that the hearing on any motion for expungement relief be scheduled no sooner than 60 days after service of the motion on the customer and FINRA. In cases resolved by settlement, FINRA should require respondents to provide to FINRA the settlement agreement along with the motion for expungement relief. Upon receipt of any motion for expungement relief and any settlement agreement, FINRA should provide those documents to the securities commissioner for the state in which the case was filed. The amended procedures should provide for FINRA and the designee of the state securities commissioner to have the right to appear at the hearing on the motion for expungement relief and to oppose expungement relief when such opposition is appropriate.

TRENDS IN ELDER ABUSE LAW

Sam Brannan[*]

When I first discovered that my eighty-two-year old mother was playing lotteries I was concerned, because I knew the lotteries were scams and I knew her judgment was not what it used to be. But I thought they were relatively harmless like bingo. So what if she blew a few bucks on such entertainment. It's her money. A chance encounter with Mom at the grocery store at 7:30 a.m. changed my mind abruptly. The bank inside the store was not yet open. I was at the ATM withdrawing some cash. Mom seemed distraught. She asked me for $800. Why do you need it, I asked uneasily? I've won $30,000 - I know I'm the winner - but I need $800 now! A man is coming over to my house to pick it up in an hour. I balked. Please don't do this, Mom, I begged. P-l-e-a-s-e, Chip, she cried! Now I panicked. She looked and sounded possessed. My sisters and I discovered her answering machine at home was full of high-pressure and disturbing messages from strangers. She was apparently supposed to meet one of them in person – someone who could easily physically harm her. There was absolute no reasoning with her about the fraudulent nature of these so-called lotteries. Even official Federal Trade Commission documents warning of these very scams had zero effect on her conviction that these scammers were her friends who sincerely wanted to see her win a lot of money. All of our friends warned that we needed to act fast to protect her assets – assets that she may well need to pay for long-term care.

My siblings and I have since taken steps to protect Mom and her assets from the huge number of crooks who have targeted her with a truck load of scam mail and badgering telephone calls. Mom seems to be doing better in some respects and we seem to be out of the woods – for now. But we've been told by experts - these situations never get better over time; they always get worse.

That was the beginning of my interest in elder abuse. I have since learned something about the problem and what is being done to try to protect our elders and other impaired adults. Mom's story is just one of countless different ways that elder persons are targeted and abused. In situations like hers, law enforcement is often futile because you are dealing with individuals and purported entities that cannot be identified or located. A telephone call

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that shows up as a local area code may actually originate from overseas, for example.

Abuse of elderly and impaired adults, including financial abuse, is a terrible tragedy that is increasing at an alarming rate.It comes in many forms, from physical and mental abuse and neglect to financial exploitation. It has been reported that approximately 11% of U.S. citizens age 60 and older suffer from some form of abuse neglect or exploitation[1]. In at least one state (Alaska), reports of abuse of its long-term care residents have increased by 200% in the past three years, with the most common reports of harm being neglect and financial exploitation.[2]

Elder persons in the United States have lost at least $2.9 billion as a result of various forms of financial abuse.[3] The true amount is undoubtedly much higher as many cases go unreported (estimates are that less than 3% of cases of financial abuse are ever reported). Elder financial abuse is expected to increase as the baby boomer population ages. Strangers account for 51% of the perpetrators of elder financial abuse, while friends, neighbors and family make up 34% of the perpetrators.[4] Individuals in the business sector commit 12% of elder financial abuse and 3% involves Medicare and Medicaid fraud.[5] Victims of financial elder abuse have a relationship of trust and confidence with 90% percent of their abusers.[6] Elder financial abuse may involve theft, forgery, deception, con-artistry (by "confidence men" or "cons"), "romance scams," coercion, and undue influence to obtain money or property, either directly by outright taking, or indirectly by means of a Will, Power of Attorney or Deed.

Older citizens, particularly those with Alzheimer's disease, dementia, and other complex health problems, as well as other adults who are mentally or physically impaired, are often singled out as victims (as I believe my mother was when her house was burglarized recently).They present attractive targets due to their dependence on others. Dependence makes it more likely

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1. H.R. 3, 27th Leg., 1st Sess. (Alaska 2011).

2. Id.

3. The MetLife Study of Elder Financial Abuse, June 2011 ("Met§Life Study"), p. 2.§.

4. MetLife Study, p.8.

5. Id.

6. National Adult Protective Services Association (NAPSA), Elder Financial Exploitation, p. 1 of 4 (*www.napsa-now.org/policy-advocacy/world-elder-abuse-awareness-day/*) ("NAPSA website").

that they will rely upon and trust others who falsely present themselves as friends and helpers who have the elder person's best interest at heart. For example, elder persons who are targeted often live alone and are uncomfortable with technology, which may present opportunities for a "helper" to gain access to bank accounts.

Theresulting emotional and physical trauma, sometimes accompanied by a significant financial loss, can have a devastating effect on victims' lives. Some victims sink into isolation, being afraid to go out anymore – to the doctor, the grocery store, to visit friends. Even those who have not experienced abuse directly often know or know of others who have, and suffer from disabling fear themselves.

Elder abuse is perpetrated by strangers, family members, and caregivers. It cuts across all socio-economic, cultural, racial, and ethnic categories. Abuse and neglect of residents in long-term care facilities often goes unreported. Victims often fear that additional abuse will result from reporting the abuse. Some victims are simply unable to understand or report such conduct to the proper authorities, just as they may be unable to protect themselves from conduct that is abusive and sometimes criminal.

Some warning signs of elder abuse may include (without limitation) one or more of the following:

- Secretiveness involving financial matters, correspondence, telephone calls, etc.
- Unusual withdrawals or transfers of money from financial accounts
- Unusual transfer of other assets, such as real property
- Unusual gifts to caregivers or others
- Unusual loans
- Other unexplained losses or changes in financial situation
- Accumulation of unpaid bills
- New friends or even romantic interests
- Changes to a Will
- Change of beneficiary.

In 2010, Congress passed The Elder Justice Act as part of the Patient Protection and Affordable Care Act.[7] It is an ambitious piece of legislation, which includes authorizing a grant program for adult protective services and various other programs and social services designed to assist states in protecting the aged and infirm. Unfortunately, as of October 2013, no money

7. National Health Policy Forum, The George Washington University, The Basics – The Elder Justice Act: Addressing Elder Abuse, Neglect, and Exploitation (Nov. 30, 2010).

has been appropriated to implement the Act, according to the National Adult Protective Services Association (a non-profit organization devoted to strengthening adult protective services programs).[8]

Georgia, for example, requires certain persons who have reasonable cause to believe that a disabled adult or elder person has been abused, neglected or exploited to cause certain reports to be made. Those persons generally include any administrator, manager or employee of a long-term care facility[9]; employees of financial institutions[10]; and any physician, osteopath, intern, resident, other hospital or medical personnel, dentist, psychologist, chiropractor, podiatrist, pharmacist, physical therapist, occupational therapist, licensed professional counselor, nurse, social worker, day-care worker, coroner, medical examiner, or other health professional.[11]

Notably, when such a person is a staff member of a facility, such as a financial institution or hospital, he or she must notify the person in charge of the facility, and the person in chargefiles (or causes to be filed) the required reports.[12] Georgia law requires any such reporting person to immediately make a report by telephone or in person to the Georgia Department of Human Services and to the appropriate law enforcement agency or prosecutor, followed by a written report within 24 hours containing the information specified in the statute.[13] Usually, the report must be made even if the reasonable cause is based upon a privileged communication.[14]

Georgia's neighboring states have statutes with similar provisions. Alabama's reporting requirement is limited to physicians and other practitioners of the healing arts, and does not include financial institutions or their employees. Virginia defines reporters to include most persons who are licensed, certified or registered by a health regulatory board, employees or

8. NAPSA Newsletter, The National APS Resource Center, June-July 2013, "States Pass New Laws to Address Elder Abuse," Colorado (*http://archive.constantcontact .com/fs161/1104089399629/archive/1114372329181.html* ("NAPSA Newsletter").

9. O.C.G.A. § 31-8-82(a)(2).

10. O.C.G.A. § 30-5-4(a)(1)(B).

11. O.C.G.A. § 30-5-4(a)(1)(A); see also New York County District Attorney's Office/NAPSA Elder Financial Exploitation Advisory Board, 2013 National Survey of Mandatory Reporting Requirements for Elderly and/or Vulnerable Persons ("National Survey of Mandatory Reporting Requirements").

12. O.C.G.A. § 30-5-4(a)(1)(C).

13. O.C.G.A. § 30-5-4(b).

14. O.C.G.A. § 30-5-4(d).

contractors who work with or provide care for adults, guardians, conservators, and law enforcement officers; it does not require reporting by financial institutions or their staff.[15] West Virginia limits reporters to medical, dental or mental health professionals, Christian Science practitioners and religious healers, social workers, law enforcementand "humane" officers, state or regional ombudsmen, and any employee of any nursing home or residential facility, but does not require financial institutions to report cases of elder abuse.[16] Other southeastern states - Florida, Kentucky, Mississippi, North Carolina, South Carolina, and Tennessee – make "any person" a potential reporting person, including (without limitation) financial institutions, long-term care facilities and nursing homes.[17]

Criminal penalties for knowingly and willfully failing to make a required report (or preventing another from doing so) are generally misdemeanors punishable as follows:
Alabama – six months imprisonment or up to $500[18]
Florida - up to 60 days imprisonment or up to $500 or double the pecuniary loss of the victim[19]
Georgia -up to 12 months imprisonment or up to $1,000 or both[20]
Kentucky – up to 90 days imprisonment[21]
Mississippi – up to 6 months imprisonment or up to $5,000 or both[22]
North Carolina – no criminal penalty found
South Carolina –up to one year imprisonment or up to $2,500[23]
Tennessee – between 30 days and 11 months and 29 days imprisonment and between $500 and $1,000[24]

15. National Survey of Mandatory Reporting Requirements, p. 38.

16. Id. At 40.

17. See generally National Survey of Mandatory Reporting Requirements.

18. Ala. Code § 38-9-10.

19. Fla. Code § 415.111.

20. O.G.C.A. §§ 30-5-8, 17-10-3.

21. Ken. Code §§ 209.990, 532.090.

22. Miss. Code § 43-47-7(c).

23. S.C. Code § 43-35-85.

24. Tenn. Code §§ 7-6-110, 40-32-104.

Virginia – up to $500 for first offense and between $100 and $1,000 for subsequent offenses[25]

West Virginia – up to 10 days imprisonment or up to $100 or both.[26]

Other states have similar statutory schemes. A few states, such as Florida[27] and California[28]- provide private rights of action for elder abuse. The trend among states, however, is to emphasize mandatory reporting of elder abuse, neglect and exploitation by persons likely to have significant contact with elder persons, such as administrators, managers and employees of long-term care facilities, nursing homes, adult day care facilities, doctors' offices, hospitals and financial institutions.

