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Public Investors Arbitration Bar Association Report
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Misleading Ads Fuel Confusion,
Underscore Need for Fiduciary Standard

Joseph C. Peiffer and Christine Lazaro

Executive Summary

No national standard exists today requiring brokerage firms to put their clients' interests first by avoiding making profits from conflicted advice. In the five years since the passage of the Dodd Frank Act, inaction by the Securities and Exchange Commission (SEC) on a fiduciary standard has cost American investors nearly $80 billion, based on estimated losses of $17 billion per year.

Amid encouraging recent signs of possible action from the Department of Labor and the SEC, there is a compelling case to be made for a ban on conflicted advice in order to protect investors. In the absence of such a standard, brokerage firms now engage in advertising that is clearly calculated to leave the false impression with investors that stockbrokers take the same fiduciary care as a doctor or a lawyer. But, while brokerage firms advertise as though they are trusted guardians of their clients' best interests, they arbitrate any resulting disputes as though they are used car salesmen.

A review by the Public Investors Arbitration Bar Association (PIABA) of the advertising and arbitration stances of nine major brokerage firms – Merrill Lynch, Fidelity Investments, Ameriprise, Wells Fargo, Morgan Stanley, Allstate Financial, UBS, Berthel Fisher, and Charles Schwab – finds that all nine advertise in a fashion that is designed to lull investors into the belief that they are being offered the services of a fiduciary.

For example, Merrill Lynch advertises as follows: "It's time for a financial strategy that puts your needs and priorities front and center." Fidelity Investments appeals to investors with these words: "Acting in good faith and taking pride in getting things just right. The personal commitment each of us makes to go the extra mile for our customers and put their interests before our own is a big part of what has always made Fidelity a special place to work and do business."

Nonetheless, all nine brokerage firms using the fiduciary-like appeals in their ads eschew any such responsibility when it comes to battling investor claims in arbitration. Adding to the confusion is the fact that five of the eight

brokerage firms – Ameriprise, Merrill Lynch, Fidelity, Wells Fargo, and Charles Schwab – have publicly stated that they support a fiduciary standard. But these firms are every bit as vociferous as the other four brokerages in denying that they have any fiduciary obligation when push comes to shove in an arbitration case filed by investors who have lost some or all of their nest egg due to conflicted advice.

In this atmosphere of misleading advertising and a complete disavowal by brokerage firms of the same ad claims in arbitration, investor losses will continue to mount at the rate of nearly $20 billion per year until the SEC and DOL prescribe the long-overdue remedy: a "fiduciary duty" standard banning conflicted advice.

Introduction

Currently, there is no national standard requiring brokerage firms to put investors' interest in preserving their nest eggs over brokerage firms' interest in making money from those investors' accounts. According to a recent study, every year that goes by without a rule that requires brokers to put investors' interests first costs American investors another $17 billion.[1] Dodd- Frank, passed five years ago, mandated that the Securities & Exchange Commission (the "SEC") study this issue. During the course of the last five years without a SEC rule, inaction on the issue has cost investors nearly $80 billion.[2]

The problem continues to grow worse as more and more Americans lose their defined benefit plans and, instead, roll their life savings into IRAs,[3] which they must invest for their future. A critical component of the problem is the brokerage industry's marketing efforts to convince investors they absolutely require the assistance of brokers to protect their retirement savings. The Public

1. *See* "The Effects of Conflicted Investment Advice on Retirement Savings," February 2015, available at http://www.whitehouse.gov/sites/default/files/docs/cea_ coi_report _final.pdf.

2. *See id.* $17 billion times 4.6 years since the passage of Dodd-Frank equals $79.22 billion.

3. Beginning in the 1970s and continuing through the end of 2013, the number of Americans covered by a traditional pension plan was cut in half while the number of Americans depending on 401(k)s and IRAs more than doubled. *See* "The Effects of Conflicted Investment Advice on Retirement Savings," February 2015, p.5 available at http://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

Investors Arbitration Bar Association ("PIABA")[4] has a conducted a study to determine whether brokerage firms advertise like they have a duty to put investors interests first, but when called to account for their actions, litigate like they have no such duty.

The results are striking. Firms routinely advertise themselves as giving personalized, ongoing, non-conflicted advice that puts the customer first. Brokerage firms have also taken the position publicly with the regulators that such a duty should exist. But, when called to account for their actions, these same brokerage firms litigate like they have no such duty. This highlights the need for a national, strong fiduciary duty that holds firms to the standard they advertise to the public and articulate to the regulators.

The lack of a national fiduciary standard is not just an abstract philosophical question. The lack of such a standard has real-world implications for investors, like Ethel Sprouse. Ms. Sprouse is a baby boomer from Cedar Bluff, Alabama. Her husband suffers from Alzheimer's disease. Her adult daughter is mentally disabled and lives in a group home. Ms. Sprouse and her husband are unsophisticated investors and, like most, entrusted their retirement savings to a trusted financial adviser, who in the Sprouses' case was a registered representative of Allstate Financial ("Allstate"). As her husband's mental capacity and daughter's health diminished, the financial strain on the family increased and Ms. Sprouse's reliance on Allstate to provide her with sound financial advice grew even more crucial. In 2007, the Sprouses transferred all of their life savings to Allstate so that it could be managed by one trusted firm. In short, Allstate used the trust placed in them and invested virtually all of the Sprouses' nest egg into a non-diversified portfolio of stocks, which objectively is very risky and unsuitable for most investors. As a result, Mr. and Mrs. Sprouse lost approximately $400,000 and the Sprouses sued Allstate in arbitration[5] to recover their losses. The arbitration case is currently pending.

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4. PIABA is a national, not-for-profit bar association comprised of more than 450 attorneys, including law school professors and former regulators, who devote a significant portion of their practice to the representation of public investors in securities arbitration.

5. Allstate included a pre-dispute mandatory arbitration clause in its brokerage agreement with Mr. and Mrs. Sprouse. As result, the Sprouses are unable to seek the help of a court or a jury of their peers, but rather, had no choice other than to file an arbitration administrated by the Financial Industry Regulatory Authority (which is owned by the very brokerage firms customers such as the Sprouses sue) to seek a recovery of their losses.

For decades, Allstate's marketing success has been based on the principle that they put their clients' interest first. The "You're In Good Hands" slogan is one of the most prolific in U.S. history. Indeed, while the Sprouses' retirement savings were invested with Allstate, every monthly account statement contained the "Good Hands" recognizable symbol and phrase of trust. However, as illustrated below, when sued, Allstate's legal position is it owed no fiduciary duty to the Sprouses. This report will first review the current landscape of the differing standards of duty that apply to brokerage firms and investment advisors and the SEC and Department of Labor's (DOL) efforts to harmonize those duties. The report then discusses a number of firms' public positions and advertisements regarding their commitment to act in investors' best interest contrasted with their litigation strategy of denying that any such duty exists. The report concludes that the SEC and DOL should hold brokerage firms to their public statements and remove all doubt that brokerage firms must put investors' interest first.

The Current Landscape: Investment Adviser and Broker Duties

Investment advice is provided to investors by two different types of financial advisors:

Investment Advisers and Brokers. Each is subject to different regulatory regimes, although there is some overlap in those who enforce the regulations. Investment Advisers are subject to the Investment Advisers Act of 1940 (the "Advisers Act") and the rules promulgated thereunder as well as state statutes and regulations. The SEC and the state securities regulators enforce those statutes and regulations. Brokers are governed by the Securities Exchange Act of 1934 (the "Exchange Act") and the rules promulgated thereunder as well as by state statutes and regulations. In addition, Brokers are regulated by the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization and are subject to the rules promulgated by FINRA.[6]

Investment Advisers must adhere to a fiduciary duty standard, which is derived from judicial interpretations of the Advisers Act. The fiduciary duty is generally defined by case law to include the duty of loyalty and care, and the obligation to always put the client's interests before and above the Investment Advisor's own interests when the Advisor interacts with a client. Brokers, instead of a fiduciary standard, must adhere to a suitability standard which is

6. Both brokers and investment advisers are subject to the various states' common law regarding the imposition of fiduciary duty. The patchwork of inconsistent state laws on the subject only serves to highlight the critical need for a national standard.

premised on a FINRA rule that requires a Broker to have a reasonable basis for believing a recommendation of a security or an investment strategy is "suitable" for a client, based on the client's investment profile.

Although both Investment Advisers and Brokers are regulated extensively, the differences in these regulatory regimes lead to different results for investors. Investors generally are not aware of these differences or their legal implications. Many investors are also confused by the different standards of care that apply to Investment Advisers and Brokers, and many do not even know with which type of investment professional with whom they are doing business. Investors believe their financial advisor, be the title "broker" or "investment adviser," is acting in their best interest. That confusion has been a source of concern for regulators and Congress. Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") required the SEC to conduct a study to evaluate:

- The effectiveness of existing legal or regulatory standards of care (imposed by the Commission, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers; and
- Whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.[7]

Proposed Changes

In January 2011, the Staff of the SEC issued its report to Congress following the study it conducted pursuant to section 913 of Dodd-Frank. The Staff made the following recommendation:

> The Commission should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

7. *See* "Study on Investment Advisers and Broker-Dealers," Executive Summary, p. i, January 2011, available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interests of the customer without regard to the financial or other interests of the broker, dealer, or investment adviser providing the advice.[8]

The Staff interpreted this uniform fiduciary standard to encompass the duties of loyalty and care as interpreted and developed under the Advisers Act Sections 206(1) and 206(2).[9]

Between 2011 and 2013, the SEC did not issue any rules in furtherance of the Staff's recommendations. Instead, in March 2013, two years after the staff recommendation, the SEC sought further data and other information, noting it had not yet decided whether to commence rulemaking.[10]

SEC Commissioner Perspectives

PIABA believes that the SEC should commence rule-making immediately, clarifying the existence and extent of the fiduciary duty and thereby holding brokerage firms to the standards of conduct they advertise to the public. Commissioners White and Aguilar have both expressed support for rulemaking that would stop brokerage firms from marketing like they have a duty to put investors first and litigating like no such duty exists.[11]

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8. *See* "Study on Investment Advisers and Broker-Dealers," pp. 109–10, January 2011, available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

9. *See id.* at p. 111.

10. *See* "Duties of Brokers, Dealers, and Investment Advisers," SEC Release No. 34069013, p. 9, available at http://www.sec.gov/rules/other/2013/34-69013.pdf.

11. Chairman White has recently expressed her view on the subject. She recently stated that the SEC should "implement a uniform fiduciary duty for broker-dealers and investment advisers where the standard is to act in the best interest of the investor." http://www.bloomberg.com/news/articles/2015-03-17/sec-will-develop-fiduciary-duty-rule-forbrokers-white-says

Commissioner Aguilar has been strongly in support of adoption of a fiduciary duty for Brokers: "I am issuing this statement to be clear as to my position — it is in the best interests of investors and our markets for broker-dealers who provide investment advice to be held to the fiduciary standard that is currently applied to investment advisers." Statement by SEC Commissioner: Statement in Support of Extending a

Commissioner Stein has not clearly articulated her stance on a uniform fiduciary rule, but has expressed support for aligning the interests of brokers and investors, which underlies a part of a uniform fiduciary rule.[12] Commissioners Gallagher and Piwowar have both stated that they believe more study is necessary.[13]

The Department of Labor Action

The Department of Labor has examined the role Brokers and Investment Advisers play in the management of retirement accounts. In 2010, the DOL proposed a rule under ERISA broadly defining the circumstances under which a person is considered to be a ''fiduciary'' by reason of giving investment

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Fiduciary Duty to Broker-Dealers who Provide Investment Advice, May 11, 2010, available at http://www.sec.gov/news/speech/2010/spch051110 laa.htm.

12. Commissioner Stein explained her position as follows:

> No doubt, disclosure remains the heart of our investor protection regime. But we also know from experience that sometimes it isn't enough – or to put it another way, that it works better under some conditions than others. What are the conditions under which it works best? Basically, where we have done everything we can to align those interests that should naturally be aligned. When interests are aligned, there are fewer incentives to play games, and better results for ordinary investors, who can make straight-forward, smart decisions… On the market participant side, we have professional standards and rules to ensure that investment advisers' and broker-dealers' interests are appropriately aligned – or at least, not misaligned – with the investors they serve… Are our rules in all of these areas perfect? No. Is there a lot to be done and improved? Absolutely. For example, the Commission is in the midst of considering how to better align the interests of broker-dealers with the investors they serve. It's an important area, and I'm looking forward to seeing progress made.

Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference, December 4, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543593434#.VO5nGfnF8Yk.

13. *See* Remarks at the 2014 SRO Outreach Conference, September 16, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370542969623#.VO5lkPnF8Yk; Remarks at the National Association of Plan Advisors D.C. Fly-In Forum, September 30, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543077131#.VO5pJfnF8Yk.

advice to an employee benefit plan or a plan's participants.[14] The DOL encountered fierce industry opposition from the very brokerage firms that advertise their personalized service, received extensive comments on the rule proposal, and withdrew the proposal in order to conduct further analysis.[15]

The DOL is in the process of reintroducing the rule proposal to require that those providing retirement investment advice act in the best interest of investors.[16] The DOL cited to a study by the White House Council of Economic Advisers to explain the harms faced by investors as a result of conflicted investment advice:

> Based on extensive review of independent research, the White House Council of Economic Advisers (CEA) has concluded that conflicted advice causes affected savers to earn returns that are roughly 1 percentage point lower each year (for example, a 5 percent return absent conflicts would become a 6 percent return). As a result, a retiree who receives conflicted advice when rolling over a 401(k) balance to an IRA at retirement will lose an estimated 12 percent of the value of his or her savings if drawn down over 30 years. If a retiree receiving conflicted advice takes withdrawals at the rate possible absent conflicted advice, his or her savings would run out more than 5 years earlier. Since conflicted advice affects an estimated $1.7 trillion of IRA assets, the aggregate annual cost of conflicted advice is about $17 billion each year.[17]

The DOL has submitted the rule proposal to the OMB's Office of Information and Regulatory Affairs ("OIRA") for a standard interagency review, after which it will publish a "Notice of Proposed Rulemaking" ("NPRM").

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14. *See* "Definition of the Term ''Fiduciary''," 29 CFR Part 2510, available at http://webapps.dol.gov/Federal Register/PdfDisplay.aspx?DocId=24328.

15. *See* Department of Labor, "FAQs: Conflicts of Interest Rulemaking," available at http://www.dol.gov/featured/ ProtectYourSavings/faqs.htm.

16. *See* Department of Labor, "FAQs: Conflicts of Interest Rulemaking," available at http://www.dol.gov/featured/ ProtectYourSavings/faqs.htm.