The mandatory reporting requirements should benefit elder persons in several ways. Most obviously, they will lead to investigations and outreach by authorities to assist elder persons after they have been victimized. They should also make persons with whom elder persons are in contact most frequently more attentive to the problem and, therefore, more likely to look out for and pick up on signs of elder abuse. Equally, important, they should cause mandatory reporters to notice that an elder person is impaired or vulnerable, and to try to take some appropriate action before an incident of abuse occurs. In this way, the mandatory reporting requirement may actually operate to counter (at least to some extent) the tidal wave of elder abuse.

On the other hand, the failure of Congress and some states to appropriate sufficient money to fund robust adult protective services activities is a serious problem. As an example, Illinois' poorly funded and inadequately staffed Vulnerable Adult Abuse Program was revamped in the wake of a media firestorm involving more than 50 vulnerable adults who died after their suspected abuse was reported to the appropriate state agency but never investigated.[29]

Lack of funding also compromises efforts to train people to identify elder financial exploitation. As a practical matter, without such training, adult protective services statutes have no teeth.

Another issue has to do with a sense of loss of independence and control that is a major source of unhappiness for many elder persons. Protection of adults may lead to an invasion of their privacy and autonomy. The

25. Vir. Code § 63.2-1606 H.

26. W. Vir. Code § 9-6-14.

27. Fla. Stat. § 415.1111.

28. Cal. Welf. & Inst. Code § 15657 and Probate Code § 859.

29. NAPSA Newsletter, supra.

mandatory reporting requirement will set in motion an investigation and possible intervention that may not be desired by the victim.

In contrast to the involuntariness of being protected by the state, a lawsuit is a voluntary act. Successful litigation and the threat of more of it can lead to widespread change that is beneficial – not only for the successful litigant but for society at large. We know that products liability litigation, as well as consumer advocacy, has resulted in a safer world for consumers. (If it were not for Ralph Nader, we might still be driving unsafe cars with metal dashboards and no seatbelts.) Yet most states have not expressly providedfor private rights of action in their elder protection statutes.

In summary, the efforts thus far represent steps in the right direction, but more needs to be accomplished. Experts say that fighting elder abuse will take more money and resources, along with greater coordination at the federal level. Given the budget standoff in Congress, those efforts have a long way to go.

UNDERSTANDING IMPASSE: HOW TO PREVENT, AVOID AND BREAK DEADLOCK

Joan Stearns Johnsen[1]

INTRODUCTION

Impasse is the point in any negotiation when communication breaks down and the parties reach for their respective briefcases. With impasse, issues of pride, mistrust or anger overcome what is truly best for the parties. Absent some intervention or course change, a settlement is never consummated; the litigation proceeds; productive negotiation ends. Impasse should not be seen as the end of any negotiation. Negotiators should always regard impasse as a detour rather than a dead end.

Negotiators often see impasse as a signal that there is no deal to be had. However, impasse is rarely confined to those deals where there is no zone of possible agreement ("ZOPA"). Most of the time, impasse occurs in situations where there are acceptable, desirable mutually beneficial deals -- missing terms waiting to be discovered by the negotiators. But parties cannot reach an agreement when they stop constructively engaging with one another.[2]

Negotiators often can anticipate and prevent their negotiations from ever devolving into impasse through careful and thorough preparation. Even when the parties are locked into what may seem like an impossible impasse, experienced negotiators and mediators can employ a range of techniques to restart the process.

There are no easy answers to breaking impasse, however. Before you can begin to identify solutions, you must analyze the source of the problem. How you seek to resolve an impasse will depend entirely on an analysis and diagnosis, which will uncover the likely cause of the impasse.

The appropriate technique for resolving impasse is wholly dependent on its cause. For example, two situations that, unaddressed, often lead to impasse include a client's misunderstanding of litigation risks and a lawyer's unfamiliarity with the area of practice. While both situations call for

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2. Mnookin, Robert H. *Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict*, 8 Ohio St. J. Disp. Res. 235 (1992-1993).

education, there are subtle but important differences. One would not use the same techniques to educate an adversary's client as one would use to educate an adversary's lawyer.

I. CAUSES OF IMPASSE

There are many complex, nuanced reasons why negotiations fall apart and many techniques for avoiding or resolving impasse. Not all solutions are suitable for all problems. Before determining how to break through an impasse, negotiators should engage in careful analysis as to its source.[3]

By far, the most personally satisfying and most appealing answer to the question "What is the source of the impasse?" is usually "It is the fault of the other guy." This is inadequate and not always true. Even in those situations where the blame should be placed squarely on one's adversary, negotiators can and should engage in further analysis. Furthermore, in all situations parties must reflect on their own contribution to the breakdown through productive communication.[4]

A common source of impasse is unreasonable expectations on the part of the lawyer, the client or both.[5] Where the client alone possesses unreasonable expectations, negotiators should consider whether this is due to his or her counsel having oversold the case in order to sign up the client or the client ignoring counsel's advice as to the case's value. Or, the client may have been influenced by the opinions of friends or family. The client may be relying on a past experience, a newspaper article or a personal sense of fairness that may be unrelated to the rules based version of fairness that the arbitrators will apply. "It's a matter of principle," they are often heard to say. Unreasonable expectations may be influenced by the lawyer as a result of poor preparation, inexperience, unfamiliarity with the subject matter or an emotional attachment to the case.

Constituencies and "phantom parties" play an important role in influencing the behavior of the negotiators at the table.

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3. Mnookin, Robert*, Strategic Barriers to Dispute Resolution*, 8 Harv. Negot. L. Rev. 1, 12 (2011).

4. Stone, Douglas, Patton, Bruce, Heen, Sheila, Difficult Conversations, (Penguin Books, 1999) 58-67.

5. See generally, Birke, Richard, *Neuroscience and Settlement: An Examination of Scientific Innovations and Practical Application,* 25 Ohio St. J. on Disp. Resol. 477, 493 (2010).

A phantom party is a person or group of people directly influencing the decisions although not participating in the creation of the deal or settlement. This is a very specific micro influence that often manifests itself when the deal is about to be consummated. This may be a spouse who, although not directly participating in the negotiation, has direct veto power over the decision from behind the scenes.

Constituencies are those people whose approval parties at the negotiating table seek. In house counsel care about how they are perceived by their colleagues and supervisors; lawyers in firms care about favorably impressing their clients and partners; parties seek validation from spouses and neighbors. This is a sort of "macro" influence. These constituencies may not have veto power over the final terms, but their approval or disapproval may be of importance to the negotiator or to the client. With a corporate party, there may be a supervisor who will not dictate, but will judge the result or process. There may be circumstances unrelated to the deal or litigation that nevertheless exert some intangible impact such as the fact that the instant negotiation may influence the value of other pending litigation. There may be concern that settling the instant case will encourage related litigation.

Another common source of impasse is when emotions overcome reason. Parties feel that they have been treated unfairly or that their adversary is not conducting the negotiation in good faith. The emotional reaction is to terminate discussion even when to do so is undesirable.[6]

Emotions can run particularly high in negotiation. Parties often perceive their interests as competing. This conflict adds a layer to any underlying disagreement or legal dispute. Even the lawyers who should not react personally often succumb emotionally to perceived slights.[7] Often the source of the impasse is the conflict arising from the negotiation itself, differing styles of negotiation, perceptions of bad faith or cultural conflicts.

Sometimes unreasonable expectations are actually a negotiating style. Positional bargainers believe that the best way to gain an optimal result is to take an extreme initial position and move less than one's adversary. With this style of negotiation, bargainers focus on winning and on defeating their

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6. Birke, Richard, *Neuroscience and Settlement: An Examination of Scientific Innovations and Practical Applications*, 25 Ohio St. J. on Disp.Resol. 477, 507 (2010).

7. See generally, Hammer, Mitchell, *The Intercultural Conflict Style Inventory: A Conceptual Framework and Measure of Intercultural Conflict Approaches,* IACM 17th Annual Conference Paper. (2002).

negotiating partner. "See how far I've come down," they say, unmindful or uncaring of their initially stratospheric gambit.

Impasse may arise because the most available resources are insufficient to satisfy the needs of all of the parties to the negotiation if the pie is simply not large enough to satisfy the interests of all of the parties to the negotiation, it may be necessary to seek out ways to expand the pie.[8]

Understanding the cause of impasse includes engaging in self-examination. Consider your own contribution to the impasse:

- You may not have intended to offend your adversary, but did you unintentionally do or say something that may have been misperceived?
- Are your own expectations unreasonable?
- Did you set a tone or create an impression of untrustworthiness?
- Have you compromised your own professional distance by allowing yourself to react emotionally?

Understanding impasse means understanding and anticipating with as much specificity as possibly the likely source of the friction giving rise to the impasse. This is particularly true where there exists a zone of possible agreement

II. PREVENTING IMPASSE

Much mediation literature has focused on breaking impasse. An equally important topic is anticipating and avoiding impasse. It is often possible to anticipate the likely source of a negotiation breakdown. When the negotiator focuses on these likely sources of impasse, the negotiator can take steps in advance of the negotiation to avoid the impasse completely.

Thorough preparation is the most effective technique for anticipating and avoiding impasse. When negotiators prepare properly - including a thorough analysis of deal terms, necessary parties and emotional issues - they can reduce the likelihood of the negotiation devolving into impasse.

Although ideally all participants to a negotiation will properly prepare, even if only one party thoroughly conducts analysis and engages in preparation, the likelihood of impasse is reduced. For example, through preparation one can anticipate one's adversary's need for education on industry standards and value. When this information is discovered in

8. Fisher, Ury, (for the second ed.,) Patton, *Getting To Yes, Chap*. 4 (Random House, 1981).

advance of the negotiation, one can provide some objective data in advance of the negotiation and allow one's counterparty an opportunity to verify that information. In the alternative, one can provide the objective data during the mediation or direct negotiation to one's adversary or to the mediator.

Learning during preparation of one's adversary's need of education may influence the decision to choose mediation and refrain from any direct negotiation. Mediation similarly may be indicated when you learn during your preparation that either your client or your adversary's client is in need of reality testing. This knowledge may also inform the choice of the particular mediator. It may mean a greater emphasis on a mediator with subject matter expertise as well as the trust of one's adversary.

Preparation is also the time to identify whether there are any phantom parties on either side who may influence the decision maker(s). Having this knowledge in advance may enable you to include these people in negotiations, even though they are not parties.

Even when there is concern that these individuals will be disruptive or negative influences, they should be included in the negotiations. They will exert their influence over the negotiation whether or not they participate directly. When they are allowed to air their views, the lawyers and mediator can address these concerns directly in the presence of the decision maker.

Thorough preparation should include investigation into the negotiating style of one's adversary. This investigation will disclose what to expect and whether there are likely to be tactics or threats. One can prepare for an extreme positional bargainer emotionally and in terms of negotiation plan.[9]

Negotiators should prepare their own cases thoroughly as well. Everyone's inclination is to value his own case more favorably than his adversary would. No one is immune to various cognitive biases that influence one's ability to be totally objective. This is exacerbated during the emotion of a heated negotiation. Negotiators should understand their alternatives and carefully choose their preliminary target, reservation point and opening offer or demand well in advance of the actual negotiation.[10]

9. Craver, Charles, *Effective Legal Negotiation* 7th Ed., pp. 11-21 (Lexus-Nexus 2012).

10. Craver, Charles, *Effective Legal Negotiation*, 7th Ed., p.62 (Lexus-Nexus 2012).

III. Interceding to Prevent Impasse

Often there are warning signs before a negotiation or mediation breaks down completely. Experienced negotiators can learn to spot the signs of impending impasse at a much earlier point so that they can make small but significant strategic or stylistic adjustments.

It is advisable to watch for these indications and to make the appropriate adjustments before there is an actual impasse. It is less disruptive to the entire process. Once parties declare that the negotiation is over, they have a greater commitment to impasse. Although not impossible, it is more difficult to bring parties back to the table when they have left.

When involved in direct negotiation, there will be obvious verbal cues such as threats and more subtle ones such as sarcasm or expressions of frustration. When in a mediation, negotiators can look to the mediator who may give indications of whether or not parties are headed towards impasse.

There are non-verbal cues that the trust has broken down and the negotiation is in jeopardy. Obviously, growing anger is troubling, but watch also for micro-expressions indicating contempt. This is generally indicated by a half smile. This is a more dangerous indication of a problem than even overt expressions of anger and frustration.[11]

Generally in a distributive negotiation - one that concerns primarily money - the moves will be larger initially. As parties begin to reach their reservation points, the size of the concessions becomes smaller. In addition, the pace usually slows as the parties get closer to their perceived bottom line. When the parties deviate from this pattern, it may be an indication - as when a party makes very small moves early in the negotiation - that the parties are headed towards an impasse. The party making the small moves may not even intend to cause an impasse. She may believe that she is simply sending a message to the other side. However, when the other side does not accommodate, she may find herself unable then to make appropriate moves and the negotiation reaches impasse. This is a particularly dangerous and common scenario.

Sometimes negotiators may recognize these warning signs, but continue along the same path, right into the impasse. A better strategy is to make adjustments as they become apparent.

If a negotiator senses that the negotiation is headed towards an impasse, she may take steps to change course and prevent the negotiation from breaking down completely.

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11. See generally, paulekman.com.

First and foremost in all situations, negotiators should avoid reacting emotionally. When one's adversary makes threats, inappropriate moves or engages in other pre-impasse behavior, the most common reaction to perceived bad faith is an emotional one. One is inclined to get angry, offended, hurt, frightened or confused. Addressing emotion with emotion is a losing dynamic for the negotiation. While an emotional reaction may be appropriate - even warranted - it is unlikely to produce a negotiated agreement. Negotiators should resist their natural tendency to expose their own emotions.

Rather than react, the negotiator should analyze the source of the impending impasse and choose an appropriate strategy. One of the most powerful techniques for dealing with an impending impasse is to take a break. This can be a brief break from negotiation during the session or it may be to conclude a negotiation session with firm plans to continue at a later time. A walk around the block will allow cooler heads to prevail and for a reboot of the session. It may be wise strategically to allow your adversary to regain his emotional footing just as it should be your objective.

Sometimes it is helpful to change the conversation. There may be too much pressure on the negotiation and merely having a social conversation can help to re-establish trust and rapport. Change the dynamic, meet with different counterparts or bring in an additional negotiator to help change the dynamic. Change the location to another setting within the same place or reconvene at a later date in another office.

A solution to avoiding impasse may be to return to the initial information-gathering phase of the negotiation. When confronted with threats or emotional outbursts, either use your mediator or make your own assessment as to the cause of your adversary's reaction. Questions to consider include:

- What is driving the reaction of your adversary?
- Is it a tactic?
- Is this posturing?
- Is there an issue that you were previously unaware of?
- Have you unintentionally offended your adversary?
- Does your adversary lack information as to the basis for your offers or demands?
- Is there a way to provide that information objectively while not embarrassing your counterpart in front of his client?

Among the most powerful techniques are *silence* and *empathic listening*. Always listen carefully and use looping techniques to make certain that you have heard and understood the content that your adversary is attempting to convey. Simply respecting your adversary's reaction may help your adversary save face and restart the negotiation in a more productive direction.

Humor is another technique that is effective when used appropriately. Humor can be used to diffuse tension and to provide a way for your adversary to come back to the table without losing face. The caveat is that when humor is used ineffectively, it can have a detrimental impact. Humor should be aimed at breaking the tension and not at embarrassing or attacking your adversary.

BREAKING IMPASSE

When you find your negotiation completely stalled and at an impasse, someone must take action. If you have a mediator, your mediator can take action to bring the parties back to the table. If you are involved in a direct negotiation, you may have to make the first move.

As discussed above, consider changing the dynamics in terms of people, place and pacing.[12] Taking a break and allowing tempers to cool is an excellent option. Speak with your adversary in different surroundings. If you have been speaking on the phone, try meeting for lunch. Re-establish trust and rapport if possible. Empirical studies have demonstrated the importance of trust and rapport in maximizing results in negotiation.[13]

Take the negotiation back to the start and gather additional information. Learn what you can about the source of the impasse. Determine whether your adversary has unreasonable expectations or is reacting to your negotiation style. They may be unhappy with where you are presently, but they may not realize where you are likely to eventually move.

Is there information that your adversary is unaware of that may have an impact on issues of liability or value? Is there information you may have missed or disregarded? Bear in mind that when providing your adversary with information, you should be conscious of dual interpretations of various evidentiary proffers. Proffers of witness testimony are rarely as persuasive as are documents that your adversary may not have seen or may not have understood.

Are there interests of your adversary's client that are not being met? Are there issues of fairness that are not being satisfied? From this you may determine an appropriate substantive strategy. Simply being the party to

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12. Golann, Dwight, *Mediating Legal Disputes*, 183 (ABA 2009).

13. Nadler, *Janice, Legal Negotiation and Communication Technology: How Small Talk Can Facilitate E-*Mail *Dealmaking*, 9 Harv.Neg.L.Rev 223 (2003).

make the first call can, rather than show weakness, show an interest in finding a mutually beneficial solution. Try to move the conversation back from personal disagreements of style or tone to a more productive conversation about problem solving.

There are additional techniques that mediators use to try to break impasse. The mediator's solution is an end of the negotiation technique. The mediator essentially selects a proposed end of deal solution that she presents to both sides, who are then permitted to accept or reject the solution. It is not to be used as a point from which to bargain. This can be dangerous if done too early. Also, the mediator should select a number that represents where she believes the case could settle. This should not be an expression of value.

If the negotiation stops, the mediator can propose that the parties try "bracketing" or "conditional" offers. The parties pick where they would like their adversary to go and where they will go in return. "If you will go to 100, I will go to 200." This allows parties to protect their prior positions (*e.g.*., the party proposing the bracket does not go to 200 unless the other side moves to 100). This is a way to share information about where a negotiator is willing to go without having to actually go there. Furthermore, most sides will extrapolate from the establishment of the bracket that the proposing party would actually be willing to settle at 150 or half way between the proposed bracket. This would seem likely, but is not necessarily always the case. Bracketing does provide some indication of a willingness to move on the part of the proposing party. The receiving party has several options. She can adopt the proposed bracket, reject brackets and continue to negotiate as before, or propose her own bracket.