17. *See* Department of Labor, "FAQs: Conflicts of Interest Rulemaking," available at http://www.dol.gov/featured /ProtectYourSavings/faqs.htm. *See also* "The Effects of Conflicted Investment Advice on Retirement Savings," February 2015, available at http://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

Brokerage Firms Advertise Like They Offer Ongoing Personalized Service That Puts the Investor First, But Deny Any Such Duty When Called To Account For Their Actions

There is a striking difference between the positions brokerage firms take when soliciting customers and those they take when those customers arbitrate claims against the same firms. Set forth below are various firms' proclamations to the public set forth in advertisements contrasted with those firms' arguments set forth to FINRA arbitrators. On one hand, the firms boast that they offer unconflicted, trustworthy advice while, on the other hand, those same firms argue they are little more than salesmen with a single duty: to execute trades in customers' accounts.

ALLSTATE

Allstate Tells The Public That Investors are "In Good Hands."

The Allstate slogan "You're in good hands" was created a half century ago by Allstate Insurance Company's sales executive David Ellis to demonstrate Allstate's ongoing commitment to customers. The phrase came to him as the result of a reassuring remark made to his wife during the Spring of 1950 about their ailing child. She told him, "The hospital said not to worry. We're in good hands with the doctor." A study announced in September 2000 by Northwestern University's Medill Graduate Department of Integrated

Marketing Communications found that the Allstate slogan "You're in good hands" ranked as the most recognizable in America.[18]

Ethel Sprouse trusted Allstate and its financial adviser. She believed that they were required to put her interests first. Indeed, while Allstate managed the Sprouses' retirement savings, every monthly account statement contained the above illustrated recognizable symbol and phrase of trust.

Allstate Tells Arbitrators That Good Hands Owe No Fiduciary Duty

Notwithstanding Allstate's famous slogan, when Ms. Sprouse sued Allstate in FINRA arbitration after her trusted Allstate financial advisor breached their trust relationship and lost approximately $400,000 of the Sprouses' life savings, Allstate raised the defense that "Állstate Financial Services owed no fiduciary duty to Claimants, and, therefore, no such duty was breached."[19]

UBS

UBS Tells The Public That the Client Comes First

"Until my client knows she comes first. Until I understand what drives her. And what slows her down. Until I know what makes her leap out of bed in the morning. And what keeps her awake at night. Until she understands that I'm always thinking about her investment. (Even if she isn't.) Not at the office. But at the opera. At a barbecue. In a traffic jam. Until her ambitions feel like my ambitions. Until then. We will not rest. UBS." (Emphasis in advertisement.)[20]

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18. *See* http://www.adslogans.co.uk/site/pages/gallery/youre-in-good-hands-with-allstate.8355.php.

19. *See* Ex. 1. Also included in the exhibit is a copy of the Sprouses' Statement of Claim that served as the basis for the Answer.

20. *See* Ex. 2.

UBS Tells Regulators That The Client Does Not Come First

UBS, like many other firms, ignores the representations in its advertising when it is forced to defend its actions. "[A] broker does not owe a fiduciary duty to his customer in a nondiscretionary account."[21]

Morgan Stanley Tells The Public That It Provides a Personalized Plan

"Having an intimate knowledge of blue chips and small caps is important. But even more important is an intimate knowledge of you and your goals. Get connected to a Morgan Stanley Financial Advisor and get a more personalized plan for achieving success."[22] Morgan Stanley Tells Arbitrators That Its Personalized Plans Can Put The Firm's Interests Ahead of Clients' Despite representing that personalized plans would be used, Morgan Stanley says it will only have a fiduciary duty when the service goes beyond the plan and includes Morgan Stanley taking over the trading in an account on a discretionary basis. "There is no fiduciary duty where, as here, the client maintains a non-discretionary brokerage account."[23]

"Claimants claim of breach of fiduciary duty fails as a matter of law and should be dismissed in its entirety. Claimant's claim seeks to impose 'fiduciary' obligations and duties on Respondents that only arise in very limited circumstances that do not exist here, i.e. where Respondents are given discretionary trading authority over Claimant's accounts."[24]

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21. *See* Ex. 3.

22. *See* Ex. 4.

23. *See* Ex. 5.

24. *See* Ex. 6.

BERTHEL FISHER

Berthel Fisher Tells The Public That It Maintains the "Highest Standard of Integrity."

"We are committed to maintaining the highest standards of integrity and professionalism in our relationship with you, our client. We endeavor to know and understand your financial situation and provide you with only the highest quality information and services to help you reach your goals."[25]

Berthel Fisher Tells Arbitrators That the "Highest Standard of Integrity" Does Not Include a Duty to Put Investors First

While "highest standard of integrity" certainly sounds like a representation that a clients' interests will be put first, Berthel Fisher says it does not owe a fiduciary duty to clients. "Respondents deny that they owed fiduciary duties to Claimants."[26]

AMERIPRISE FINANCIAL

Ameriprise Financial Tells The Public That Its Advisors are Ethically Obligated To Act With Your Best Interests At Heart."

"Focus on your dreams and goals

"Once you've identified your dreams and goals, and you and the advisor have decided to work together, you can count on sound recommendations that address your goals. You'll be able to clearly see and discuss how the actions and decisions you make today will affect your tomorrow. You can expect to hear about the options you have and any underlying factors to consider. Our advisors are ethically obligated to act with your best interests at heart."[27]

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25. *See* http://www.kevinyaley.com/!CustomPage.cfm?PageID=1&disclaimer=accept.

26. *See* Ex. 7.

27. From the Ameriprise Financial website, Our Advisors, "What to expect from an Ameriprise financial advisor," http://www.ameriprise.com/financial-planning/

"Personalized advice and recommendations on an ongoing basis

"Perhaps the best thing about working with a personal financial advisor is that your financial plan is custom made for you. The financial advisor you choose to work with knows all about you. When and if you experience a life change, your priorities shift or you have a pressing financial question, you can contact your advisor for information and financial advice that's meaningful to you. You may meet a few times during a year and have several discussions. Your advisor will make every effort to be available to you when needed."[28]

Ameriprise Financial Tells Regulators That It Advocates For A Uniform Fiduciary Duty

Ameriprise has publicly told the SEC that it supports the imposition of a fiduciary duty on brokers, such as Ameriprise. "Our business has been built on a financial planning model with personalized investment advisory services at its core. Our experience in offering retail advice under the Advisers Act, with its enhanced disclosure requirements and other investor protections, has led us to advocate for a uniform fiduciary standard throughout the recent legislative process and endorse SIFMA's support of a uniform fiduciary standard of conduct for broker-dealers and investment advisers providing personalized advice about securities to retail clients."[29]

Ameriprise Financial Tells Arbitrators That It Doesn't Believe this Duty Exists

Despite is advertising campaign promising to put client interests first and even publicly supporting and acknowledging a belief that a fiduciary duty is required, Ameriprise has nevertheless argued in arbitration it owes no such

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ameriprise-financialadvisors/financial-advisor-expectations.asp, last visited February 25, 2015.

28. From the Ameriprise Financial website, Our Advisors, "What to expect from an Ameriprise financial advisor," http://www.ameriprise.com/financial-planning/ameriprise-financialadvisors/financial-advisor-expectations.asp, last visited February 25, 2015.

29. Ameriprise Financial, Inc. Letter to the SEC dated August 30, 2010, available at http://www.sec.gov/comments/ 4-606/4606-2640.pdf.

duty. "Respondent owed no fiduciary duties to Claimants and, even if it did, no such duties were breached."[30]

MERRILL LYNCH

Merrill Lynch Tells The Public That It Puts Investors "Needs Front and Center"

"It's time for a financial strategy that puts your needs and priorities front and center.

"Adapting the approach as life changes and goals are reached. As goals and priorities change, so should your approach."[32]

"Our organization has all the tools and technology and ease of use that you would want. But ultimately, the real measure is when you sit down with your advisor and build that trusting relationship… and at any time you know exactly where you stand… when you think about progress towards what it is you want to accomplish with your… finances and with your money.

"Our entire company's purpose is to help you achieve the best life for yourself, and for your family. And this purpose, to making life better extends even further to our communities and beyond. We're proud of our company. We want you to be proud of it as well, and for you to value your relationship with us."[33]

30. *See* Ex. 8.

31. [sic] Footnote omitted from original report.

32. From the Merrill Lynch website, Working with Us, "From a Conversation to a Relationship," https://www.ml.com/life-goals.html, last visited February 25, 2015.

33. From the Merrill Lynch website, Working with Us, "From a Conversation to a Relationship," John Thiel, the head of Merrill Lynch Wealth Management, on what makes working with Merrill Lynch so different, https://mlaem.fs.ml.com/content/dam/ML/working-with-us/pdfs/transcriptlife-goals-thiel.pdf, last visited February 25, 2015.

Merrill Lynch[34] Tells Regulators That It Supports A Uniform Fiduciary Duty

"Bank of America supports applying a new, harmonized standard of care to all financial professionals providing personalized investment advice to individual investors. In particular, we believe that both broker-dealers and investment advisers giving personalized investment advice to individual investors should be subject to a fiduciary duty that is clearly prescribed. We further believe that any new fiduciary standard of care should be applied in a manner that both enhances investor protection and preserves the availability of choices for clients. Informed client choice is critical to ensuring that investment objectives are attained.[35]

Merrill Lynch Tells Arbitrators That It Has No Duty to Put Investors "Front and Center"

Despites marketing that clients' interest would be "front and center" and a desire to "build a trusting relationship" as well as publicly supporting the imposition of a fiduciary duty, Merrill Lynch has refused to acknowledge it owes a fiduciary duty in arbitration when it breaches that duty to investors. "The Second Circuit ruled that in a non-discretionary securities account, there is no ongoing duty of reasonable care that requires a brokerage firm to give advice or monitor information beyond the limited transaction-by-transaction duties that are implicated in executing its customer's instructions."[36]

"Respondents did not stand in a fiduciary relationship with Claimants."[37]

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34. Bank of America purchased Merrill Lynch in the fall of 2008 and Merrill Lynch is therefore now a division of Bank of America Corp.

35. Bank of America Corp. Letter to the SEC dated August 30, 2010, available at http://www.sec.gov/comments/4-606/4606-2583.pdf.

36. *See* Ex. 9.

37. *See id.*

FIDELITY INVESTMENTS

Fidelity Investments Tells The Public That It Puts Investors' "Interests Before Our Own"

"Acting in good faith and taking pride in getting things just right. The personal commitment each of us makes to go the extra mile for our customers and put their interests before our own is a big part of what has always made Fidelity a special place to work and do business. With millions relying on us for their savings or the growth of their business, we handle every action and decision with integrity and personal attention to detail. Getting things just right doesn't mean we're perfect, but rather setting high standards, refusing to cut corners, and believing that every product, every experience, and every outcome can always be better."[38]

Fidelity Investments Tells Regulators That It Supports A Uniform Fiduciary Duty

"Fidelity supports a uniform fiduciary duty for broker-dealers and investment advisers that would require broker-dealers and investment advisers to act in the best interest of retail customers when offering personalized investment advice about securities to such retail customers."[39]

Fidelity Tells Arbitrators That It Denies Any Duty To Put Investors' Interests Before Their Own

Even though Fidelity Investments markets that it will put investors' interests before its own and has publicly supported a fiduciary standard for brokerage firms, Fidelity has argued no such duty exists when defending itself in arbitrations with customers. "Claimants first claim fails because Fidelity did not owe [the investors] any fiduciary duty."[40]

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38. From the Fidelity Investments website, About Fidelity, "Our Purpose and Standards," https://www.fidelity.com/about-fidelity/our-purpose-standards, last visited February 25, 2015.

39. Fidelity Investments Letter to the SEC dated July 5, 2013, available at http://www.sec.gov/comments/4-606/4606-3117.pdf.

40. *See* Ex. 10.

WELLS FARGO

Wells Fargo Tells The Public That Investors "Feel that Your Best Interests are the Top Priority"

"Are we working toward common goals? A healthy relationship with your Financial Advisor should make you feel that your best interests are the top priority, no matter what is happening in the market and no matter the size of your portfolio. Furthermore, you should like your advisor, and both you and your advisor should feel that all concerns are heard and addressed."[41]

"Are we sharing information and asking questions? Your financial consultant should provide you with the relevant information needed to help you feel informed about financial events that pertain to your investments. Your Financial Advisor may also answer any questions you might have about your monthly statements. Stay in contact to ensure that your advisor is current on your objectives and can make changes when necessary."[42]

Wells Fargo Tells Regulators That It Supports A Uniform Fiduciary Duty

"Wells Fargo fully supports the adoption of a uniform federal fiduciary duty standard for broker dealers when providing personalized investment advice regarding securities to retail clients. Properly implemented, such a standard will enhance protections for clients, preserve the opportunities for clients to select the level of service and type of relationship they desire, allow clients of all levels of sophistication and resources to be fully served and foster competition in the industry."[43]

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41. From the Wells Fargo Advisors website, Working With a Financial Advisor, "How to Evaluate a Financial Advisor," https://www.wellsfargoadvisors.com/financial-advisor/articles/evaluatefinancial-advisor.htm, last visited February 25, 2015.

42. *See id.*

43. Wells Fargo & Co. Letter to the SEC dated August 30, 2010, available at http://www.sec.gov/comments/4-606/4606-2592.pdf.

Wells Fargo Tells Arbitrators To Forget About Feelings, The Firm Is Not Required to Consider Investors' Interest First

Ignoring that it markets itself as making investors feel their "best interests are the top priority" and that Wells Fargo has even publicly supported the need for a uniform fiduciary duty, in private arbitrations, Wells Fargo has refused to acknowledge owing a fiduciary duty. "The law establishes that a broker does not owe a fiduciary duty to a customer with respect to a nondiscretionary account."[44]

CHARLES SCHWAB

Charles Schwab Tells The Public That Its Brokers Are Proactive

"For many years, we've encouraged investors like you to "Talk to Chuck" so we could help you manage through the array of investing challenges and opportunities. I still encourage you to do that. We'll share with you our passion for investing and our thoughts on how to do it well, and we'll listen to you to understand how we can help you reach your goals. But going forward, you'll be hearing more about the values we stand for and why they might matter to you. Our communications will emphasize the fundamental belief we share with you: a belief that through personal engagement and a relationship of mutual respect, your financial goals and a better tomorrow are within reach."[45]

"Does my broker discuss the risks in my investment portfolio?

"All investors need to understand the various risks in their investment portfolio and their tolerance level for those risks. But, how much and how often do you discuss these risks with your broker? Is your broker proactive about communicating possible risks as things change in the markets, economy or in your personal situation?"[46]

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44. *See* Ex. 11.

45. From the Schwab website, Why Choose Schwab, "An Open Letter from Chuck," http://www.schwab.com/public/file/P-6083252/Chuck_Open_Letter.pdf, last visited February 25, 2015.

46. From the Schwab website, Own Your Tomorrow, "Stay Engaged Questions," http://content.schwab.com/corporate/own-your-tomorrow/#Stay-Engaged-Questions, last visited February 25, 2015.

Charles Schwab Tells Regulators That The Customers' Interests Should Come First

"Given the narrow area of overlap, the Commission should consider a straight-forward rule, simply tracking the language of Dodd-Frank Section 913(g)(1):

> "The standard of conduct" when providing non-discretionary "personalized investment advice about securities to a retail customer" for a commission or other transaction-based compensation is "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.""[47]

Charles Schwab Tells Arbitrators That Customers' Interests Do Not Come First.

Even though Charles Schwab told regulators that personalized investment advice provided in exchange for a commission should require the broker to act in the best interest of a customer without regard to the broker's own financial interest, it takes a very different approach when pleading its case to the arbitrators. "Where a customer maintains a non-discretionary account, a broker-dealer's duties are quite limited. A broker does not, in the ordinary course of business, owe a fiduciary duty to a purchaser of securities."[50]

Why Wouldn't Investors Want A Uniform Fiduciary Rule?

In the above advertisements, brokerage firms consistently acknowledge that investors want, expect and need for brokerage firms to put their interests first. However, when the reality of the imposition of a fiduciary duty is evaluated, broker firms have changed their story and often argued that such a

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47. Charles Schwab & Co., Inc. Letter to the SEC dated July 5, 2013, available at http://www.sec.gov/comments/4-606/4606-3137.pdf.

48. [sic] Footnote omitted from original report.

49. [sic] Footnote omitted from original report.

50. Ex. 12.

duty would actually harm investors. If some representatives of the brokerage industry are to be believed, the imposition of a national fiduciary duty would result in higher costs for investors and a barrier to low-income investors' access to brokerage advice. For example, the National Association of Plan Advisors ("NAPA"), a securities industry advocacy group, claims that a "conflict of interest" rule is really a "no advice" rule. In other words, according to NAPA, prohibiting conflicts of interests would "block Americans from working with the financial advisors and investment providers they trust simply because they offer different financial products – like annuities and mutual funds – with different fees."[51]

NAPA continues: "This rule could even restrict who can help you with your 401(k) rollover." The situation would be particularly dire, according to a 2011 study prepared by Oliver Wyman Inc. in response to the DOL's first attempt to propose a uniform fiduciary standard.[52]

According to the abstract of the report, IRAs are widely held by small investors, who overwhelmingly favor brokerage relationships over advisory ones, and the proposed rule would prohibit 7.2 million current IRAs from receiving investment advice thanks to account minimums.[53]

Further, the study claims that costs for brokerage IRA customers would increase between 75% and 195%.[54]

Actual data, as opposed to the rhetoric and hyperbole, demonstrates that the imposition of a fiduciary duty upon brokers has no meaningful impact on cost to investors or access to investment advice.[55]

In fact, differences in state broker-dealer common law standards of care have been tested to determine whether a relatively stricter fiduciary standard of care affects the ability to provide services to customers, and it was found that there is no statistical difference in the brokers' ability to provide services

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51. "White House Rule Could Block 401(k) Participants from Advice," available at http://asppanews.org/2015/02/23/white-house-rule-could-block-401k-participants-from-advice/

52. The report was submitted to DOL by Davis & Harman LLP on April 12, 2011, on behalf of twelve financial services firms that offer services to retail investors. The cover letter and report can be found at http://www.dol.gov/ebsa/pdf/WymanStudy 041211.pdf.

53. *See id.* at p. 2.

54. *See id.*

55. Finke, Michael S. and Langdon, Thomas Patrick, The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice (March 9, 2012). Available at SSRN: http://ssrn.com/abstract=2019090 or http://dx.doi.org/10.2139/ssrn.2019090.

to higher or lower wealth clients, or their ability to provide a broad range of products including those that provide commissioned compensation. There was also no difference in the ability to provide tailored advice. And, perhaps most cuttingly for the industry's argument – there was no difference in the cost of compliance.

Given that the imposition of a uniform fiduciary rule neither affects access to investment advice nor increases costs, it is clear that the rule stands to benefit investors in a meaningful way by prohibiting conflicted investment advice.

Conclusion

Billions each year slip through the fingers of American investors because of the conflicted investment advice they receive. The SEC and DOL must take action to force brokerage firms to live up to the standard that they market to investors rather than the one brokerage firms argue when they have wronged those same investors. Brokerage firms advertise that they put customers' interests first, offer personalized advice and do all of this on an ongoing basis. In other words, they advertise that they are a fiduciary such as a doctor or lawyer. But, when a dispute arises with investors, brokerage firms consistently argue they have the duties of a used car salesman. SEC and DOL action for a strong, national fiduciary standard is the only way to protect investors' hard-earned retirement savings by holding firms to the image they themselves present.

Notes & Observations

FEE-SHIFTING FOR FRAUDSTERS: WHY CLAIMANTS DON'T HAVE TO AGREE

Adam M. Nicolazzo, Esq. and Robert M. Van De Veire, Esq.

Let's paint the picture: you represent an investor in a FINRA arbitration and have elected not to name their former registered representative. Maybe the broker has filed bankruptcy, works for a different broker-dealer than the one your client is suing, or has left the industry altogether. In any case, the broker likely has valuable documents relating to the events and transactions underlying your client's claims, but you will need a subpoena or an order of production to get them. The panel chairperson has executed your subpoena/order to the former registered representative, but now the broker is demanding to be reimbursed for the costs incurred in having to produce the requested documents.

Should your client have to pay? Should the respondent? Or should the broker have to bear his or her own costs of production? How does the analysis change, if at all, if the broker is no longer affiliated with a FINRA member?

A. What Do The FINRA Rules Say?

The first step in our analysis is to review the applicable FINRA Rules. Production costs for third-party subpoenas/orders in investor cases are controlled by FINRA Rules 12512(g) (Subpoenas) and 12513(g) (Orders), which state, in pertinent part:

> 12512(g): If the arbitrators issue a subpoena to a non-party FINRA member and/or any employee or associated person of a non-party FINRA member at the request of a FINRA member and/or employee or associated person of a FINRA member, the party requesting the subpoena shall pay the reasonable costs of the non-party's appearance and/or production, unless the panel directs otherwise. [1]
>
> 12513(g): Unless the panel directs otherwise, the party requesting the appearance of witnesses by, or the production of documents from, non-parties under this rule shall pay the reasonable costs of the appearance and/or production. [2]

1. FINRA, RULE 12512(g) (2013).
2. FINRA, RULE 12513(g) (2013).

On its face, Rule 12512(g) appears to require fee shifting only when a party FINRA member requests an appearance and/or production of a non-party FINRA member, and does not apply to a public investor claimant.[3] By contrast, Rule 12513(g) appears to require fee shifting when any party (including public investor claimants) requests the appearance of, and/or production of documents from, a non-party FINRA member or the employee or associated person of a FINRA member.[4]

Regulatory Notice 13-04, issued by FINRA to explain the February 2013 amendment to members and investors, provides color and reiterates FINRA's basic belief that a party member firm has the obligation to reimburse a non-party member firm for production costs, whether requested by order or subpoena.

> Amendments to the Subpoena Rule 12512: Under the new rules, if an arbitrator issues a subpoena, the party firm requesting the subpoena shall pay the reasonable costs of the non-party's appearance and/or production, unless the panel directs otherwise.[5]
>
> Amendments to the Order Rule 12513: The rules also provide that unless the panel directs otherwise, the party requesting the appearance of witnesses or the production of documents from non-parties pays the reasonable costs of the appearance and/or production.[6]

Given our hypothetical, because your client is not a FINRA member firm, the fee shifting provision of Rule 12512(g)[7] does not apply. However, regardless of whether the broker is associated with a member or not, your client may be obligated to pay the production costs associated with compliance with orders of production under Rule 12513(g), "unless the panel directs otherwise."[8]

In an absence of any further instruction on the issue from FINRA, and recognizing the limited precedential value of unreasoned arbitration awards, we look to published court decisions concerning cost-shifting in connection with subpoenas for guidance to determine whether or not your panel should deny the broker's request for costs under Rules 12512 or 12513.

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3. FINRA, RULE 12512(g) (2013).

4. FINRA, RULE 12513(g) (2013).

5. FINRA, REGULATORY NOTICE 13-04 (2013) at 3.

6. *Id.* at 4.

7. FINRA, RULE 12512(g) (2013).

8. FINRA, RULE 12513(g) (2013).

B. FINRA's Cost Shifting Rules Differ from Applicable Federal Case Law

Notwithstanding the fee-shifting called for by Rule 12513(g), a customer claimant may argue that it offends common sense to require a public investor party to pay a nonparty broker/associated person for the cost of production of documents. Such cost-shifting may be especially unfair where the documents requested relate to the broker's own bad acts or a course of conduct by a member firm that may have been initiated by the broker. In addition to this fairness argument, practitioners may argue by analogy to federal case law concerning Fed. R. Civ. P. 45 subpoenas that, where brokers/associated persons are involved in the underlying facts and/or have an interest in the outcome of the litigation, they not entitled to fee-shifting.

FINRA's rule mandating shifting of costs in connection with orders of production under Rule 12513, absent a panel order to the contrary, departs from the "American rule" of discovery, that each litigant pays his or her own costs. FINRA's Rule 12513 is also different from the federal rule pertaining to responding to subpoenas. Fed. R. Civ. P. 45(c)(2)(B), amended in 1991, provided that "an order to compel production shall protect any person who is not a party or an officer of a party from significant expense resulting from the inspection and copying commanded."[9]

The 1991 amendment to Rule 45 removed the discretion of the courts to condition the enforcement of subpoenas upon a serving party's payment to a nonparty of costs production—this has now become mandatory.[10]

Despite this, federal courts around the country, beginning with *First Am. Corp*. which noted that the issue was of "first impression," have delineated between true non-parties who must be afforded the protection from "significant expense" incurred by responding to subpoenas, and interested parties who have an interest in the litigation, or were involved in the underlying transaction, and could have anticipated playing a role in the litigation.[11]

The *First Am. Corp.* Court began by determining that the costs sought were recoverable under the amended Rule 45, and then moved to the issue of

9. FED. R. CIV. P. 45(c)(2)(B) (1991) (current version at FED. R. CIV. P. 45(d)(2)(B)(ii) (2013)).

10. *See* First Am. Corp. v. Price Waterhouse LLP, 184 F.R.D. 234, 240 (S.D.N.Y. 1998).

11. *Id.*

the non-party's involvement in the transaction underlying the litigation.[12] The Court determined that the non-party was entitled to the shifting of a small portion of their subpoena production costs, because:

> PW-UK was not the quintessential innocent, disinterested bystander in the DC Action or in the proceedings before this Court. According to FAC, because of the role PW-UK played in the collapse of BCCI, it should have reasonably anticipated being drawn into subsequent litigation resulting from the BCCI fraud, such as the DC Action. Where a nonparty was 'substantially involved in the underlying transaction and could have anticipated that [the failed transaction would] reasonably spawn some litigation,' expenses should not be awarded.[13]

The *First Am. Corp*. Court was also swayed by the fact that the subpoenaed non-party was a party to several other litigations arising from the same transaction at issue in that case, citing precedence that "where the nonparties were 'involved in litigation … arising out of the same facts,' courts have viewed such parties as 'not neutral' for purposes of awarding costs."[14]

In a more recent district court case out of the Second Circuit, the subpoenaed non-party in *Chevron Corp. v. Donziger* claimed that compliance with the subpoena would require 30-40 weeks to complete review and production, and cost more than $1 million.[15] The Court held that the subpoenaed non-party was not entitled to fee shifting for the production because it:

> [I]s no ordinary unrelated non-party witness. It is an alleged co-conspirator and some of its actions are at issue in this case regardless of whether the Subpoena as narrowed is enforced. Moreover, it stands to reap a fee that has been estimated at hundreds of millions of dollars if the Judgment is enforced and collected.[16]

The *Donziger* Court went on to reason that "[w]here a nonparty was substantially involved in the underlying transaction and could have anticipated

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12. *Id.*

13. *Id*. at 242 (internal citation omitted).

14. *Id*. (citing Jackson Jordan Inc. v. Kyle Rys., No. 87-1059-C, 1988 U.S. Dist. LEXIS 19437, at *6, 1988 WL 236172, at *2 (D. Kan. Mar. 23, 1988)).

15. No. 11-Civ-0691 (LAK), 2013 U.S. Dist. LEXIS 36353, at *117-21, 2013 WL 1087236, at *32-33 (S.D.N.Y. Mar. 15, 2013).

16. *Id*. at *117, 2013 U.S. Dist. LEXIS 36353.

that [it] would reasonably spawn some litigation, expenses should not be awarded."[17]

Since *First Am. Corp*., federal courts around the country have consistently applied a three-factor test first set forth in *In re Exxon Valdez*: "[u]nder that case law, it is relevant to inquire [1] whether the putative non-party actually has an interest in the outcome of the case, [2] whether it can more readily bear its costs than the requesting party, and [3] whether the litigation is of public importance."[18]

Courts applying the *Exxon Valdez* test have generally found that various companies and persons who were either (i) interested in the litigation or (ii) involved in the underlying transaction that spawned litigation are not entitled to fee shifting.

i. Interest in the Litigation

Courts have found a non-party's "interest in the litigation" to include situations where the subpoenaed non-party has a financial interest in the litigation or interest in the field that may be affected by the litigation.[19] Actual interest in the litigation need not be proven. For example, the *Bell* Court found

17. *Id*. at *120, 2013 U.S. Dist. LEXIS 36353, (citing *First Am. Corp*.).

18. 142 F.R.D. 380, 383 (D.D.C. 1992) (internal citations omitted).

19. *See, e.g.*, Behrend v. Comcast Corp., 248 F.R.D. 84, 87 (D. Mass. 2008) (despite the fact that Greater Media is no longer directly affiliated with the cable industry, it is clear that Greater Media has an interest in the outcome of this litigation. Greater Media was involved in a transaction with Comcast and could have anticipated such a transaction could potentially spawn litigation or discovery); United States v. McGraw-Hill Cos., 302 F.R.D. 532, 536 n.1 (C.D. Cal. 2014) (finding some fee-shifting to requesting party S&P was likely, given that the strong public interest in determining who held blame for the 2008 financial crisis, the subpoenaed non-parties' interest in the outcome of the lawsuit and the extremely broad discovery requests sought by defendant S&P); Heartland Surgical Specialty Hosp., LLC v. Midwest Div., Inc., No. 05-2164-MLB-DWB, 2007 U.S. Dist. LEXIS 53216, at *25 (D. Kan. 2007) (holding that subpoenaed non-parties, a doctor and his medical group, had a substantial financial interest in a party to the antitrust litigation, and must bear their own expenses in responding to the subpoenas); United States v. Blue Cross Blue Shield of Mich., No. 10-CV-14155, 2012 U.S. Dist. LEXIS 146403 at *10, 2012 WL 4838987, at *4 (E.D. Mich. 2012) (shifting only 15% of subpoena production costs to requesting party because subpoenaed non-parties were hospitals which "ha[d] an interest in the outcome of the [anti-competitive] case").

a non-party to be interested where the party may be involved in future litigation over the same or related facts: "[w]hen a non-party has a potential interest in the underlying litigation, courts have weighed that interest against shifting the costs of production to the requesting party."[20]

ii. Involvement in the Underlying Transaction

Similarly, courts have found non-parties involved in the underlying transaction that spawned litigation were not entitled to an award of costs in various situations.[21] A non-party involved does not necessarily need to be a bad actor; simply having reasonable anticipation of litigation resulting from the underlying act is sufficient.[22]

While some courts have been willing to shift at least a portion of attorneys' fees for subpoenaed non-parties, the *Behrend* Court noted that any attorneys' fees incurred from retaining outside counsel to review the production for privileged materials were for the subpoenaed non-party's interest only and denied the motion for costs, holding that it is "purely [the non-party's] decision

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20. Bell Inc. v. GE Lighting LLC, No. 6:14-cv-00012, 2014 US Dist LEXIS 56170, at *43, 2014 WL 1630754, at *13 (W.D. Va. 2014).