When parties reach a standstill, they can try the "last best offer" or "baseball" technique. Each side will make a best and final offer to the mediator. The mediator will select from between the two proposals. The mediator will not be able to modify either offer. Since the most reasonable proposal is the most likely to be accepted by the mediator, this encourages the parties to avoid extreme positions. In "night baseball," each party's proposal is private (i.e., it is not disclosed to the other side). With baseball or last best offer, the offers are known to both sides.

If the parties cannot settle, they can agree to allow the mediator to transition into the role of arbitrator. This must be done with full disclosure and waivers of conflicts and knowing acceptance of the ramifications of the mediator assuming this new role. The mediator will have been privy to confidential information from both sides and will possess this information as she assumes the role of trier of fact. This can be agreed to at the end of a failed mediation. If it is disclosed that arbitration with the mediator as arbitrator will follow a failed mediation, the parties can adjust their strategies and disclosures throughout the mediation. In arb/med, the mediator first acts as arbitrator and hears the case or an abbreviated version of the case. The arbitrator makes a decision, but does not present it to the parties unless the mediation (which follows the arbitration) does not result in an agreement.

IV. CONCLUSION

Too often, negotiations fail for reasons having nothing to do with the merits of the available deal. Parties find themselves unable to overcome the impasse that they have created. They react emotionally or personally. They fear appearing weak or losing face. With thorough preparation, however, negotiators can anticipate a number of factors likely to lead to impasse and avoid them entirely. Parties should intervene when they sense that they are moving towards an impasse and shift tone or style. When the parties arrive at what appears to be an insurmountable impasse, they should persevere. When either a mediator or one of the parties intervenes, impasse can be overcome by focusing on objectives and problem solving.

Although the inclination is to succumb to emotional reactions, negotiators should focus on objectives. They should continue to behave rationally and analytically. By doing so, negotiators can salvage deals and break through impasse. That is, of course, if the parties are truly desirous of settlement. In all circumstances your analysis should also include looking objectively at the likely deal in relation to your best alternative to settlement. Resist pressure to reach agreement. As the negotiation progresses there can be a sense that if the negotiation does not result in a settlement that it has failed. Your approach to any impasse must continue to reflect your assessment of the situation and an honest re-examination of whether the deal offered is preferable to the alternatives.[14] When the deal is better than the alternatives, wise negotiators know how to step in, break the impasse and salvage the deal.

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14. Mnookin, Robert, *Bargaining with the Devil* (Simon & Schuster, 2010).

BLAME-THE-VICTIM IS NOT A DEFENSE TO ALLEGATIONS OF UNSUITABLE RECOMMENDATIONS

*Mark A. Tepper**

INTRODUCTION

This article discusses FINRA members ("members") using blame-the-victim as a defense to unsuitable recommendations in customer arbitration. Members answer these charges by arguing that the customer wanted the recommendation.

It also discusses dismantling those sham defenses designed to take advantage of any misunderstanding of the plain meaning of the Suitability Rule. Further corrective and disciplinary action by FINRA is recommended to cure this rash of irrelevant and inflammatory blame shifting.

Members' attempts to shift the arbitrators' focus from an alleged violation of securities laws and FINRA Rules, where it belongs, to whether the customer considered the transaction(s) suitable, is irrelevant and prejudicial to a suitability determination.

FINRA Rules place the duty to make suitable recommendations squarely on members and their associated persons ("brokers"). Blaming-the-victim for unsuitable recommendations by members is not an exception to this duty.

The securities regulators responsible for interpreting the Suitability Rule – SEC and NASD (n/k/a "FINRA") – have made it abundantly clear, in prior disciplinary decisions, that members' efforts to blame-the-victim are *not* a defense to unsuitable recommendations. The probative value of such irrelevant allegations is far exceeded by their prejudicial effect.

CAST DOUBT BY BLAMING THE VICTIM

Arbitrators sometimes refuse to accept the plain meaning of the Suitability Rule that a member must prove its broker had a reasonable basis for each recommendation to a customer at the time it was made to establish suitability.[1] Members seize this opportunity to turn a suitability

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1. Suitability Rule 2111 sets forth the suitability obligations for broker-dealers and registered representatives. In July, 2012, Rule 2111 replaced Rule 2310.

determination from an objective evaluation of their legal duties into an irrelevant examination of what the customer purportedly wanted.

These baseless defenses seek to blame and humiliate the victim. Such prejudicial allegations continue unabated in customer arbitration, despite the well settled history of disciplinary actions against them.

Members consistently allege blame-the-victim defenses in their answers when responding to charges of unsuitable recommendations. This widespread practice, which is both irrelevant and inflammatory, cries out for corrective and disciplinary action by FINRA.

Blame-the-victim is a defense without merit because it is not related to the customer's financial situation and needs which are the key factors in determining suitability. Therefore, blame-the-victim is irrelevant to the matter in controversy. However, like most inflammatory and highly prejudicial arguments, if not discredited, they are likely to have an unfair impact on the fact finder, frustrating fundamental fairness.

THE EVER POPULAR BLAME-THE-VICTIM SHAM DEFENSES

The all-time favorite sham defenses include:

a. The customer-wanted-it;
b. The customer-understood-the-risk;
c. The customer was fully advised of all the risks; and
d. The customer ratified the transaction(s).

The SEC, FINRA and the 9th Circuit Court of Appeals have, for decades, ruled that these blame-the-victim sham defenses are without merit. In spite of this clear message, members continue to use them in customer arbitration, instead of answering the charges of unsuitable recommendations.

Regardless of the broker's breach of his duty to make suitable recommendations, members argue that the customer wanted it because she was fully advised – knew what she was doing – consequently, the losses were her fault.

This argument is irrelevant because it is not related to the merits of suitability. Blame-the-victim ignores the standard for determining suitability set out in the Suitability Rule – whether the broker had a reasonable basis for each recommendation at the time it was made.

The customer-wanted-it does *not* establish the necessary reasonable basis for suitability. As FINRA has previously asserted: suitability ". . . requires more than simple adherence to a customer's desires." *Department of Enforcement v. Jack H. Stein*, Hearing Panel Decision, No. CO7000003, March 6, 2001.

As a result, these sham defenses have no evidentiary value. Rather than answer the unsuitability allegations, members attempt to misdirect the arbitrators' attention away from the key factors for determining suitability.

Sadly, these sham defenses have a strong emotional appeal to some arbitrators. That appeal may explain members' mis-use of them, which undermines the fairness and credibility of FINRA customer arbitration.

Under FINRA's Suitability Rule, it is the broker's duty to use diligence to determine the customer's financial situation and needs before making a *suitable* recommendation. It is not the customer's duty to supervise the broker's activities in the customer's account(s). FINRA imposes that duty on its members. FINRA/NASD Rule 3010.

The SEC and FINRA agree in their construction of the Suitability Rule that:

> ". . . the test is not whether the client considered the transactions suitable, but whether the representative 'fulfilled the obligation he assumed when he undertook to counsel [the client], of **making only such recommendations as would be consistent with [the client's] financial situation and needs**.'" *(Emphasis added).*

Department of Enforcement v. Jack H. Stein, Hearing Panel Decision, No. CO7000003, March 6, 2001; citing *In re Eugene J. Erdos*, 47 S.E.C. 985, 1983 SEC LEXIS 332, at *10-11 (1983), aff'd, *Erdos v. SEC*, 742 F.2d 507 (9th Cir. 1984).

More importantly, even if true, according to the plain meaning of FINRA's Suitability Rule, these blame-the-victim allegations are <u>not</u> a defense to a charge of unsuitable recommendations. The SEC and FINRA have previously ruled that blame-the-victim allegations are not related to a suitability determination. *Id.* Suitability is established when there is a reasonable basis showing that the recommendation satisfies the customer's financial situation and needs at the time it was made.

THE CUSTOMER WANTED THE BROKER'S RECOMMENDATIONS IS *NOT* A DEFENSE TO UNSUITABLE RECOMMENDATIONS

The SEC has specifically rejected the relevance of she-wanted-it or the she-acquiesced in the recommendation arguments as not related to whether a recommendation was suitable. The SEC's decision in *In Re James B. Chase*, SEC Rel. 34-47473, March 10, 2003 is one example that explains why she-wanted-it is *not* a defense to unsuitable recommendations:

> "Moreover, assuming that [the customer] did want to invest in FHC, that did not affect Chase's responsibility to recommend a suitable investment. The test for whether Chase's recommendations were suitable is not whether [the customer] acquiesced in them, but whether his recommendations were consistent with her financial situation and needs."

The SEC explained its reasoning, as follows:

> "[R]egardless of whether [the customer with limited means] appeared willing, or even eager, to pursue 'growth' as [the registered representative] understood it, it was [the registered representative's] duty to advise [the customer] against that pursuit to the extent that it was incompatible with her acknowledged needs."
>
> *Id.* citing *Charles W. Eye*, 50 SEC 655, 659 (1991).

Even if the customer wanted to engage in speculative trading, the broker is obliged to abstain from making recommendations that are inconsistent with the customer's financial situation and needs. *See*, *In re John M. Reynolds*, 50 S.E.C. 805 (1992)("Reynolds' claims are implausible. [FN9] Nevertheless, even if the committee authorized aggressive trading, Reynolds was not entitled to ignore the financial situation and character of the account. [FN10] As stated, the account was a church building fund financed by donations from parishioners").

See also In Re Gordon Scott Venters, 51 S.E.C. 292 (1993), ("At the very least, when Venters learned about his customer's age and situation, he had a duty to abandon the promotion in which he was engaged, and to advise against an investment such as Medi-Quip").

The customer-wanted-it argument does not answer the charge of unsuitable recommendations by the broker. It is not related to whether the recommendations were suitable. Even if the sham defense was true, that fact would not change an *un*suitable recommendation into a suitable one.