21. *See, e.g.,* Wells Fargo Bank, N.A. v. Konover, 259 F.R.D. 206 (D. Conn. 2009) (interested non-party not entitled to costs for subpoena production when case arose from alleged fraudulent transfer by the subpoenaed nonparty); J.P. Morgan Chase Bank v. Winnick, No. 03-Civ-8535 (GEL), 2006 US Dist. LEXIS 80202, at *3, 2006 WL 3164241, at *2 (S.D.N.Y. 2006) (interested non-party not entitled to subpoena production costs because "[i]t was entirely foreseeable that the purchaser of the debt would bring claims such as those at issue in this lawsuit against defendants, and that defendants would seek discovery concerning those loans that only the [non-party] could provide"); In re Mushroom Direct Purchaser Antitrust Litig., No. 06-0620, 2012 U.S. Dist. LEXIS 12319, 2012 WL 298521 (E.D. Pa. 2012) (reserving judgment as to production costs incurred by subpoenaed non-party who was the exclusive distributor of mushrooms for one of the defendants); *Bell, Inc.* 2014 US Dist. LEXIS 56170, (interested non-party seller of patent that underlies the dispute at bar was entitled to partial shifting of subpoena production costs); In re Seroquel Prods. Liab. Litig, No. 6:06-md-1769-Orl-22DAB, 2007 U.S. Dist. LEXIS 89903, at *11-12, 2007 WL 4287676, at *4-5 (M.D. Fla. 2007) (holding that subpoenaed non-party who researched and designed advertisements was entitled to only partial production cost shifting given the subpoenaed non-party's activities related directly to the requesting party's claims).

22. *Winnick,* 2006 US Dist. LEXIS 80202, at *3.

to make" if it wants to conduct a privilege review despite the greater expense.[23] The *Behrend* Court was swayed by the requesting party's offer to send their own employees to the non-party's office to review documents prior to production.[24]

C. Our Broker Should Not Recover Costs of Production

Looking back at our hypothetical, our broker should not recover costs of production. Our broker is both an "interested" party to the litigation and was involved in the underlying acts that spawned the litigation. Our broker, as a licensed person, certainly has an interest in the preservation of his or her U-4. Also a consideration for our broker is the risk of contingent liability in a claim brought against them by their former firm for indemnification or contribution, in the event your client prevails. Even in the unlikely event that your panel is not convinced that the broker is an "interested party," logic would dictate that they find the broker, upon whose acts your client has premised their claims, to have been involved in the underlying transactions that spawned the litigation.

D. Conclusion

In short, it is highly likely that if your arbitration panel is swayed by the law, it will find persuasive decisions of the federal courts that consistently hold

23. 248 F.R.D. at 87.

24. *Id.* at 85.

that interested non-parties, like our hypothetical broker, are not entitled to cost-shifting for production of documents pursuant to subpoenas[25] in which the non-party holds an interest in the outcome of the case, or was involved in the underlying transaction that spawned the litigation.

25. Practitioners may also wish to move for the arbitrators to issue subpoenas, rather than orders of production, when documents and information are sought from FINRA members and associated persons, as the two devices are fairly interchangeable in these circumstances, and a subpoena under Rule 12512(g) may call for the same production of documents or appearance as an order of production under Rule 12513(g), but triggers no cost shifting when requested by a public customer (whereas an order of production would trigger cost shifting). *But see,* FINRA, FINRA DISPUTE RESOLUTION ARBITRATOR'S GUIDE (2014), at 29, *available at* http://www.finra.org/sites/default/files/Arb%20Guide_FINAL%20%28October%202014%29%20WORD.pdf. ("Only after determining the relevancy of the documents requested [by a subpoena], should arbitrators consider the parties' costs, and by whom such costs will be borne.").

CRAFTING AN ARGUMENT THAT STATUTES OF LIMITATIONS DO NOT APPLY IN ARBITRATION

Jason W. Burge and Lara. K. Richards

With the expansion of arbitration as an alternative forum to resolve disputes, the question of whether statutes of limitations apply in arbitrations has been the subject of much debate. This Article traces the causes of this confusion – from uncertain guidance of arbitral forums to varying interpretations of state statutes – and provides practical tools to litigators who are arguing that statutes of limitations should not apply in arbitration.

I. Determining when Statutes of Limitations Apply in Arbitration

The uncertainty about whether statutes of limitations apply to arbitrations stems from two main factors. First, there is an absence of definitive guidance from arbitral forums regarding their applicability, as virtually none of the leading arbitral forums' procedural rules explicitly state that time limitations apply. Second, there is also a general lack of clarity in state law when parsing the exact language of the statutes themselves, which has led to varying interpretations by courts across the nation. In the absence of a state statute explicitly stating that the time limitations apply to arbitrations (which is the case in three states), or an express contractual provision in the parties' contract to apply them in the arbitral proceeding, parties are often left guessing and arguing about whether statutes of limitations apply to claims brought in arbitration.

A. Arbitral Forums and Statutes of Limitations

Most of the large arbitral forums – AAA, JAMS, and FINRA – do not provide explicit procedural guidelines in their own rules addressing the issue of timeliness as it relates to statutes of limitations. For instance, although AAA's Employment Arbitration Rules and Mediation Procedures do provide that the initiation of arbitration must be "within the time limit established by the applicable statute of limitations," the Commercial Arbitration Rules and

Mediation Procedures do not contain a similar reference.[1] Similarly, the JAMS Comprehensive Arbitration Rules and Procedures also do not explicitly state whether statutes of limitations will apply to disputes filed in their arbitral forum.[2] FINRA only addresses the issue of timeliness with its own six-year eligibility rule, but does not indicate whether state statutes of limitations will also apply to FINRA arbitrations.[3] In fact, only the National Arbitration Forum expressly incorporates reference to statutes of limitations in its code of procedure, stating that "[n]o Claim may be brought after the passage of time which would preclude a Claim regarding the same or similar subject matter being commenced in court."[4]

AAA, JAMS and FINRA also offer conflicting guidance on the applicability of time limitations through their procedural rules governing dispositive motions. Importantly, AAA recently amended its commercial rules to allow for motions to dismiss, including perhaps on issues such as statutes of

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1. *Contrast* AM. ARBITRATION ASS'N, EMPLOYMENT ARBITRATION RULES AND MEDIATION PROCEDURES § 4(b)(i)(1), at 13 (Nov. 1, 2009), *available at* https://www.adr.org/cs/groups/lee/documents/document/dgdf/mda0/~edisp/adrstg_004366.pdf *with* AM. ARBITRATION ASS'N, COMMERCIAL RULES § R-4(c), at 11 (Oct. 1, 2013), *available at* https://www.adr.org/aaa/ShowProperty?nodeId=/UCM/ADRSTG_004103, [hereinafter "AAA Commercial Rules"] which governs the filing requirements for commercial disputes in AAA, and provides: "It is the responsibility of the filing party to ensure that any conditions precedent to the filing of a case are met prior to filing for an arbitration, as well as *any time requirements associated with the filing*. Any dispute regarding whether a condition precedent has been met may be raised to the arbitrator for determination." (emphasis added).

2. *See* JAMS, JAMS COMPREHENSIVE ARBITRATION RULES AND PROCEDURES (2010), *available at* http://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_comprehensive_arbitration_rules-2010.pdf [hereinafter "JAMS Rules"].

3. *See* FINRA, CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES, [hereinafter "Customer Code"], R. 12206, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4112, which governs disputes between customers and FINRA members, and provides: "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this rule."

4. *See* NAT'L ARBITRATION FORUM, CODE OF PROCEDURE R. 10(A), at 16 (Aug. 1, 2008), *available at* http://www.adrforum.com/users/naf/resources/CodeofProcedure2008-print2.pdf.

limitations.[5] JAMS Rule 18 similarly allows arbitrators to entertain dispositive motions and, in informal guidance, has suggested that these motions could address issues surrounding the timeliness of the filing.[6] While AAA and JAMS allow pre-hearing dispositive motions, however, they do not explicitly state whether they will entertain motions to dismiss based on time limitations.

In sharp contrast to the AAA and JAMS arbitral forums, FINRA only allows dispositive motions in three instances: (1) when they are based on failure to meet the six-year eligibility rule under Rules 12206 or 13206; (2) when they are based on a failure to comply with the rules or an arbitration panel's ruling; and (3) when they concern allegations of discovery abuse.[7] Importantly, in 2008, FINRA added Rule 12504 to ensure that dispositive motions, including on potential statutes of limitations issues, would be extremely limited prior to the end of the Claimant's case in chief.[8]

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5. *See AAA Commercial Rules*, *supra* note 1, at 22. ("The arbitrator may allow the filing of and make rulings upon a dispositive motion only if the arbitrator determines that the moving party has shown that the motion is likely to succeed and dispose of or narrow the issues in the case."). For a summary of the rule change, see AM. ARBITRATION ASS'N, SUMMARY OF CHANGES: COMMERCIAL ARBITRATION RULES § 3 (Oct. 1, 2013) *available at* http://images.go.adr.org/Web/AmericanArbitrationAssociation/%7B9ac03162-02f3-4948-98a1-ee2d342bf36a%7D_AAA_CommRules_SummaryChanges_Web.pdf.

6. *See* JAMS, JAMS COMPREHENSIVE ARBITRATION RULES AND PROCEDURES R. 18 (2014), *available at* http://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_comprehensive_arbitration_rules-2014.pdf; JAMS, JAMS RECOMMENDED ARBITRATION DISCOVERY PROTOCOLS FOR DOMESTIC, COMMERCIAL CASES 7 (2010), *available at* http://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_Arbitration_Discovery_Protocols.pdf; JAMS, JAMS CLAUSE WORKBOOK 8 (2011), *available at* http://www.jams adr.com/files/Uploads/Documents/JAMS-Rules/JAMS-ADR-Clauses.pdf ("[D]ispositive motions can sometimes enhance the efficiency of the arbitration process if directed to discrete legal issues, such as statute of limitations or defenses based on clear contractual provisions. In such circumstances, an appropriately framed dispositive motion can eliminate the need for expensive and time consuming discovery.").

7. *See Customer Code*, *supra* note 3, FINRA R. 12504(c)-(e) *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7377; FINRA, CODE OF ARBITRATION PROCEDURE FOR INDUSTRY DISPUTES, FINRA R. 13504(c)-(e) *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7378.

8. Order Approving Proposed Rule Change, Exchange Act Release No. 34-59189, 94 SEC Docket 3205, at 8 (Dec. 31, 2008).

B. Three Instances When Statutes of Limitations Apply in Arbitration

There are generally three circumstances in which statutes of limitations are applicable in an arbitral forum: (1) when the parties expressly incorporate them into their arbitration agreement; (2) when a state statute expressly addresses the issue; and (3) when courts or arbitrators hold that state statutes imply that statutes of limitations are applicable.

The easiest way for parties to ensure that statutes of limitations will apply to a future dispute is to explicitly incorporate a reference in their arbitration agreement that the limitations periods for a particular state, or another agreed-upon time limitation, will apply to the contract.[9]

The second circumstance in which statutes of limitations apply to arbitrations is when state statute expressly provides for this application. A Washington statute explicitly provides that an action that is time-barred in court will also be time-barred in arbitration, while both Georgia and New York provide a mechanism for challenging an arbitration on the basis that the arbitral claims would be time-barred if filed in state or federal court.[10] This action by the state legislatures provides definitive guidance on the interaction between statutes of limitations and arbitration. The final circumstance in which statutes of limitations may apply to arbitrations is when either a court or arbitration panel rules that a state's statutory language provides that the time limitations apply to a dispute in arbitration. In their analysis, courts will parse the language of the statutes in question to examine whether arbitration falls within the parameters of the statutes' scope, which often turns on the interpretation of the

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9. *See, e.g.*, NCR Corp. v. CBS Liquor Control, Inc., 874 F. Supp. 168, 172-73 (S.D. Ohio 1993), *aff'd*, 43 F.3d 1076 (6th Cir. 1995) ("[The parties] could have lawfully incorporated . . . either an express limitation on claims or incorporated a statute of limitations by reference, but they did not do so."); Broom v. Morgan Stanley DW Inc., 236 P.3d 182, 188 (Wash. 2010) ("If desired, parties may agree contractually to the applicability of state statutes of limitations, in which case those limits would be applied by the arbitral panel. But here, no such agreement existed."); Carpenter v. Pomerantz, 634 N.E.2d 587, 589 (Mass. App. Ct. 1994) ("Neither the agreement nor the rules of the American Arbitration Association, made applicable to the agreement by the arbitration clause, provide that a demand for arbitration must be made within any specified time.").

10. GA. CODE ANN. § 9-9-5 (2012); N.Y. C.P.L.R. § 7502(b) (MCKINNEY 2013); WASH. REV. CODE. § 7.04A.090(3) (2013).

term "action."[11] As will be examined in the next section, in the past few years, the State Supreme Courts in Washington and Florida have issued lengthy and considered opinions addressing the applicability of their state's statutes of limitations in arbitration.

II. Analysis by the Washington and Florida Supreme Courts in *Broom* and *Raymond James*

In *Broom v. Morgan Stanley DW Inc.*[12] and *Raymond James Fin. Servs. Inc. v. Phillips*,[13] the State Supreme Courts in Washington and Florida addressed the issue of whether statutes of limitations apply to claims brought in arbitrations. The courts reached opposite results.

A. *Broom v. Morgan Stanley DW (Wash. 2010)*

Three years after the death of their father, Dick Broom, his three children filed a FINRA arbitration against his investment advisor and Morgan Stanley. The children alleged that the investment advisor had breached her various duties by liquidating blue chip stocks and concentrating the account in high

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11. *See, e.g.*, Cameron v. Griffith, 370 S.E. 2d 704, 704 (N.C. Ct. App. 1988) ("[B]y its terms the limitations period stated in [the statute] applies only to an 'action,' which is a 'judicial proceeding' . . . and an arbitration is neither an 'action' nor a 'judicial proceeding,' but a non-judicial, out-of-court proceeding which makes an action or judicial proceeding unnecessary.") (internal citation omitted); Har-Mar, Inc. v. Thorsen & Thorshov, Inc., 218 N.W.2d 751, 754 (Minn. 1974) ("The few Minnesota cases which have attempted a common-law definition of the term 'action' have restricted it to 'the prosecution in a court of justice of some demand or assertion of right by one person against another.' . . . It thus appears that [the statute], both by statutory definition and at common law, was intended to be confined to judicial proceedings.").

12. 236 P.3d 182 (Wash. 2010).

13. 126 So. 3d 186 (Fla. 2013).

tech stocks.[14] Morgan Stanley moved to dismiss most of the claims based on Washington's statute of limitations, and the panel granted the motion.[15]

The children filed suit to vacate the award, and the Washington state courts granted them relief. The Washington Supreme Court examined Washington law on statutes of limitations, and noted that the statutes addressed only the periods during which *actions* can be commenced.[16] The Court concluded that the Washington legislature "chose its statutory language carefully," as the legislature had referred throughout the Washington Arbitration Act to arbitrations variously as "arbitration," "hearing," or "proceeding" and lawsuits as "civil actions," "actions," or "suits."[17] Relying on this textual difference, the Court concluded that "arbitration is not an 'action' subject to state statutes of limitations in these circumstances," and the arbitrators "exceeded their powers by applying statutes of limitations inapplicable to arbitral proceedings."[18] The Court vacated the arbitral award that had dismissed the children's claims.[19]

B. *Raymond James Financial Services, Inc. v. Phillips (Fla. 2013)*

Five customers of a Raymond James' branch manager filed a FINRA arbitration in 2005, alleging that the branch manager breached his duties to them by concentrating their investments in tech stocks.[20] Raymond James moved to dismiss the claims on the basis that they were time-barred by Florida's statute of limitations, and the panel scheduled a hearing on the

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14. *Broom*, 236 P.3d at 183 ("Blindheim liquidated Broom's blue chip stocks and purchased high tech stocks. After these purchases, Broom's account decreased in value by 25 percent.").

15. Broom v. Morgan Stanley DW Inc., NASD Case No. 05-05019 (July 12, 2006), http://finraawardsonline.finra.org/viewdocument.aspx?DocNB=24906.

16. *Broom*, 236 P.3d at 188. WASH. REV. CODE § 4.16.005 (2013) provides "Except as otherwise provided in this chapter, and except when in special cases a different limitation is prescribed by a statute not contained in this chapter, actions can only be commenced within the periods provided in this chapter after the cause of action has accrued."

17. *Broom*, 236 P.3d at 188.

18. *Id.*

19. *See* Broom v. Morgan Stanley DW, Inc., 146 Wash. App. 1043 (Wash. Ct. App. September 2, 2008).

20. Raymond James Fin Servs., Inc. v. Phillips, 126 So. 3d 186, 189 (Fla. 2013).

motion to dismiss. Before the hearing could be heard, however, the investors filed an action in state court, seeking a declaration that statute of limitations do not apply in arbitration.[21]

The trial court agreed with the investors, on the grounds that the Florida Supreme Court's decision in *Miele v. Prudential-Bache Sec., Inc.* had previously resolved that arbitration was not a "civil action."[22] The intermediate appellate court disagreed that *Miele* was controlling, because the statute of limitations applied to any "civil action or proceeding."[23] Nonetheless, the intermediate court ruled in favor of the investors, concluding that Florida statutes of limitations do not apply in arbitration because there was no "clear indication of legislative intent" to apply statutes of limitations to arbitration proceedings.[24] The intermediate court also certified a question of "great public importance to the Florida Supreme Court: "Does [Florida's statute of limitations] apply to arbitration when the parties have not expressly included a provision in their arbitration agreement stating that it is applicable?"[25]

The Florida Supreme Court answered that question in the affirmative, reversing the intermediate court and finding that Florida's statute of limitations does apply to claims brought in arbitration.[26] The court focused on the specific text of the Florida statute, which applied to "a civil action or proceeding."[27]

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21. *Id.*

22. *Id.* The trial court relied on the Florida Supreme Court's ruling in *Miele v. Prudential-Bache Sec., Inc.*, 656 So. 2d 470 (Fla. 1995). In *Miele*, the court considered whether a Florida law requiring that an award of punitive damages had to be split between the plaintiff and Florida's General Revenue Fund applied to an arbitral award. *See* FLA. STAT. § 768.73 (1991). The Court concluded that since the statute applied only to a "civil action," the statute did not apply to arbitration, which was not a "civil action" under Florida law. *Miele,* 656 So. 2d at 473.

23. Raymond James Fin. Servs., Inc. v. Phillips, 110 So. 3d 908, 911-12 (Fla. Dist. Ct. App. 2011). FLA. STAT. § 95.011 (2013) provides "A civil action or proceeding, called 'action' in this chapter … shall be barred unless begun within the time prescribed in this chapter or, if a different time is prescribed elsewhere in these statutes, within the time prescribed elsewhere."

24. *Raymond James*, 110 So. 3d at 913.

25. *Id.* at 914.

26. Raymond James Fin. Servs., Inc. v. Phillips, 126 So. 3d 186 (Fla. 2013).

27. *Id.* at 190. *See* FLA. STAT. § 95.011 (2013) (clarifying that Florida's statutes of limitation apply to any "civil action or proceeding, called 'action' in this chapter.").

The court looked to dictionary definitions of "proceeding" and "common usage of the term," concluding that proceeding included arbitration.[28] The court also looked at "related statutory provisions," and noted that the Florida legislature referred to arbitration as an "arbitration proceeding" in various provisions.[29] Turning to legislative history, the court noted that the legislature had in 1974 amended the statute of limitations to apply to a "civil action or proceeding" rather than a "suit," suggesting an intent to expand the application of statutes of limitations.[30] Finally, the court noted that the purpose of the statute of limitations – "to discourage stale claims" – would be frustrated if statutes of limitations did not apply in arbitration.[31] Finding that statutes of limitations do apply, the court quashed the intermediate court's decision.[32]

C. Comparing *Broom* and *Raymond James*

In considering how to harmonize *Broom* and *Raymond James* for application in other states, it is important to emphasize the grounds that distinguish them. Notably, the facts of the disputes underlying both cases are nearly identical. Both involved FINRA arbitrations filed by investors who complained that their accounts had been overly concentrated in tech stocks. These investors brought many of the same claims.[33]

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28. *Raymond James*, 126 So. 3d at 190-91.

29. *Id.* at 191-192. Ironically, the Court also considered Florida law that forbids the shortening of any statute of limitations by contract, and expressed concern that if an arbitration were not a proceeding, plaintiffs would lose the protection of this law because an arbitration agreement "could circumvent section 95.03 and actually *shorten* the applicable statute of limitations." *Id.* at 191 (emphasis in original).

30. *Id.* at 192.

31. *Id.* at 192-93.

32. *Id.* at 193.

33. *Compare* Broom v. Morgan Stanley DW Inc., 236 P.3d 182, 183 (Wash. 2010) (investors alleged "negligence, failure to make suitable investment recommendations, violation of state and federal securities law, breach of fiduciary duty, misrepresentation and omissions, failure to supervise, breach of contract, and violation of Washington's Consumer Protection Act (CPA), chapter 19.86 RCW.") *with* Raymond James Fin. Servs., Inc. v. Phillips, 126 So. 3d 186, 189 (Fla. 2013) (investors alleged "federal securities violations and violations of chapter 517, Florida Statutes, which governs Florida securities transactions, and asserted that Raymond James negligently failed to supervise Vandenberg").

The prior case law in Washington and Florida appeared very similar. The Florida court in *Miele* had previously held that an arbitration was not an action for the purpose of applying laws regulating the award of punitive damages.[34] Washington courts had likewise previously held that an arbitration was not an action in interpreting the state's claim filing rules.[35] At the time the arbitrations in *Broom* and *Raymond James* were filed, there was little evidence in the existing case law that time limitations were likely to apply differently in the two arbitrations.

The main distinction between the *Broom* and *Raymond James* decisions concerns the language of the Washington and Florida statutes at issue. Both courts emphasized that the question was one of statutory interpretation, and that the precise language of the statute was important.[36] The Washington statute provided that statutes of limitations apply to "actions."[37] The Florida statute provided that statutes of limitations apply to a "civil action or proceeding."[38] Thus, the inclusion of the word "proceeding" in the Florida statute is the primary distinction between the two statutes, and it appeared to make the crucial difference between the Florida and Washington decisions.

Additionally, although the courts did not specifically base their rulings on the parties' contracts, it is an interesting backdrop to the decisions that the *Raymond James* agreement specifically mentioned statutes of limitations, while the Morgan Stanley agreement did not. Before deciding that

34. Miele v. Prudential-Bache Sec., Inc., 656 So. 2d 470, 473 (Fla. 1995).

35. Thorgaard Plumbing & Heating Co. v. Cnty. Of King, 426 P.2d 828, 832 (Wash. 1967); *see also* City of Auburn v. King Cnty., 788 P.2d 534, 536 (Wash. 1990) (holding, with no analysis, that "The trial court correctly concluded that the statute of limitations by its language does not apply to arbitration.").

36. *See* Raymond James Fin. Servs., Inc. v. Phillips, 126 So. 3d 186, 190 (Fla. 2013) ("Questions of statutory interpretation are reviewed by this Court de novo. The primary rule of statutory construction is to give effect to legislative intent, which is the polestar that guides the court in statutory construction. In answering a statutory interpretation question, this Court must begin with the actual language used in the statute because legislative intent is determined first and foremost from the statute's text. The starting point of our analysis thus begins with the actual language of the statute.") (internal citations and quotations omitted); Broom v. Morgan Stanley DW Inc., 236 P.3d 182, 188 (Wash. 2010) ("[I]n the arbitration statute before us, the legislature chose its statutory language carefully to distinguish between arbitrations and judicial proceedings.").

37. WASH. REV. CODE. § 4.16.005 (2013).

38. FLA. STAT. § 95.011 (2013).

Washington's statutes of limitations do not apply to arbitrations, the Washington Supreme Court noted that "the parties did not explicitly state in their agreement that claims would be subject to Washington State statutes of limitations."[39] The Washington court's decision was expressly limited to contracts without "such an indication" of the parties' intent.[40] By comparison, the Florida Supreme Court outlined the reference to statute of limitations in the Raymond James contract:

> (d) Nothing in this agreement shall be deemed to limit or waive the application of any relevant state or federal statute of limitation, repose or other time bar. Any claim made by either party to this agreement which is time barred for any reason shall not be eligible for arbitration. The determination of whether any such claim was timely filed shall be by a court having jurisdiction, upon application by either party.[41]

While the Florida Supreme Court was careful to note that it was not basing its decision on "whether the contract expressly incorporate the statute of limitations,"[42] the fact that the parties specifically addressed statutes of limitations in their arbitration agreement surely colored the Court's thinking about the legal issue before it.

D. Post-*Broom* and *Raymond James* developments.

Following the Washington Supreme Court's decision in *Broom*, the Washington legislature was quick to respond to "waves of panic in the Washington legal community" about the decision and the specter of decades-old claims being revived in arbitration.[43] The Washington legislature amended the state's arbitration act to clarify that "a claim sought to be arbitrated is subject to the same limitations of time for the commencement of actions as if the claim had been asserted in a court."[44] The explicit purpose of this amendment, as voiced by the bill's supporters, was to overrule the Washington

39. *Broom*, 236 P.3d at 186.

40. *Id.* at 188.

41. *Raymond James*, 126 So. 3d at 188-89 (quoting the parties' arbitration agreement).

42. *Id.* at 189.

43. *See generally* Lara K. Richards & Jason W. Burge, *Analyzing the Applicability of Statutes of Limitations in Arbitration*, 49 GONZ. L REV. 213, 237-240 (2014) (chronicling the Washington legislature's response to *Broom*).

44. WASH. REV. CODE § 7.04A.090(3) (2013).

Supreme Court's decision in *Broom*.[45] That the legislature decided, for policy reasons, to apply statutes of limitations to arbitration does not detract from the soundness of the Washington Supreme Court's legal reasoning. In fact, by continuing to juxtapose "arbitration" to "actions … asserted in court," the legislature appears to have continued to recognize the distinction that was the basis of the Court's decision in *Broom*.

In a little over a year since its publication, the *Raymond James* decision has been cited only once in reference to arbitration, in *Snell v. Mott's Contracting Services, Inc*.[46] That case concerned whether arbitrators could award attorney's fees under a lien enforcement statute that provided for fees "in any action brought to enforce a lien."[47] Under the statute, an action had to be filed "in a court of competent jurisdiction." The court relied heavily on *Raymond James* in holding that, since an arbitration is not an action and was not brought in court, an arbitrator could not award attorney's fees under the statute.[48] Although *Snell* is but a single case, it suggests that the initial legacy of the *Raymond James* decision will be an emphasis on closely parsing statutory language before statutory remedies or defenses are applied to arbitrations.

III. In Light of *Raymond James* and *Broom*, Will Statutes of Limitations Apply to Arbitrations Brought in Other States?

Because *Raymond James* and *Broom* apply by their terms only to the statutes of limitations in Florida and Washington, these decisions can provide only persuasive authority regarding whether other state's statutes of limitations are likely to apply to arbitration. In considering that issue, the two main considerations are the text of the other states' statutes of limitations and the actions taken by the other state's legislatures.

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45. *See generally* Addressing the Applicability of Statutes of Limitation in Arbitration Proceedings: Hearing on H.B. 1065 before the S. Comm. on Law and Justice, 2013 Leg., First Reg. Sess. (Wash. 2013) http://www.tvw.org/index.php? option=com_tvw player&eventID=2013031053 (statement of Roger Goodman, Rep., 45th Leg. District) (17:50-18:00; 19:28-19:37).

46. 141 So.3d 605 at 609 (Fla. Dist. Ct. App. May 21, 2014).

47. *Id.*

48. *Id.* at 610.

A. The Phrasing of State Statutes of Limitations

Forty-eight states have statutes of limitations for fraud and breach of fiduciary duty that are phrased as applying to "actions."[49] The sole exceptions are Texas and Pennsylvania.