SHE UNDERSTOOD-THE-RISK – AN ALL TIME FAVORITE

The frequently made argument that the victim understood-the-risk is *not* a defense to unsuitable recommendations, according to FINRA, the SEC and the Federal Court of Appeals, which have clearly and consistently rejected this argument:

> **“For purposes of this decision, the Panel assumes that EA was not naïve and that she knowingly authorized or acquiesced in all of the transactions, knowing the risks involved. Stein's reliance on such facts nevertheless does not constitute a defense to a charge of making unsuitable recommendations**. The Securities and Exchange Commission and the National Adjudicatory Council ("NAC") have made clear that Rule 2310 requires more than simple adherence to a customer's desires. Even where the customer wants to engage in speculative trading, a broker has a duty to refrain from recommending such transactions when doing so would be unsuitable, considering the client's financial situation. [footnote omitted] . . . . *In re Eugene J. Erdos*, 47 S.E.C. 985, 1983 SEC LEXIS 332, at *10-11 (1983), aff'd, *Erdos v. SEC*, 742 F.2d 507 (9th Cir. 1984).” Emphasis added.

Department of Enforcement v. Jack H. Stein, Hearing Panel Decision, No. CO7000003, March 6, 2001.

The customer-understood-the-risk allegation is a sham defense because it is not related to whether the broker had a reasonable basis for the recommendation based on the customer’s financial situation and needs. Proof that the customer understood the risk does not convert an otherwise *un*suitable recommendation into a suitable one. Nor does it excuse the member’s liability for it:

> “As Eye knew, [the customer] was ignorant of investment matters and depended heavily on him to generate an adequate level of income. Her request for a plan to increase that income was not a warrant to escalate risks unduly. If the only approach capable of producing the desired income involved significant dangers, Eye should have advised against it.
>
> Even assuming that [the customer] had the objectives and assets cited by Eye, our conclusion would be the same. Here Eye was dealing with a single, unemployed mother who needed income to cover living expenses. The fact that

> she might have possessed about $70,000 in addition to her account would not justify the exposure to heavy losses and the drain on income to which she was subjected. [FN7] Moreover, regardless of whether [the customer] appeared willing, or even eager, to pursue 'growth' as Eye understood it, it was Eye's duty to advise her against that pursuit to the extent that it was incompatible with her acknowledged needs. [FN8]" *Charles W. Eye*, *supra.*

Following the logic of the SEC and FINRA's analysis, whether or not the arbitrator believes that the victim understood the recommendation, is not related to a suitability determination.

There is an urgent need for FINRA to issue an arbitrator training bulletin to deliver this vital message to *all* its arbitrators, that blame-the-victim is *not* a defense to unsuitable recommendations. This would have a chilling effect on the abuse.

FULL RISK DISCLOSURE IS NOT A DEFENSE TO UNSUITABLE RECOMMENDATIONS

The broker's alleged disclosure of *all* the risks, even if true, by itself, does not establish that a broker's recommendation was suitable:

> "Similarly, Chase did not satisfy the suitability requirement simply by informing Horvath of the risks of investing in FHC. **Mere disclosure of risks is not enough.** A registered representative must 'be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks.'" (Emphasis added). *Chase*, *supra.* at 5.

The broker's full disclosure of the risks to third parties, regardless of whether they are a close family member or a professional advisor, has no bearing on the lack of suitability of recommendations:

> "That Chase may have informed Horvath's mother, accountant, and attorney of his purchases of FHC stock for Horvath is irrelevant. His client was Horvath, not her mother, accountant, or attorney. It was Chase's duty to ensure that Horvath understood the risks." *Id.*

THE COMMON LAW DEFENSE OF RATIFICATION DOES NOT APPLY TO A VIOLATION OF FINRA RULES

Ratification is a common law defense. Florida, like most states, defines ratification as "[b]efore one may infer that a principal ratified the unauthorized act of his agent, the evidence must demonstrate that the principal was fully informed and that he approved of the act." *United Parcel Service v. Buchwald Jewelers*, 476 So.2d 772 (Fla. 3d DCA 1985); *Pedro Realty, Inc. v. Silva*, 399 So.2d 367 (Fla. 3d DCA 1981); *Bach v. State Bd. of Dentistry*, 378 So.2d 34 (Fla. 1st DCA 1979); *G & M Restaurants Corp. v. Tropical Music Service, Inc.*, 161 So.2d 556 (Fla. 2d DCA 1964); *Ball v. Yates*, 158 Fla. 521, 29 So.2d 729 (1946), cert. denied, 332 U.S. 774, 68 S.Ct. 66, 92 L.Ed. 359 (1974).

Ratification is a knowing waiver. Ratification does not apply to violations of the securities laws or violations of FINRA rules because federal and state law each prohibit a customer from waiving the protections in the securities laws. Any such waiver or ratification would be void as a matter of statute or rule:

> Federal law - 15 USC §78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."); and
>
> Florida Law - Fl. Adm. Code § 69W-600.012 (2) ("A dealer shall not enter into any contract with a customer if the contract contains any condition, stipulation or provision binding the customer to waive any rights under Chapter 517, F.S. [the Florida Investor Protection Act], or any rule or order thereunder. Any such condition, stipulation or provision is void.")

Moreover, FINRA members cannot shift their professional duties for investor protection to the customers they are duty bound to protect.

Based on the proceeding references to federal and state law and rules, ratification does not excuse an unsuitable recommendation. A customer's ratification cannot change an *un*suitable recommendation into a suitable one. FINRA's Suitability Rule requires that the broker have a reasonable basis for each recommendation at the time it is made.

REGULATORY DECISIONS GUIDE THE SECURITIES INDUSTRY'S CONDUCT

SEC and FINRA regulatory actions, also known as disciplinary actions, discussed above, tell us how the rules are interpreted by those whose job it is, to enforce them fairly for the benefit of the entire securities industry. It is significant to note that the Federal Appeals Court also relied on such disciplinary decisions. *Erdos, supra.*

According to the United States Supreme Court, the SEC and FINRA disciplinary decisions should be given great weight:

> "Steadman's attack on the precedential value of Provident is without merit. Although that opinion was issued in connection with an offer of settlement, the Commission's construction of the securities laws in settled cases as well as litigated ones is entitled to great weight. *E. I. duPont de Nemours & Co. v. Collins*, 432 U.S. 46, 54, 97 S.Ct. 2229, 2234, 53 L.Ed.2d 100 (1977)." *Steadman v. SEC*, 603 F.2d 1126, 1136 (5th Cir. 1979).

Accordingly, the disciplinary decisions, cited above, have a very important precedential value in a civil action for damages related to violations of the securities laws or FINRA Rules. They are to be given great weight. That view is supported by logic, the United States Supreme Court, the SEC, FINRA and the 9th Circuit Court of Appeals.

NO BLAME-THE-VICTIM EXCEPTION IN THE "NEW" SUITABILITY RULE

FINRA's new Suitability Rule does not change the factors for determining suitability. According to FINRA, "[i]n general, FINRA's new suitability rule retains the core features of the previous NASD suitability rule, NASD Rule 2310. In addition, Rule 2111 codifies several important interpretations of the predecessor rule and imposes a few new or modified obligations." Notice to Members ("NTM") 12-25.

FINRA's Suitability Rule 2111 and its related NTMs clearly establish that the broker must still have a reasonable basis to establish that each recommendation was suitable for the customer's financial situation and needs at the time of the recommendation.

Rule 2111 does not establish any exceptions to the broker's duties to retail customers according to the Suitability Rule. FINRA's NTMs 12-25 and 13-31, which explain the Suitability Rule, do not specify any exceptions to the retail customer portion of the Suitability Rule, because there are none.

Using blame-the-victim as an exception to the Suitability Rule is a sham defense that FINRA simply does *not* recognize as legitimate. Clearly, if a blame-the-victim exception was intended, FINRA would have included it in the Suitability Rule or the NTMs.

Consequently, members who plead blame-the-victim as a defense to unsuitable recommendations are allegedly violating FINRA Rule 2010 – Standards of Commercial Honor and Principles of Trade: “A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”

The act of misleading an arbitration panel into reaching an unjust decision, using inflammatory allegations about the victim that are not related to the matter in controversy, violates those standards.

FINRA members cannot contract out of or otherwise disregard FINRA Rules. See FINRA Rule 0140 titled "Applicability," which states ". . . [FINRA] rules shall apply to all members and persons associated with a member.”

Although there are sufficient rules to make the members’ obligations clear, members still find it to their advantage to violate FINRA rules in arbitration alleging unsuitable recommendations. The apparent member perception, that violating FINRA Rules has no consequences, *must* change if FINRA arbitration is to be perceived as fundamentally fair and FINRA Rule 0140 is to have any meaning. Hence, the present and immediate need for FINRA to enforce its Rules through disciplinary actions.

CONCLUSION

Blame-the-victim is a sham defense that does *not* answer allegations of unsuitable recommendations in FINRA customer arbitration. Instead, it threatens both fair decision making and the integrity of the process.

Clearly, stronger sanctions are needed to curb this abuse. It is time for FINRA to take more decisive disciplinary action and/or corrective measures if it is to protect customers from these unfair attacks that lead to unjust results.

At the very least, Arbitrators need to be armed with the best suitability training tools available. FINRA's publication of an arbitrator training bulletin together with commencement of a vigorous campaign of disciplinary proceedings would have a chilling effect on members who use sham defenses designed to mislead by blaming the victim.

Notes & Observations

RECENT ARBITRATION AWARDS

John S. Burke

AUTO CITY SERVICE, INC., AUTO CITY CLARK, INC., AND FOWLERVILLE EXIT SHELL SERVICE, INC. v. J.P. MORGAN SECURITIES, INC., J.P. MORGAN SECURITIES LLC, NICOLE MOTEN, JOHN BUENO, DAVID MAKSYMETZ, JPMORGAN CHASE BANK, N.A., JPMORGAN CHASE & CO., XYZ CORPORATION, JOHN DOE, AND MARY ROE
FINRA Case No. 11-03013

Claimants asserted the following causes of action: (1) misrepresentations; (2) negligent misrepresentation; (3) violations of Michigan securities law; (4) violations of federal securities law; (5) negligence; (6) breach of fiduciary duty; (7) breach of contract; (8) inappropriate investment conduct; (9) failure to supervise; (10) respondeat superior; and (11) negligent supervision. The causes of action related to Claimants' allegations that Respondents failed to properly effectuate account transfers, erroneously computed account assets, and did not properly advise regarding Claimants' margin and default concerns after Claimants transferred their business (including various unspecified securities, a business loan, and an interest rate swap) to Respondents.