Texas' statutes of limitations apply to a "suit [brought] on the action," language that explicitly limits their application to actions in court.[50] In interpreting a contract under Texas law, the Court of Appeals for the Fifth Circuit has noted that a "suit" is "an action or process in a court for the recovery of a right or claim."[51] Accordingly, the court found that the use of

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49. *See, e.g.,* ALA. CODE § 6-2-38(l) ("All actions for any injury to the person or rights of another not arising from contract and not specifically enumerated in this section must be brought within two years."); ARIZ. REV. STAT. ANN. § 12-543(3) (West) ("There shall be commenced and prosecuted within three years after the cause of action accrues, and not afterward, the following actions…For relief on the ground of fraud or mistake…"); DEL. CODE ANN. tit. 10, § 8106(a) (West) ("[N]o action to recover damages caused by an injury unaccompanied with force or resulting indirectly from the act of the defendant shall be brought after the expiration of 3 years from the accruing of the cause of such action…"); 735 ILL. COMP. STAT. 5/13-205 (West 2010) ("[A]ctions on unwritten contracts, expressed or implied, or on awards of arbitration, or to recover damages for an injury done to property, real or personal, or to recover the possession of personal property or damages for the detention or conversion thereof, and all civil actions not otherwise provided for, shall be commenced within 5 years next after the cause of action accrued."); LA. CIV. CODE ANN. art. 3492 ("Delictual actions are subject to a liberative prescription of one year."); MASS. GEN. LAWS ANN. ch. 260, § 2A (West) ("[A]ctions of tort, actions of contract to recover for personal injuries, and actions of replevin, shall be commenced only within three years next after the cause of action accrues."); OR. REV. STAT. ANN. § 12.110 (West) ("An action for assault, battery, false imprisonment, or for any injury to the person or rights of another, not arising on contract, and not especially enumerated in this chapter, shall be commenced within two years; provided, that in an action at law based upon fraud or deceit, the limitation shall be deemed to commence only from the discovery of the fraud or deceit."); UTAH CODE ANN. § 78B-2-305(3) (West) ("An action may be brought within three years… for relief on the ground of fraud or mistake…").

50. *See, e.g.,* TEX. CIV. PRAC. & REM. CODE ANN. § 16.004 (West) ("A person must bring suit on the following actions not later than four years after the day the cause of action accrues: … (4) fraud; or (5) breach of fiduciary duty.").

51. *See* Pers. Sec. & Safety Sys. Inc. v. Motorola Inc., 297 F.3d 388, 396 n. 10 (5th Cir. 2002) (citing Webster's Third New Int'l Dictionary 2286 (1993)).

the word "suit" demonstrates intent to limit the application to claims brought in court.[52]

Pennsylvania's statutes of limitations are phrased as applying to "actions and proceedings."[53] On their face, then, statutes of limitations in Pennsylvania would appear to apply to arbitrations, particularly in light of the fact that most other states have statutes of limitations phrased in terms of "actions," suggesting Pennsylvania intended a broader scope then the other states. Pennsylvania's statutes go on to define proceeding, however, as including "every declaration, petition or other application which may be made ***to a court*** under law or usage or under special statutory authority, but the term does not include an action or an appeal."[54] Pennsylvania has thus expressly limited the definition of proceedings to events occurring in a court, which contradicts the analysis of *Raymond James* and suggests that statutes of limitations will not apply to a claim brought in arbitration in Pennsylvania.

The fact that the other states' statutes of limitations are phrased as applying to "actions," however, is not the end of the inquiry. As we saw in section III above, Florida's statutes separately defined "action" to include any "civil action or proceeding," language the *Raymond James* court relied on to conclude that the statute of limitations applied in arbitration. Florida is not alone in providing a statutory definition of "action." As we will see, however, many other states have defined "action" specifically to limit it to court proceedings, further suggesting that their statutes of limitations do not apply to claims brought outside of judicial litigation.

i. States that explicitly limit the definition of action to a claim in court.

Eleven states have statutorily defined action as a "proceeding *in a court*,"[55]

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52. *Id.* at 396.

53. 42 PA. CONS. STAT. ANN. § 5524 (West) ("The following actions ***and proceedings*** must be commenced within two years…") (emphasis added).

54. 42 PA. CONS. STAT. ANN. § 102 (West) (emphasis added).

55. ALASKA STAT. ANN. § 01.10.060(a)(1) (West); ARIZ. REV. STAT. ANN. § 1-215(1) (West); CAL. CIV. PROC. CODE § 22 (West); IOWA CODE ANN. § 611.2 (West) (same); N.C. GEN. STAT. ANN. § 1-2 (West); N.D. CENT. CODE ANN. § 32-01-02 (West); OHIO REV. CODE ANN. § 2307.01 (West); S.D. CODIFIED LAWS § 15-1-1 (emphasis added); *see also* KY. REV. STAT. ANN. § 446.010 (West) ("proceedings in a court"); VA. CODE

and two others have defined action as a "judicial" proceeding.[56] Under the *Raymond James* and *Broom* analysis cited earlier, these definitions suggest that in these states, statutes of limitations are explicitly limited to judicial suits.

ii. States that define action to include "special proceeding."

Montana defines "actions" to include "special proceedings."[57] Montana defines an action as "an ordinary proceeding in a court of justice by which one party prosecutes another for the enforcement or protection of a right, the redress or prevention of a wrong, or the punishment of a public offense" and a "special proceeding" as "every other remedy."[58] This broad language suggests that, consistent with the analysis in *Raymond James*, statutes of limitations are likely to apply to arbitrations in Montana.[59]

ANN. § 8.01-2(1) (West) ("'action' and 'suit'… shall include all civil proceedings… whether in circuit or district courts.").

Nebraska defines "action" as "all actions and proceedings *in any court*" or before particular public or corporate bodies, which do not include arbitration panels. NEB. REV. STAT. § 25-520.02 (emphasis added). Nebraska thus limits the application of "action" to courts or non-arbitral tribunals.

56. GA. CODE ANN. § 9-2-1 (West) ("As used in this title, the term: (1) 'Action' means the judicial means of enforcing a right."); TENN. CODE ANN. § 28-1-101 (West) ("'Action' in this title includes motions, garnishments, petitions, and other legal proceedings in judicial tribunals for the redress of civil injuries.").

57. MONT. CODE ANN. § 27-2-101 ("The word 'action', as used in this chapter, is to be construed, whenever it is necessary to do so, as including a special proceeding of a civil nature."). New York also defines actions to include "special proceedings," *See* N.Y. C.P.L.R. 105 (McKinney), but as noted above, New York also has statutorily provided that time limitations apply in arbitration. *See supra* n. 10.

58. MONT. CODE ANN. § 27-1-102.

59. In addition, other definitions of action in Montana's statutes, not specifically applicable to the statutes of limitations, define action to include arbitration. *See* Uniform Foreign-Money Claims Act, MONT. CODE ANN. § 25-9-702 ("In this part, the following definitions apply: (1) 'Action' means a judicial proceeding or arbitration in which a payment in money may be awarded or enforced with respect to a foreign-money claim.").

iii. Other states

Other states either lack a definition of "action" as used in their statutes of limitations, or provide a definition that is circular, defining "action" by reference to itself.[60] The lack of a definition of action that includes proceedings suggests that the ordinary understanding of action, as "a judicial proceeding," should likely apply, unless there has been contrary indication in the case law of the state.[61]

B. Legislative Action

In reaching its decision rejecting the application of statutes of limitations to an arbitration in the *Broom* case, the Washington Supreme Court relied heavily on two of its prior decisions, which had declined to extend the term "action" to include arbitrations.[62] In ultimately reaching its decision, the Washington Supreme Court took great guidance from the fact that the Washington legislature had not reacted to the court's decisions in *Thorgaard*, decided in 1967, and *City of Auburn*, decided in 1990, by passing legislation to clarify that actions do encompass arbitrations.[63] In making this statement, the Court essentially dared the legislature to act, and within three years, the legislature had indeed amended Washington's Uniform Arbitration Act to expressly provide that statutes of limitations would apply to arbitral proceedings.

Practitioners in at least five other states can also reach a similar conclusion as the Washington Supreme Court did in *Broom*, i.e. that the state legislature's silence is tacit approval of decisions holding that statutes of limitations do not apply to arbitrations. Courts in Connecticut, Maine, Minnesota, North Carolina, and Ohio have held that statutes of limitations do not apply in

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60. *See, e.g.,* UTAH CODE ANN. § 78B-2-101 (West) ("The word 'action' as used in this chapter includes counterclaims and cross-complaints and all other civil actions in which affirmative relief is sought.").

61. *See, e.g.,* Uniform Commercial Code §1-201(b)(1) ("'Action', in the sense of ***a judicial proceeding***, includes recoupment, counterclaim, set-off, suit in equity, and any other proceeding in which rights are determined." (emphasis added)).

62. *See* Thorgaard Plumbing & Heating Co. v. Cnty. Of King, 426 P.2d 828 (Wash. 1967); City of Auburn v. King Cnty., 788 P.2d 534 (Wash. 1990).

63. Broom v. Morgan Stanley DW Inc., 236 P.3d 182, 188 (Wash. 2010).

arbitrations.[64] These decisions extend as far back as 1963 to as recent as 1993, and yet none of the legislatures in these states have taken steps to correct these courts' interpretations that arbitrations are a separate animal from an "action" in court, and therefore, statutes of limitations are inapplicable. By allowing these decisions to stand, the state legislatures have tacitly approved these holdings. It naturally follows, therefore, that the legislative silence following these decisions implies that this interpretation is correct. These decisions extend as far back as 1963 to as recent as 1994, and yet none of the legislatures in these states have taken steps to correct these courts' interpretations that arbitrations are a separate animal from an "action" in court, and therefore, statutes of limitations are inapplicable. By allowing these decisions to stand, the state legislatures have tacitly approved these holdings. It naturally follows, therefore, that the legislative silence following these decisions implies that this interpretation is correct.

Courts in four other states – California, Idaho, Indiana, and Michigan – have also ruled that the term "action" does not encompass an arbitration in contexts outside of a statute of limitations analysis.[65] Although these cases are not directly on point, the strong language used by these courts can also be a powerful tool in arguing that statutes of limitations are not applicable to arbitrations because arbitration is not an "action" as that term is used in state statute. This language, and the fact that state legislatures have not reacted by passing legislation to clarify or correct the interpretation, are useful facts to

64. *See* Skidmore, Owings & Merrill v. Conn. Gen. Life Ins. Co., 197 A.2d 83 (Conn. Super. Ct. 1963); Lewiston Firefighters Ass'n v. City of Lewiston, 354 A.2d 154 (Me. 1976); Har-Mar, Inc. v. Thorsen & Thorshov, Inc. 218 N.W. 2d 751 (Minn. 1974); Cameron v. Griffith, 370 S.E. 2d 704 (N.C. Ct. App. 1988); and NCR Corp. v. CBS Liquor Control dba Acme Cash Register, 847 F.Supp. 168 (S.D. Ohio 1993). In a sixth decision, *Carpenter v. Pomerantz*, a Massachusetts Appeals Court stated that a statute of limitations that used the word "action" was "inapplicable to demands for arbitration" because "the word 'action' has been consistently construed to pertain to court proceedings." 634 N.E.2d 587, 590 (Mass. App. Ct. 1994). The court refrained from ruling on whether or not the claims were time-barred, however, because the court stated that the issue was one for the arbitrators, rather than the court, to decide. *Id*.

65. *See* Moore v. Omnicare, Inc., 118 P.3d 141 (Idaho 2005) (Eismann, J. concurring) ("The arbitration panel was neither a court nor a judge, and the arbitration proceedings were not a civil action. A civil action is commenced by filing a complaint with the court."); Manhattan Loft, LLC v. Mercury Liquors, Inc., 93 Cal. Rptr. 3d 457 (Cal. Ct. App. 2009); Pathman Constr. Co. v. Knox Cnty. Hosp. Ass'n, 326 N.E.2d 844 (Ind. Ct. App. 1975); Kent Cnty. Deputy Sheriff's Ass'n v. Kent Cnty. Sheriff, 616 N.W.2d 677 (Mich. 2000).

argue a dispute involving the interplay between statutes of limitations and arbitration.

IV. Constructing an Argument that Statutes of limitations Do Not Apply in Arbitration

A statute of limitations defense is a very common affirmative defense that will often arise in an arbitral dispute, especially in FINRA arbitration where FINRA's six-year eligibility rule is often much longer than most state's statutes of limitations governing the cause of action in the dispute. As discussed above, constructing a solid argument that the statute of limitations defense is not available in an arbitration means focusing intently on the explicit language of the statute itself, while also relying on varying interpretations by courts across the nation about the proper reading of terms such as "action," "proceeding," and "suit." As an example, we provide the following sample argument that statutes of limitations do not apply in a FINRA arbitration filed in Texas involving claims for fraud and breach of fiduciary duty.

A. Sample Argument

Claims for fraud and breach of fiduciary duty are governed by a four-year statute of limitations under Texas law.[66] In this case, the Defendants are arguing that the Claimant's claims have expired because the Claimant's claims began to accrue in November 2009, and therefore, that the Claimant's claims are time-barred. A review of Texas' statutes and case law, however, demonstrates that its statute of limitations do not apply to claims brought in arbitration. Therefore, only FINRA's six-year eligibility rule would apply, making the Claimant's claims timely under FINRA's rules.

The relevant statute establishing the limitations period for fraud and breach of fiduciary duty under Texas law states: "A person must ***bring suit*** on the following **actions** not later than four years after the day the cause of action accrues ..."[67] Although no Texas court has expressly ruled on the issue of whether statutes of limitations apply to arbitrations, outside of the context of statute of limitations, the Texas Supreme Court, the Court of Appeals for the Fifth Circuit, and a Texas appellate court have all noted the difference between

66. *See* TEX. CIV. PRAC. & REM. CODE ANN. § 16.004 (West 2005).

67. *See id.* (emphasis added).

the bringing of "suits" or "actions" versus the initiation of an arbitration under Texas law. In *Personal Sec. & Safety Systems, Inc.*, for instance, the Fifth Circuit examined whether a forum selection clause executed in a subsequent agreement between the parties waived the right to arbitrate.[68] The forum selection clause stated that "any suit or proceeding brought hereunder shall be subject to the exclusive jurisdiction of the courts located in Texas."[69] The Fifth Circuit held that the language in the forum selection clause did not waive the right to arbitrate because it referenced only the bringing of "any suit or proceeding."[70] The Fifth Circuit noted that this interpretation "comports with the plain meaning of the terms 'suit' and 'proceeding.' *See* Webster's Third New Int'l Dictionary 2286 (1993) (defining 'suit' as 'an action or process in a court for the recovery of a right or claim'); *id.* at 1807 (defining a 'proceeding' as 'the course of procedure in a judicial action or in a suit in litigation')."[71]

Similarly, the Texas Supreme Court has noted that bringing suit and initiating arbitration are distinctive concepts.[72] "The words Court and suit have a distinctive meaning, and suggest a very different idea, from arbitrators and arbitration. These words have been understood and construed, in the connection in which they are used, to mean either the District Court, or that of a Justice of the Peace . . ."[73] In addition, a Texas Appellate Court has also noted the distinction between "suits" and "arbitrations" when interpreting a forum selection clause that stated: "Venue for any suit arising out of any relationship between Seller and Buyer shall be the appropriate court in Harrison county [sic], Texas."[74] The court held that the language merely

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68. Pers. Sec. & Safety Systems Inc. v. Motorola Inc., 297 F.3d 388, 395 (5th Cir. 2002).