In the Statement of Claim, Claimants requested: (1) compensatory damages in an amount greater than $100,000.01; (2) interest; (3) attorney fees; and (5) costs. At the close of hearing, Claimants requested (1) compensatory damages in the amount of $6,000,000.00; (2) Interest at 6%; (3) attorney fees in the amount of $242,000.00; and (4) other costs in the amount of $50,000.00.

Respondents denied the allegations in the Statement of Claim and asserted affirmative defenses. Respondents requested that the claims asserted against them be dismissed in their entirety and that they be awarded their costs, attorneys' fees, and other appropriate relief.

Award: The Panel found that Respondents JPMorgan Chase Bank, N.A. and JPMorgan Chase & Co., both of which did not voluntarily submit to FINRA arbitration, are not compelled by the rules to arbitrate disputes in FINRA arbitration forum. In the absence of the voluntary submissions of JPMorgan Chase Bank, N.A. and JPMorgan Chase & Co., FINRA did not have jurisdiction over these parties. The Panel further found that Claimants did not identify Respondents XYZ Corporation, John Doe, or Mary Roe by name, and as a result the Panel did not adjudicate any claims against these unnamed parties.

The Panel found that Respondents J.P. Morgan Securities, Inc. and J.P. Morgan Securities LLC were jointly and severally liable and ordered these Respondents to pay Claimants as follows: (1) $1,680,000.00 in compensatory damages; (2) interest on the aforementioned sum at the rate of 5% per annum from and including October 9, 2008 through October 21, 2013; (3) $50,000.00 in costs; (4) $300.00 as reimbursement for the non-refundable portion of FINRA filing fee; and (5) $242,000.00 in attorneys' fees pursuant to statute. The Panel denied Claimants' claims against Respondents Nicole Moten, John Bueno, and David Maksymetz, and dismissed the claims with prejudice.

Claimants' Counsel: Mark E. Maddox, Esq. and Thomas K. Caldwell, Esq., Maddox Hargett & Caruso, P.C., Fishers, Indiana.

Respondents' Counsel: Frank Ortiz, Esq., Dickinson Wright PLLC, Detroit, Michigan.

Claimants' Expert: Dr. Craig McCann, Securities Litigation & Consulting Group, Fairfax, Virginia.

Respondents' Expert: None.

Arbitrators: Stuart Sinai (Public Chairperson); Stephen D. Kursman (Public); Patrick R. Sughroue (Public).

This case is significant because of the very large award of damages by the Panel. This case resulted from the mismanagement of the Claimants' account in the mist of the financial crisis during the fall of 2013. Respondents solicited Claimants by representing how they could properly manage Claimants' securities/investment accounts, business loan and Swap. Despite their representations, Respondents failed to transfer all of Claimants' securities/investment accounts to JP Morgan Securities in a timely manner. When the market tumbled in the fall of 2008, Claimant was advised against liquidations of the investments. The Respondents assured Claimant that they had sufficient cash reserves when in fact they did not. Moreover, Respondents provided Claimants with incorrect information as to their margin ratios, account status and values. As a result of the erroneous account computations and failure to transfer accounts, Claimants' business loan was declared in default, and Claimants incurred substantial penalties. To add insult to injury, after liquidating Claimants' assets, Respondents required Claimants to maintain the funds in a cash account that earned less interest than the Business loan's interest due.

The Panel found the conduct of Respondents was the cause of Claimants' losses. Claimants' case was supported by Dr. Craig McCann, while Respondents did not offer any expert testimony in its favor. Claimants were awarded a multi-million dollar award that included compensatory damages, interest for five years, fees and costs.

THEODORE R. DAVIS TRUST DTD 3/8/2007 v. SUNSET FINANCIAL SERVICES, INC.
FINRA Case No. 13-00640

Claimant asserted the following causes of action: (1) breach of fiduciary duty; (2) common law fraud; (3) negligence; (4) failure to supervise; (5) violation of the Missouri Securities Act of 2003; and (6) violation of the Missouri Merchandising Practices Act. The causes of action related to the recommendation and purchase of two Real Estate Investment Trusts ("REITS"): the Behringer Harvard Real Estate Investment Trust ("Behringer Trust") and the KBS Real Estate Investment Trust ("KBS Trust"). Claimant alleged that Respondent, through its agent, misrepresented to Ted Davis that investing in the Behringer Trust and the KBS Trust were suitable investments. Claimant asserted, however, that the investment objectives were preservation of principal for Ted Davis' long-term care and disability.

In the Statement of Claim, Claimant requested (1) actual/compensatory damages in the amount of $137,071.61; (2) exemplary/punitive damages; and (3) attorneys' fees.

At hearing, Claimant requested: (1) rescission; (2) $ 219,500.00 in actual/compensatory damages; and (3) $83,917.00 in attorneys' fees and costs under Missouri securities law.

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses. At hearing, Respondent requested that the claims asserted against it be denied in their entirety and that it be awarded its costs and attorneys' fees.

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant as follows: (1) $132,000.00 in compensatory damages; (2) $38,000.00 in pre-Award interest on the compensatory damages; (3) post-Award interest at the rate of 4% per annum; (4) $7,500.00 in costs; (5) $56,666.00 in attorneys' fees pursuant to Missouri securities law; and (6) $300.00 as reimbursement for the non-refundable portion of the filing fee. Claimant was also ordered to return the securities at issue to Respondent.

Claimant's Counsel: Thomas F. Burke, Esq., Law Office of Thomas F. Burke, Chicago, Illinois.

Respondent's Counsel: Stephen J. Fields, Esq., Brinker & Doyen, LLP, Clanton, Missouri.

Claimant's Expert: Jeffrey Schaff, Ardor Fiduciary Services, Ltd., Northlake, IL.

Respondent's Expert: Michael Alderson, Professor of Finance, Saint Louis University, Saint Louis, Mo.

Arbitrators: David F. Barrett (Public Chairperson); John R. Loss (Public); Michael A. Rzewnicki (Non-Public).

This case is significant because Claimant received his full award and attorney fees in a case involving non-traded REITS. Claimant had an associate degree from a community college. He was disabled with social security as his only source of income. The money invested by Respondent was to pay for future medical needs and care and should have been invested for safety of principal.

Respondent argued that Claimant signed various offering documents disclosing the risk of the investments. At hearing, however, Respondent's representative testified that the investments were not high risk. The representative was methodically impeached with the same documents that clearly stated that the investments were not conservative, safe investments.

SANDRA GOLDBERG, SAMSON AND DINA FIXLER, MARK AND SHARON KREINDEL, NATALIE WILBUR, RONALD RAFAL, LEE SEIDMAN, INDIVIDUALLY AND LEE SEIDMAN AS TRUSTEE UNDER THE LEE G. SEIDMAN TRUST U/A DATED 4/27/1987 v. SECURITIES AMERICA, INC.

FINRA Case No. 12-02683

Claimants asserted the following causes of action: (1) material misrepresentations; (2) failure to disclose material information; (3) breach of fiduciary duties; (4) violation of FINRA's Conduct Rules; and (5) negligent supervision. The causes of action related to the recommendation and purchase of certain Real Estate Investment Trusts ("REITs"). Claimants alleged that Respondent, through its representatives, did not make proper disclosures to Claimants of the material elements of the REITs and valued them on Claimants' monthly account statements inconsistently with their true value.

In the Amended Statement of Claim, Claimants requested (1) compensatory damages in the amount of $3,818,000.00; (2) interest; (3) attorney fees; (4) other monetary relief; and (5) rescission of the purchase of the securities. At the close of the hearing, Mark and Sharon Kreindel submitted final damages in two alternative theories: out of pocket measurement damages of $2,341,766.35 and rescission damages of

$988,489.85. Claimants Goldberg, Samson, Fixler, Rafal and Wilbur settled and dismissed their claims prior to hearing.

Respondent requested that the claims asserted against it be denied in their entirety and that it be awarded its costs and attorneys' fees. In addition, Respondent requested that the Panel expunge all references to this matter from the registration records of the unnamed parties, Michael Perlmuter, Bradley Schlang, and Howard Slater, which were maintained by the Central Registration Depository ("CRD").

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimants as follows: (1) to Claimants, Mark and Sharon Kreindel, the sum of $573,316.29 in rescission damages in return for Claimants Mark and Sharon Kreindel transferring to Respondent title to the shares of Behringer Harvard REIT I they purchased on 7/2/2008 for $ 250,000.00 and on 9/4/2008 for $ 268,000.00; and (2) interest on the above-stated sum at the rate of 3% per annum from and including thirty days (30) after the date of service of the Award through and including the date this Award was paid in full. The Panel denied with prejudice Respondent's Request for Expungement of unnamed parties, Michael Perlmuter, Bradley Schlang, and Howard Slater.

Claimants' Counsel: David E. Robbins, Esq., Kaufmann, Gildin & Robbins, LLP, New York, New York.

Respondent's Counsel: Bruce M. Bettigole, Esq., Sutherland, Asbill & Brennan, LLP, Washington, DC.

Claimants' Expert: James Vodola, Partners Advisory Services Corp., White Plains, NY.

Respondent's Expert: None.

Arbitrators: Michael D. McDowell (Public Chairperson); James D. Ellis (Public); Douglas L. Alder (Non-Public).

The Kreindel Claimants were one of six families that purchased non-traded REITs from Respondents. The Kreindel Claimants were looking for a safe investment for all of their assets. Respondent recommended non-traded REITs, including Behringer Harvard REIT I, Behringer Harvard Multifamily REIT I, Dividend Capital Total Realty Trust, IMH Secured Loan Fund, and Inland American REIT. Respondent claimed that the non-traded REITs were safe. Respondent failed to discuss the risks and the lack of liquidity. Respondents also failed to disclose information obtained from the 10-K's of the respective REITs that would have warned of the steady decline of the REITs operating income and of the operating income being insufficient to pay the planned distributions.

Claimants argued that FINRA Rule 2310(3) required Respondent to inform the prospective participant of all pertinent facts relating to liquidity and marketability of the REITs. Claimants also relied on FINRA Rule 2340(c) requiring Respondent's customer statements to disclose the bases for estimated values of the REITs and the illiquid nature of the securities. Respondent argued that the written offering materials and subscription agreement adequately disclosed the risks to Claimants. The Panel did not believe that the written disclosures by the product sponsors were sufficient to meet Respondent's duty to inform under FINRA Rule 2310 and 2340, in finding for Claimants.

KRISTOPHER BROWNLOW, ALISON CARPENTER, AS TRUSTEE OF THE DEREK MASON TRUST, ALISON CARPENTER, AS TRUSTEE OF THE MARTHA H. MASON TRUST v. STERLING ENTERPRISES GROUP, INC., RETIREMENT SECURITIES, INC.
FINRA Case No. 13-00089

Claimants asserted the following causes of action: (1) negligence; (2) breach of fiduciary duty; (3) negligent supervision; (4) common law fraud; (5) breach of contract (as third-party beneficiaries); and (6) violation of the Florida Securities and Investor Protection Act (Chapter 517, Florida Statutes). The causes of action relate to Claimants' investments in non-tradable Inland Western and Inland American Real Estate Investment Trusts.

In the Statement of Claim, Claimants requested (1) compensatory damages in the amount of $1,000,000.00; (2) interest; (3) costs; (4) expenses; (5) filing fees paid to FINRA and all forum fees advanced by Claimants; (6) punitive damages in accordance with the law; (7) attorneys' fees pursuant to Section 517.211 Florida Statutes (to be determined by a court of competent jurisdiction); and (8) such further relief as the Panel deemed just and proper. At the close of the hearing, Claimants requested costs advanced to FINRA; punitive damages; attorneys' fees in an unspecified amount; and compensatory damages inclusive of interest as follows: (1) Kristopher Brownlow, $47,552.19; (2) Allison Carpenter, Trustee of the Derek Mason Trust, $719,971.65; and (3) Allison Carpenter, Trustee of the Martha H. Mason Trust, $133,154.49.

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

Award: The Panel found that Respondent Sterling Enterprises Group, Inc. and Respondent Retirement Securities, Inc. were jointly and severally liable and ordered Respondents to pay Claimants as follows: (1) for violations of Section 517.301 Florida Statutes compensatory damages (inclusive of interest) in the amount of $47,552.19 to Claimant Kristopher Brownlow; (2) for violations of Section 517.301 Florida Statutes compensatory damages (inclusive of interest) in the amount of $ 719,971.65 to Claimant Alison Carpenter, as Trustee of the Derek Mason Trust; (3) for violations of Section 517.301 Florida Statutes compensatory damages (inclusive of interest) in the amount of $ 133,154.49 to Claimant Alison Carpenter, as Trustee of the Martha H. Mason Trust; (4) Claimants' attorneys' fees pursuant to Section 517.211 Florida Statutes to be determined by a court of competent jurisdiction; and (5) the sum of $375.00 representing reimbursement of the non-refundable portion of the claim filing fee previously paid by Claimants to FINRA Dispute Resolution.

Claimants' Counsel: Jeffrey P. Coleman, Esq. and Will Aubrey, Esq., Coleman Law Firm, Clearwater, Florida.

Respondent Sterling Enterprises Group, Inc.'s Counsel: Alyn Towne, III, President, Sterling Enterprises Group, Inc., Treasure Island, Florida.

Respondent Retirement Securities, Inc.'s Counsel: None.

Arbitrators: Russell W. Merriman (Public Chairperson); Constance d'Angelis (Public); A.J. Seier (Public).

This case is significant because of the amount of the award. The Claimants received full recovery of their damages from the sale of Inland Western and Inland American Real Estate Investment Trusts. They also were awarded attorney fees pursuant to Section 517.211 Florida Statutes.

ANNE R. JONES v. OPPENHEIMER & CO, INC. and GROVER KEITH COOK
FINRA Case No. 12-02052

Claimant asserted the following causes of action: (1) breach of fiduciary duty; (2) misrepresentations/non-disclosures; (3) suitability; (4) failure to supervise; and (5) negligence. Claimant alleged that Respondent Cook invested her in several aggressive high-risk and speculative investments, including Crude Carriers Corp., Grant Park Global Alternative Markets, First Trust High Income L/S Fund, Oppenheimer Global Fund B, and China Shengda Packaging, which, according to Claimant, were inconsistent with her stated investment objective of preservation of capital for her retirement. Claimant further alleged that Oppenheimer failed to adequately supervise the actions of Cook and, as a result, was liable for any damages incurred. At hearing, Claimant renewed her request for damages for loss and punitive damages, attorneys' fees in the amount of Claimant's 1/3 contingency fee contract with her attorney, interest at the legal Ohio statutory rate, and costs, including reimbursement of expert witness fees.

Respondent Oppenheimer & Co., Inc. denied the allegations in the Statement of Claim and raised various affirmative defenses. At hearing, Oppenheimer requested that the claims asserted against it be denied in their entirety and that it be awarded its costs and attorneys' fees.

Award: The Panel found that Respondents Oppenheimer & Co., Inc. and Grover Keith Cook were jointly and severally liable and ordered these Respondents to pay Claimant as follows: (1) compensatory damages in the amount of $89,803.00; and (2) interest on the above-stated sum in the rate of 4% per annum, from and including October 1, 2011 through and including the date this Award is paid in full. The Panel found Respondent Oppenheimer & Co., Inc. liable and ordered Respondent Oppenheimer to pay Claimants as follows: (1) the sum of $29,934.34 in attorneys' fees pursuant to *Ivanic v. Enos*, 2012-Ohio-3639; (2) the sum of $6,550.00 in expert witness fees; (3) the sum of $ 225.00 as reimbursement of the non-refundable portion of the filing fee; and (4) denied other relief including punitive damages.

Claimant's Counsel: David S. Blessing, Esq., The Blessing Law Firm, Cincinnati, Ohio.

Respondent Oppenheimer's Counsel: Leo Kogan, Esq., Oppenheimer & Co., Inc., New York, New York.

Respondent Cook appeared pro se.

Claimant's Expert: Ross Tulman, Trade Investment Analysis Group (formerly Tulman Investment Advisory), Columbus, Ohio.

Respondent's Expert: Bryan Tutor, Oppenheimer & Co., Inc. Cincinnati, Ohio.

Arbitrator: Bill Swinford, Jr. (Public).

This case is significant because Respondent Oppenheimer attempted to use one of its employees as an expert witness. Respondent Oppenheimer had named Bryan Tutor as its expert witness. Mr. Tutor was Oppenheimer's representative and the Assistant Branch Office Manager of Oppenheimer's Cincinnati, Ohio office. Claimant made an oral motion to bar the proposed expert at the beginning of the hearing, but the motion was denied. The Arbitrator permitted testimony on damages by Mr. Tutor. After allowing Mr. Tutor to testify, however, the Arbitrator found that under the Daubert standard, Mr. Tutor was not an expert on damages. The Arbitrator further found that he should disregard Mr. Tutor's testimony on the issue of damages.

Claimant's damage claim was based on a well-managed portfolio theory. Claimant's damages included loss in value of the portfolio in the amount of

$67,386.51. Claimant argued that if the portfolio had been properly managed in conservative investments, she would have earned another $17,156.19 from her portfolio. The Arbitrator agreed and awarded Ms. Jones her well managed portfolio theory damages, as well as interest on the damages, and her attorney fees, expert fees and other costs.

WHERE WE STAND

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

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

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

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

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Jason Doss at jasondoss@dossfirm.com, Joseph Peiffer at jpeiffer@praclawfirm.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to BrokerCheck* was submitted to the Securities and Exchange Commission by Jason Doss on December 9, 2013.

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

Re: SR-FINRA-2013-047

Dear Ms. Murphy:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is a bar association comprised of attorneys who represent investors in securities arbitration. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure.

PIABA is supportive of FINRA's latest efforts to make BrokerCheck more complete and thorough by including information about members and associated persons of any CRD Exchange. PIABA appreciates that this is the latest in a series of expansions of the BrokerCheck system largely since 2010. The significance of increasing public customers' awareness and access to background information about the member and/or associated person handling or potentially handling their account cannot be understated.

While this is certainly a step in the right direction, the BrokerCheck system still does not provide the same amount of information as available through several state regulatory bodies. PIABA has regularly raised this important issue in commentary to several rule proposals surrounding BrokerCheck. State regulators, such as the Florida Office of Financial Regulation, provide far more thorough CRD reports than those available through BrokerCheck. Such reports contain significant information, which may not appear on BrokerCheck reports. For example, prior bankruptcies entered into by an individual broker often appear on state CRD reports, but not BrokerCheck. A broker's prior mismanagement of his or her own personal finances is certainly something that may influence a public investor's decision to do business with that broker. Given that this information is already contained within the system, there is no reason that public investors located across the country should not have access to it, regardless of the state in which they reside. If a broker is not registered with Florida, or another state with a similar system, such information will continue to remain unavailable to the public absent an expansion of BrokerCheck.