69. *Id.*

70. *Id*. at 396. ("[T]he forum selection clause confers 'exclusive jurisdiction' on Texas courts only with respect to 'any suit or proceeding.' This limitation suggests that the parties intended the clause to apply only in the event of a non-arbitrable dispute that must be litigated in court.").

71. *Id.* at 396 n.10; *see also* Son Shipping Co. v. De Fosse & Tanghe, 199 F.2d 687, 689 (2d Cir. 1952).

72. Yarborough v. Leggett, 14 Tex. 677, 681 (Tex. 1855).

73. *Id.*

74. *In re* Winter Park Const., Inc., 30 S.W.3d 576, 578 (Tex. App.—Texarkana 2000).

governed the location of a suit filed in court, not the initiation of an arbitration.[75]

In addition to the Texas cases cited above, there is a growing body of case law providing that statutes of limitations do not apply in arbitration. Courts in Connecticut, Minnesota, Ohio, Maine and North Carolina have all held that statutes of limitations do not apply to arbitration proceedings.[76] Each court reasoned, under the law of each state, that the statutes of limitations provisions in each state applied only to "actions" or "suits," which are proceedings brought in a court of law, not to "arbitrations," which are proceedings brought in front of private tribunals.[77] Courts have also ruled that arbitrations are not "actions" in contexts outside of statute of limitations issues. [78]

It is also important to note that the Texas legislature has not reacted to the decisions by the Fifth Circuit, the Texas Supreme Court, and the Texas appellate court to correct these courts' decisions that distinguish the words "suit" and/or "proceeding" from the term "arbitration." If the Texas Legislature wanted to clarify the issue or correct the previous courts' interpretations, it easily could. In the absence of a reaction, however, it is proper to interpret the legislature's silence as approval for the courts' decisions

75. *Id.* ("Taking the provisions in context, they simply provide that venue of any suit over the contract will be in Harrison County and that Texas law will govern in any such litigation. Thus, the provisions specifically apply to lawsuits, not to arbitration.").

76. Skidmore, Owings & Merrill v. Conn. Gen. Life Ins. Co., 197 A.2d 83 (Conn. Super. Ct. 1963); Har-Mar, Inc. v. Thorsen & Thorshov, Inc. 18 N.W.2d 751 (Minn. 1974); NCR Corp. v. CBS Liquor Control, 874 F.Supp. 168 (S.D. Ohio 1993); Carpenter v. Pomerantz, 634 N.E.2d 587 (Mass. App. Ct. 1994)(See note 64); Lewiston Firefighters Ass'n v. City of Lewiston, 354 A.2d 154 (Me. 1976); Cameron v. Griffith, 370 S.E. 2d 704 (N.C. Ct. App. 1988).

77. *See, e.g.*, Lewiston Firefighters Ass'n v. City of Lewiston, 354 A.2d 154, 167 (Me. 1976) ("Arbitration is not an action at law and the statute is not, therefore, an automatic bar to the Firefighters' recovery."); Shafnacker v. Raymond James & Assocs., Inc., 683 N.E.2d 662, 666 (Mass. 1997) ("This statute does not aid the plaintiff's cause because the filing of a claim for arbitration is not an 'action' within the meaning of [the statute].").

78. *See* Manhattan Loft, LLC v. Mercury Liquors, Inc., 173 Cal.App.4th 1040, 1051 (Cal. Ct. App. 2009); *see also* Moore v. Omnicare, Inc., 118 P.3d 141, 153 (Idaho 2005) (Eismann, J. concurring) (holding that attorney's fees were not available in arbitration under the statute); Pathman Constr. Co. v. Knox Cnty. Hosp. Ass'n, 326 N.E.2d 844, 854 (Ind. Ct. App. 1975); Kent Cnty. Deputy Sheriff's Ass'n v. Kent Cnty. Sheriff, 616 N.W.2d 677, 683 n. 18 (Mich. 2000) ('arbitration is not a 'civil action'").

that make a clear distinction between the terms "action" and/or "proceeding" and a "suit."

Of course, parties to an arbitration agreement are entitled to create their own limitations for actions, and an arbitral body is free to limit actions as well.[79] Here, however, where the parties have not included any guidance on statutes of limitations in their agreement, and their chosen arbitral forum of FINRA has not expressly ruled that statutes of limitations apply in FINRA arbitration, the reasonable pre-dispute expectation of the parties would be that statutes of limitations would not apply to claims brought in arbitration. Those claims would instead be limited by FINRA's six-year rule. The Respondents' defense of statutes of limitations should be rejected, as the Texas' statutes of limitations are inapplicable to claims brought in arbitration.

B. Conclusion

The *Raymond James* decision and the Washington legislature's action following the *Broom* decision have established that statutes of limitations apply to claims filed in arbitration in Washington and Florida. But these two decisions have also shed light on this issue, and pointed the way toward an argument that, in many other states, statutes of limitations will not apply in arbitration. Because many states have structured their statutes of limitations to apply to "actions" and many have even explicitly defined "action" as limited to judicial proceedings in courts, under the analysis of both the court in *Raymond James* and the court in *Broom*, statutes of limitations should not apply in arbitration in these states.

Given that a statute of limitation defense is a common affirmative defense brought by Respondents in arbitration, attorneys who handle securities arbitration need to be familiar with these decisions and be prepared to present and explain to arbitrators that the statute of limitations defense is often not valid in arbitration.

79. *See* AM. ARBITRATION ASS'N, EMPLOYMENT ARBITRATION RULES AND MEDIATION PROCEDURES 13 r.4(b)(i)(1) (Nov. 1, 2009), *available at* https://www.adr.org/cs/groups/lee/documents/document/dgdf/mda0/~edisp/adrstg_004366.pdf (stating that initiation of arbitration must be "within the time limit established by the applicable statute of limitations.").

IS SECTION 11 OF THE SECURITIES ACTS OF 1933 A STRICT LIABILITY OFFENSE?

Milly Dick

I. Introduction

Section 11 of the Securities Act of 1933 (the "SA") creates civil liability against stock issuers who include false or misleading statements or omissions in otherwise valid registration statements filed with the Securities and Exchange Commission ("SEC") prior to a public offering.[1] Effectively, the SA creates a duty for certain individuals in a publicly traded entity to provide honest and complete disclosures.[2]

The SA provides private individuals and the government with the means to encourage and enforce compliance with its provisions against publicly traded entities and individuals within those entities.[3] Among the enforcement provisions, sections 11 and 12 provide for private civil liability and express rights of action for private plaintiffs.[4] Other sections of the SA empower the government to seek civil sanctions, such as injunctions and other stop orders, while additional sections provide for criminal penalties under certain

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1. 15 U.S.C. § 77k (2006) [hereinafter "section 11"].

2. Horace A. Teass, *Duty of Directors and Others as Prescribed by Section 11 of the Securities Act of 1933*, 20 VA. L. REV. 817, 820–21 (1934).

3. EDWARD T. MCCORMICK, UNDERSTANDING THE SECURITIES ACT AND THE S.E.C. 24-25 (1948).

4. Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 244 (1933). Section 12 creates two types of liability: (1) "liability for the sale of securities which should have been registered but . . . were not," and (2) liability for material misstatements and omissions made by the issuer in connection with the "sale of a security 'by means of a prospectus or oral communication.'" PAUL, HASTINGS, JANOFSKY & WALKER LLP, SECURITIES LAW CLAIMS: A PRACTICAL GUIDE 119-20 (2004).

circumstances.[5] Over time, the courts have recognized additional implied rights of action in the Act.[6]

Currently, there is a circuit split on the question of whether section 11 is a strict liability offense when a registration statement contains soft information[7]—such as an opinion, a prediction of future performance, or a statement of general compliance with the law. Specifically, the circuits are split on the issue of whether a plaintiff satisfies section 11 pleading requirements when he alleges that a statement regarding soft information is objectively false, or whether a plaintiff satisfies his pleading burden only when he alleges that the statement in question was both subjectively and objectively false. Three circuits have considered this issue and have reached two different conclusions. The Second and Ninth Circuits have concluded that plaintiffs must plead both objective and subjective falsity.[8] The Sixth Circuit has split and, in April 2013, held that section 11 is a strict liability offense—that plaintiffs need only plead objective falsity to state a section 11 claim.[9] On November 3, 2014, the U.S. Supreme Court heard oral argument on the Sixth Circuit's decision.

This article first explores the history of section 11 under the federal securities laws and its pleading requirements. Next, it examines the decisions comprising the circuit split, and notes the differing approaches each court has taken in arriving at its holding. Finally, this article concludes that the Sixth Circuit's approach is the most consistent with applicable law, the history of section 11, and congressional intent in providing for an express right of action.

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5. The government can impose criminal sanctions for willful misstatements and omissions of material facts and other fraud. MCCORMICK, *supra* note 3, at 25.

6. WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 206 (4th ed. 2012).

7. *See* Elizabeth Demers & Clara Vega, *Soft Information in Earnings Announcements: News or Noise?*, BD. OF GOV. OF FED. RES. SYS. 1, n. 1 (Oct. 2008), *available at* http://www.federalreserve.gov/pubs/ifdp/2008/951/ifdp951.pdf ("[S]oft information is characterized as that which is directly verifiable only by the person who collected and produced it."); *see also* Garcia v. Cordova, 930 F.2d 826, 830 (10th Cir. 1991) ("Soft information contrasts with hard information which is typically historical information or other factual information that is objectively verifiable.").

8. Fait v. Regions Fin. Corp., 655 F.3d 105 (2d. Cir. 2011); Rubke v. Capitol Bancorp, Ltd., 551 F.3d 1156, 1161 (9th Cir. 2009).

9. Ind. State Dist. Council v. Omnicare, Inc., 719 F.3d 498, 502 (6th Cir. 2013), *cert. granted*, 13-435, 2014 WL 801097 (Mar. 3, 2014).

II. Section 11 Civil Liability

Section 11 "was designed to assure compliance with the disclosure provisions of the [SA] by imposing a stringent standard of liability on the parties who play a direct role in a registered offering."[10] A defendant is liable when, at the time of filing, the registration statement contains an omission or untrue statement that is material.[11] Material statements, for the purposes of this section, are statements that "would have misled a reasonable investor about the nature of his or her investment."[12] Information disclosed in the registration statement, according to the SEC, "enables investors, not the government, to make informed judgments about whether to purchase a company's securities."[13]

Investors may hold two types of defendants liable under section 11—issuers and non-issuers.[14] Once a plaintiff has made out a prima facie case for a section 11 violation, the defendant's position in the corporate structure

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10. Herman & MacLean v. Huddleston, 459 U.S. 375, 382–83 (1983).

11. 15 U.S.C. § 77k(a) (2006). A plaintiff must also show that the registration statement was effective, that he owned the security, and that he is within the one year statute of limitations. 15 U.S.C. § 77m (2006); KATHLEEN ANN RUANE, CONG. RESEARCH SERV., R40498, OVERVIEW OF THE SECURITIES ACT OF 1933 AS APPLIED TO PRIVATE LABEL MORTGAGE-BACKED SECURITIES 8 (2009).

12. In re Daou Sys., Inc., 411 F.3d 1006, 1027 (9th Cir. 2005) (internal quotation marks omitted); *see also* SEC Staff Accounting Bulletin No. 99, 7 Fed. Sec. L. Rep. (CCH) ¶75,763, ¶75,701 (Aug. 12, 1999) (cited in PAUL, HASTINGS, JANOFSKY & WALKER LLP, *supra* note 4, at 113). Unlike other remedies, a plaintiff is not required to show causation (i.e., reliance on the statements) in order to recover under section 11. *Huddleston*, 459 U.S. at 382; *but see* Marc I. Steinberg & Brent A. Kirby, *The Assault on Section 11 of the Securities Act: A Study in Judicial Activism*, 63 RUTGERS L. REV. 10-12 (2010) (discussing recent decisions, following the 11th Circuit's lead, that have found that a plaintiff must show reliance in order to prevail under section 11).

13. U.S. Securities and Exchange Commission, *Registration Under the Securities Act of 1933* (Sept. 2, 2011), *available at* http://www.sec.gov/answers/regis33.htm.

14. Specifically, five categories of individuals may be held liable: (1) "every person who signed the registration document;" (2) directors; (3) those who are listed as "or are about to become a director;" (4) "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him" that is employed in the registration document; and, (5) "every underwriter with respect to such security." 15 U.S.C. § 77(a)(1)–(5) (2006).

dictates the statutory defenses available to her.[15] Moreover, once a statement has been shown to be false, misstated, or improperly omitted, there is a very strong presumption of liability against section 11 defendants.

Issuers have almost absolute liability.[16] Indeed, they may be held liable "for innocent misstatements"[17] and "[h]onest mistakes are not a defense."[18] Issuers' only affirmative defense is that the plaintiff knew that the registration statement contained a material, false, or omitted statement and purchased the security anyway.[19]

Non-issuer defendants have limited affirmative defenses under the statute. Non-issuer defendants include individuals who sign the registration statement as experts and use their qualifications to attest to certain statements, and individuals who must sign by virtue of their presence on the board of directors of the issuing company.[20] Non-issuer defendants may employ the statutory due diligence defense, which assesses the reasonableness of both the defendants' actions and their beliefs in the veracity of the statements at issue.[21] In essence, individuals who sign the registration document verifying its truthfulness may only avoid liability by attesting that within their professional capacity and the scope of their responsibilities, they reasonably believed the veracity of the statements.

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15. 15 U.S.C. §§ 77(a), (b) (2006).

16. *Huddleston*, 459 U.S. at 382.

17. Morton S. Robson, *Liability Under the Securities Laws*, PUBLIC OFFERINGS: AN INTRODUCTORY COURSE 124 (1971).

18. *Id.*

19. Shulman, *supra* note 4, at 248.

20. RUANE, *supra* note 11.

21. 15 U.S.C. § 77k(b)(3) (2006) (providing a defense if "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statement therein not misleading").

III. The Applicability to Section 11 Claims of a Heightened Pleading Standard Under the PSLRA and Rule 9(b)

In 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA").[22] The PSLRA provides for, among other things, heightened pleading standards for private plaintiffs in civil liability actions for fraud under the securities laws.[23] The Act heightened the pleading requirements for claims under section 10(b) of the Securities Exchange Act of 1934 (the "SEA").[24] Section 10(b) and its implementing Rule 10b-5 are the main antifraud provisions under the federal securities laws; they are not strict liability offenses.[25]

Under the PSLRA, plaintiffs making section 10(b) allegations must plead falsity and scienter with particularity,[26] though Congress intentionally did not provide for "how that standard should be met."[27]

Section 11, in contrast, is not specifically an antifraud provision.[28] While courts have agreed that the PSLRA does not apply to section 11 claims, the PSLRA's influence has encouraged some courts to impose generally higher pleading standards when section 11 claims sound in fraud.[29]

In addition, at least since the PSLRA became law, courts have generally agreed that the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure, which explicitly apply to allegations of "fraud or

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22. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

23. Denis T. Rice, *A Practitioner's View of the Private Securities Litigation Reform Act of 1995*, 31 U.S.F. L. REV. 283, 285, 322–26 (1997).