PIABA again requests that the information contained within the CRD system be made available without the restraints of artificial time periods. Material information should not be eliminated from the system and thereby withheld from the investing public simply because of the expiration of an arbitrary, artificial time period. Information that is material in year nine does not automatically become inconsequential in year ten.

PIABA believes that BrokerCheck should further be amended to include, among other things, disclosures about the registered representative's education background and professional designations. In the current market, PIABA members have noticed that many registered representatives utilize multiple professional designations. Professional designations in the securities industry vary greatly with respect to the efforts required to obtain them.[1] BrokerCheck should provide a description of the respective professional designations used by a registered representative to aid investors.

Yours truly,

Jason Doss
President

1. Some, such as the CFA ("Chartered Financial Analyst") require the passage of three full day examinations coupled with countless hours of independent study over three years, while others can simply be acquired over a long weekend or even online.

The following PIABA Comment Letter regarding the *Proposed Rule Change SR-FINRA-2013-048* was submitted to the Securities and Exchange Commission by Jason Doss on December 9, 2013.

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

Re: SR-FINRA-2013-048

Dear Ms. Murphy:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is a bar association comprised of attorneys who represent investors in securities arbitration. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure.

PIABA strongly supports SR-FINRA-2013-048 because it provides additional pertinent information to investors and the general public. A former associated person who was the subject of an investment-related civil action brought by a state or foreign regulator that was dismissed pursuant to a settlement agreement may still be in the financial industry more than ten years after the event in question. A regulatory civil action may involve an issue of great concern to an investor, and that concern is not erased or mollified simply because the matter was resolved pursuant to a settlement agreement or because an arbitrary period of time has passed. Permanently including this information in BrokerCheck better protects investors by giving them the tools to fully assess and evaluate financial professionals who were once associated with a FINRA member.

We appreciate the opportunity to comment in support of SR-FINRA-2013-048.

Sincerely yours,

Jason Doss,
President

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to Series 6 Examination* was submitted to the Securities and Exchange Commission by Jason Doss on November 14, 2013.

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

Re: SR-FINRA-2013-045

Dear Ms. Murphy,

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC"), the Public Investors Arbitration Bar Association ("PIABA") submits its comment to the SEC concerning SR-FINRA-2013-045 and its proposed changes to the Series 6 Examination. These changes would be to "update the material to reflect changes to the laws, rules and regulations covered by the examination and to incorporate the functions and associated tasks currently performed by an Investment Company and Variable Contracts Products Representative." While PIABA believes that these changes are a move in the right direction, especially as the changes pertain to an increased focus on suitability, the changes should go even further to promote investor protection.

PIABA is a bar association whose attorneys are committed to representing investors in securities arbitrations. In promotion of these efforts, PIABA often comments upon proposed changes to the arbitration process to ensure the rights and fair treatment of the investing public. PIABA submits its comment herein because it believes the issue to be of significant importance to the investing public.

SR-FINRA-2013-045, the proposed change, modifies the Series 6 content outline to comport with current rules and regulations. These modifications to the content outline give suitability requirements (as identified in FINRA Rule 2111) greater prominence and reflect recent changes to the suitability rule. PIABA supports such modifications because PIABA supports the addition of anything that increases broker awareness and understanding of suitability requirements. Suitability violations constitute 953 of the 2809 arbitration cases filed with FINRA during 2013 (through

September 2013).[1] Testing on the suitability rule has become even more important due to recent changes to Rule 2111. PIABA supports the modifications to the Series 6 Exam that reflect those changes.

The testing and outline, however, should go further to protect investors. PIABA would like to see additional issues receive greater attention in the Series 6 Exam. The Series 6 allows a broker to sell variable life products and investment company products. The members of PIABA commonly see issues in these areas, including annuity and mutual fund switching, and break point violations that could be resolved with better testing and education of brokers. PIABA would like to see greater testing on these issues as a condition precedent to getting a Series 6 license to better protect the investing public.

We further suggest that the training concerning suitability focus first on the critical need for the selling agent to understand the products being considered for sale to their customers. PIABA membership has witnessed a significant increase in the number of clients suffering significant losses in very complex annuities and life insurance products. It can take someone well-versed in the area hours, if not days, to understand how a particular product calculates its surrender value or death benefit. But, as our membership has seen, selling agents are often more interested in spending their time selling these high-commission products than they are in understanding them so that they can determine whether they would be appropriate for any of their clients. The customer-specific issues addressed in Sections 2.1 and 2.2 of the proposed outline are a meaningful step in the right direction, but they cannot come into play until the agent spends the time to truly understand the products they sell – as addressed in Section 2.3. An agent can't abide by FINRA Rule 2111's requirement that they have a reasonable basis for believing the recommended transaction is suitable unless they understand the product being offered. Thus, we strongly suggest that the training outline be modified to focus first upon the broker's need to understand the products they offer. Specifically, we suggest that Section 2.3 be expanded and replace Section 2.1, with Sections 2.1 and 2.2 being re-labeled 2.2 and 2.3, respectively.

1. http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

In sum, PIABA supports the new rule proposal but hopes that the new outlines would go further in an effort to protect investors. I would like to thank you once again for the opportunity to comment on this rule proposal.

Sincerely yours,

Jason Doss
President

REMEMBERING BOYD PAGE

Seth E. Lipner

I first met Boyd Page in Dallas Texas in 1990. Stuart Goldberg, whose idea it was to create PIABA, had invited thirteen lawyers from around the country to meet in Dallas to discuss forming a bar association. Eight of us came. Boyd was one of them. I knew nothing about him.

It was the height of the scandal involving the sale of Limited Partnerships by Prudential-Bache Securities. Boyd and his law firm were being sued by Prudential for theft of trade secrets, because they had gotten a list of Pru's clients from a whistle-blowing broker. Boyd seemed energized by the law suit, and was looking forward to using it to embarrass Pru. And that is exactly what happened. Pru wound up putting its tail between its legs, and soon thereafter withdrew the case. The story is featured in Kurt Eichenwald's book, *Serpent on the Rock*, together with a great picture of the original PIABA Directors.

We met for the second time a year later in Austin. Stu had summoned us to meet again to figure out what to do with this Public Investors Arbitration Bar Association that we had formed. Boyd was elected Treasurer. We decided to hold a meeting of members at Walt Disney World in Orlando, a CLE event before anyone had ever heard of that term.

PIABA was a new organization. We had a few thousand dollars in the bank from the $50 in dues we charged. Disney World wanted a personal guarantee on the contract. Boyd signed it without hesitation, guaranteeing them fifty hotel rooms for a long weekend.

Ninety five people showed up. The room was packed. When it was over, I watched Boyd write out the biggest check I had ever seen, and with a big sigh of relief we handed it to Disney. The meeting was a huge success. PIABA was established.

For the first time, attorneys for investors were collaborating. The more amazing part is that we still are. Not just once a year, but every day. PIABA held its 22nd Annual Meeting in 2013. It was't quite the same without him. But none of it would even "be" without Boyd's courage and leadership.

Within a year of that first Annual Meeting, PIABA had several hundred members. During that time, PIABA's official address (pre-Robin) was at Boyd's firm. When we were big enough to need a part-time secretary to run the organization, Boyd gave us his secretary (but continued to pay her salary).

It took a few years after that for PIABA to command attention and be recognized by the NASD as a voice for aggrieved investors. That was mostly because of Boyd. He became PIABA's 3rd President. He got a seat on the NASD's National Arbitration Committee (now known as the "NAMC"), our first representative. In 1994, when the SEC created a Task Force to study securities arbitration (the so-called "Ruder Commission"), Boyd was again our representative. The Task Force consisted of powerful people like Steve Hammerman (General Counsel and Vice-Chair of Merrill Lynch), Richard Speidel (Law Professor and author of the leading five-volume treatise on federal arbitration law), John Bachman (the head of Edward D. Jones and Chairman of the SIA) and Linda Fienberg (she was David Ruder's counsel when he was Chair of the SEC, and was a partner at Covington & Burling at the time). Boyd was the sole investor-side person.

The recommendations of the Task Force shook the ground. The prohibition on arbitrators awarding punitive damages and attorneys fees would soon fall. The eligibility rule would be emasculated. Administrative appointment of arbitrators was replaced with a rotational system. And we had a seat at the table.

In those days, the Board met once a year. How I looked forward to those meetings. The Board members were giants, and I loved them all, but the chance to spend time with Boyd was always the highlight for me. There was, of course, the usual sharing of information, war-stories and trial techniques. But we were also developing policy and strategies for something important – turning PIABA into an organization that would be "the" voice for investors in arbitrations. It wasn't easy – a bunch of small-firm "trial lawyers" fighting a powerful industry and its trade association. It would not have happened without him.

Of course, Boyd had interests beyond his profession. Some time around 2000, I was in Atlanta for a case. The next day, Boyd and I were to play golf, but there was one thing that Boyd said we needed to do first. His son Jay (who was about 8) was playing in a Little League game. I tried to get out of it. But he we said had to go – or no golf. Twelve years later, we were working on a case together in Boca. It was after a day of work, during a good dinner, with a big mediation the next day. Boyd kept stepping out to make phone calls. I asked him why. Jay, who was by then starting for Emory University, was playing. He kept calling to find out how the game was going.

Silver-tongued and bigger than life, Boyd commanded everyone's attention. Whether it was a presentation at a PIABA meeting, a tense session with industry representatives and FINRA executives or a summation at an arbitration, you hung on every word. He would start with a "well, ya know...," or a "it's kinda like this..., " talking much too slowly for a New Yorker like me. But there was always something important in whatever message he would deliver. How I will miss it.

As many of us can attest, and as one friend already wrote me, he changed my life, and that of so many others. It is not an overstatement to say that the world is a safer place for investors because of his dedication and the work he did. As Dave Robbins said, "there was only one Boyd; he was like Madonna - there's no need for a last name. In our little corner of the world, you just refer to 'Boyd,' and everyone knows who you're talking about."

I think it will be that way for a long time.