24. 15 U.S.C. § 78j (2006).

25. *Id.*; *see also* 17 C.F.R. § 240.10b-5 (2010).

26. 15 U.S.C. §78u-4(b)(1) (2006); In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1085 (9th Cir. 2002).

27. Helwig v. Vencor, Inc., 251 F.3d 540, 548 (6th Cir. 2001) (citing H.R. Conf. Rep. No. 104-369, at 41 (1995)).

28. PAUL, HASTINGS, JANOFSKY & WALKER LLP, *supra* note 4, at 75, 113.

29. Rubke v. Capitol Bancorp, Ltd., 551 F.3d 1156, 1161 (9th Cir. 2009) (holding that "the heightened pleading requirements of the PSLRA do not apply to section 11 claims").

mistake," also apply when a section 11 claim sounds in fraud.[30] A court determines whether a claim under this section for civil liability "sounds in fraud" by considering the "language and structure of the complaint."[31] Allegations that sound in fraud generally "allege a unified course of fraudulent conduct" or "rely entirely on [a fraudulent] course of conduct as the basis of a claim."[32] That is, the complaint must identify (1) what is false or misleading about a statement contained in a registration document, and (2) why it is false or misleading.[33] Notably, section 11 claims are frequently combined with allegations of fraud because the same evidence is often used to prove more than one claim.[34] Thus, even though a section 11 claim does not itself require a showing of fraud, alleging fraud as evidence of material omission or

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30. FED. R. CIV. P. 9(b); *e.g.*, Ind. State Dist. Council v. Omnicare, Inc., 719 F.3d 498, 502 (6th Cir. 2013), *cert. granted*, 13-435, 2014 WL 801097 (Mar. 3, 2014); Rombach v. Chang, 335 F.3d 164, 170–71 (2d Cir. 2004); *but see* Krista L. Turnquist, Note, *Pleading Under Section 11 of the Securities Act of 1933*, 98 MICH. L. REV. 2395, n. 10-12 (noting split among circuits as to the circumstances in which Federal Rule of Civil Procedure § 9(b) applies to section 11 claims, as of 2000). The Eleventh Circuit remains the only circuit that does not require the heightened pleading requirements of Rule 9(b) for section 11 claims grounded in fraud, but it was the first to require plaintiffs to show causation. In re NationsMart Corp. Sec. Litig., 130 F.3d 309, 315 (8th Cir. 1997); Steinberg & Kirby, *supra* note 12.

31. *Rubke*, 551 F.3d at 1161 (internal quotation marks omitted) (quoting, in part, Vess v. Ciba-Geigy Corp., USA, 317 F.3d 1097, 1103-04 (9th Cir. 2003)).

32. *Vess*, 317 F.3d at 1103–04. Rule 9(b), which requires complainants to plead cases with heightened particularity, applies to claims of fraud. FED. R. CIV. P. 9(b). In 2010, the Supreme Court granted certiorari in an earlier set of *Omnicare* litigation to resolve the issue of whether 9(b) applies to section 11 claims when proof of fraud or mistake was not an element of prima facie liability. The Court did not reach the issue because it dismissed the case under Rule 46. Laborers Dist. Council Constr. Indus. Pension Fund v. Omnicare, Inc., 133 S. Ct. 21 (2010).

33. *Vess*, 317 F.3d at 1161-62. If a statement is misleading, the plaintiff must "not [state] simply why the statements were incomplete." Brody v. Transitional Hosp. Corp., 280 F.3d 997, 1006 (9th Cir. 2002).

34. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 382–83 (1983) (holding that a plaintiff may allege fraud and seek relief under both section 11 of the SA and section 10(b) of the SEA, even though only the latter explicitly provides a remedy for fraud).

misstatement invokes the Rule 9(b) higher pleading requirements.[35] This raises a difficult issue: Rule 9(b) provides that plaintiffs may plead knowledge with generalities, but section 11 does not, on its face, require plaintiffs to plead knowledge at all. This appears to be one cause of the circuit split.

IV. Pleading Falsity as to Soft Information Under Section 11

The circuit split on the issue of whether a plaintiff must plead subjective and objective falsity regarding soft information for a section 11 claim derives from the 1991 Supreme Court's decision in *Virginia Bankshares v. Sandberg*, which addressed a claim under section 14(a) of the SEA.[36] This decision is credited with having established the principle that, when a plaintiff alleges that an issuer has made a false statement, her claim is actionable only when she alleges that the statement was both knowingly and actually false.[37]

In *Virginia Bankshares*, minority shareholders sued the issuer bank and its directors under section 14(a) of the SEA.[38] In soliciting proxies to vote on a proposed merger, the minority shareholder alleged that the bank directors falsely stated that they approved the merger plan "because of its opportunity for the minority shareholders to achieve a 'high' value, which they elsewhere described as a 'fair' price, for their stock."[39] The plaintiffs alleged that, in reality, these bank directors were hoping to save their jobs, and therefore hid the fact that the shares were undervalued.[40] After trial, a jury found the defendants liable for making false statements.[41]

On appeal to the Supreme Court, the defendants argued that their statements were not actionable because they were statements of opinion, not facts.[42] Although the statements at issue were opinions, the Court held that the

35. *See Huddleston*, 459 U.S. at 382 (noting that section 11 does not require plaintiff to prove scienter).

36. Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1087 (1991).

37. *Id.* at 1088.

38. *Id.* at 1083.

39. *Id.* at 1088.

40. *Id.*

41. *Id.*

42. *Id.* at 1091.

opinions at issue were factual, and therefore actionable, in two ways. First, the opinions explained facts that "the directors do act for the reasons given or hold the belief stated."[43] Second, the opinions were factual "as statements about the subject matter or the reason for the belief expressed [by the defendants]."[44] The Court explained, however, "that proof of mere disbelief . . . should not suffice for liability under section 14(a)."[45] The Court accordingly held that "disbelief or undisclosed motivation, standing alone, [is] insufficient to satisfy the element of fact that must be established under section 14(a)."[46]

In applying these conclusions to the case at bar, the Court held that the jury must have understood "that the directors' statements of belief and opinion were made *with knowledge* that the directors did not hold the beliefs or opinions expressed."[47] Therefore, the Court concluded that the jury had inferred objective falsity upon finding subjective falsity—that the directors had disbelieved their own actually false statements.

Justice Scalia concurred in part and concurred in the judgment. Although the purpose of his short concurrence seemingly was to explain that statements that may appear to be opinions may be facts, his summation of the majority's holding has been widely cited as the rule of *Virginia Bankshares*. Scalia wrote: "As I understand the Court's opinion, the statement 'In the opinion of the Directors, this is a high value for the shares' would produce liability if in fact it was not a high value and the directors knew that."[48] This restatement, that plaintiffs must allege both objective and subjective falsity to prevail on securities law claims involving allegations of false statements, is routinely cited by defendants and increasingly applied by courts today.[49]

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43. *Id.* at 1092.

44. *Id.*

45. *Id.* at 1096.

46. *Id.*

47. *Id.* at 1090 (emphasis added).

48. *Id.* at 1108-09 (Scalia, J., concurring).

49. *Id.* (Scalia, J., concurring).

V. The Circuits Split Over Whether Section 11 Requires Plaintiffs to Plead Knowledge of Falsity When Issuers Provide Statements of Opinion

Against this backdrop, the circuits have split as to whether or not section 11 imposes strict liability. Although the facts of the cases underlying the split differ in many regards, all of the cases have addressed a statement that the respective court determined to be an opinion. Each court has also applied the Rule 9(b) pleading standard.

A. Circuits Holding That Plaintiffs Must Allege Objective and Subjective Falsity in Section 11 Claims

The Second and Ninth Circuits have held that section 11 is not a strict liability claim. These decisions therefore "represent[ ] an extension" to the SA of the *Virginia Bankshares* rule articulated in Justice Scalia's concurring opinion.[50] Although these circuits have employed distinctly different reasoning, they have reached the same conclusion.

1. Ninth Circuit: Rubke v. Capitol Bancorp

In *Rubke*, the minority shareholder alleged violations of section 11 of the SA and two sections of the SEA in connection with a proposed acquisition whereby the minority shareholders shares would be exchanged for shares in the acquiring company.[51] In connection with the exchange offer, the plaintiffs received a copy of the registration statement.[52] The plaintiffs alleged that the registration statement had falsely stated that "that the transaction was

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50. Paul Dutka, *Defending 1933 Act Claims: Rewriting the Playbook After Fait v. Regions Fin. Corp.*, BLOOMBERG LAW (Aug. 19, 2013), http://about.bloomberglaw.com/practitioner-contributions/defending-1933-act-claims-rewriting-the-playbook-after-fait-v-regions-fin-corp/.

51. Rubke v. Capitol Bancorp, Ltd., 551 F.3d 1156, 1160 (9th Cir. 2009) ; 15 U.S.C. § 78j (2012). Specifically, "[s]ection 14(e) prohibits any person from making false or misleading statements or engaging in fraudulent, deceptive or manipulative actions" in a tender offer. PAUL, HASTINGS, JANOFSKY & WALKER LLP, *supra* note 4, at 135.

52. *Rubke*, 551 F.3d at 1160.

'financially fair' to the minority shareholders."[53] This conclusion was based on independent fairness assessments ordered by defendant Capitol and produced by two independent firms.[54] Believing that the exchange offer was unfair, a group of minority shareholders had ordered two additional independent fairness opinions.[55] Each of these alternate opinions valued the shares at a price approximately one-third greater than that offered by Capitol and assessed as "fair" in Capitol's registration statement.[56]

The plaintiffs did not specifically argue that section 11 was a strict liability claim.[57] Instead, they claimed that the registration statement's "fairness" conclusion was objectively misleading. The plaintiffs argued that the board knew the statement of fairness was misleading because all of the fairness opinions available, both those cited in the registration statement and those ordered by the group of minority shareholders, had been "circulated to [board] members of Capitol."[58]

The Ninth Circuit held that the plaintiffs had failed to meet the pleading standards of section 11 because the complaint did not plead facts indicating that "the statements were both objectively and subjectively false or misleading." [59] The court concluded that the fairness determinations were "misleading opinions, not statements of fact."[60] Accordingly, the court upheld the dismissal of the complaint because the plaintiffs had failed to allege that

53. *Id.* at 1161.

54. *Id.* at 1160.

55. *Id.*

56. *Id.* These alternate fairness opinions each concluded that "the fair market value of the NCB common shares was approximately $21 per share" as opposed to the $15.90 value assessed by Capitol's fairness opinions. *Id*.

57. *Id.* at 1160–61.

58. *Id.*

59. *Id.* at 1162.

60. *Id.*

the Capitol directors believed the offer was unfair.[61] The court cited *Virginia Bankshares* in support of its holding.[62]

2. Second Circuit: Fait v. Regions Financial Corporation

The plaintiffs in *Fait* alleged that the defendants had issued a registration statement that was false and misleading, and had included other errors in their prospectus supplement. The plaintiffs alleged violations of section 11 and two other sections of the securities laws.[63]

In regard to the section 11 claim, the plaintiffs alleged that one defendant, a regional bank holding company that in November 2006 had acquired another regional bank holding company with a significant residential homebuilder portfolio, had failed to write down goodwill and adequately increase its loan loss reserves to account for the acquired company's residential portfolio.[64] After stock prices fell and the company "was downgraded below investment grade status," plaintiffs sued.[65] The plaintiffs claimed that the registration statement referenced "negligently false and misleading" statements that overstated goodwill and "vastly underestimated" the company's loan loss reserves.[66]

The Second Circuit reasoned that the allegedly false and misleading statements involved opinions, not facts, because the accounting procedures summarized in the registration statement reflected accounting and managerial judgment. The court stated that "the statements regarding goodwill at issue . . . are subjective ones rather than 'objective factual matters.'"[67] Similarly, the

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61. *Id.*

62. *Id.*; *see also* In re Washington Mutual, Inc. Sec., Derivative & ERISA Litig., 694 F.Supp.2d 1192, 1223–24 (W.D. Wash. 2009) (noting that *Rubke*'s subjective and objective pleading requirements apply to misleading opinions not factual claims).

63. Fait v. Regions Fin. Corp., 655 F.3d 105, 107-109 (2d. Cir. 2011). The plaintiffs also alleged violations of sections 12 and 15 of the SA.

64. *Id.* at 107–08.

65. Regions Fin. Corp., Response to SEC Letter of Comment Regarding 2010 Annual Report (Form 10-K) 2 (Aug. 18, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1281761/000119312511226752/filename1.htm.

66. *Fait*, 655 F.3d at 108.

67. *Id.* at 111.

court found that "determining the adequacy of loan loss reserves is not a matter of objective fact."[68]

The court reasoned that the securities laws—including section 11—impose liability only when misleading or false statements concern "objective factual matters."[69] Therefore, whether there was liability at all was governed by *Virginia Bankshares*. The Second Circuit noted the *Virginia Bankshares* rule as providing that statements of opinion are "actionable [under the federal securities laws only] if they misstate the opinions or belief held . . . *and* are false or misleading with respect to the underlying subject matter they address."[70] The court explained that "[t]his approach makes logical sense" because plaintiffs would have to identify the factual components in the allegedly misleading or false opinion statements.[71]

The court further found that section 11 does not have a scienter requirement, and explained that requiring a plaintiff to plead objective and subjective falsity was not the same as requiring him to plead scienter. The court stated that scienter involves fraudulent intent while the subjective falsity requirement merely requires "that a plaintiff plausibly allege that [a] defendant misstated his truly held belief."[72]

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68. *Id.* at 113. The district court had reached the same conclusion, noting that goodwill and loan loss reserves reflect opinions of management. *See* Fait v. Regions Fin. Corp., 712 F.Supp.2d 117, 122, 124 (S.D.N.Y. 2010); *Fait*, 655 F.3d at 109. The district court provided that "[a]n opinion is actionable under [s]ection 11 . . . only if the complaint alleges that the speaker did not truly hold the opinion at the time it was issued." *Fait*, 712 F.Supp.2d at 121.

69. *Fait*, 655 F.3d at 111 (quoting I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co., Inc., 936 F.2d 759 (2d Cir. 1991)).

70. *Id.* (emphasis in original) (citing both the majority and Scalia's concurring opinions in *Virginia Bankshares*).

71. *Id.* at 112.

72. *Id.* at 112, n. 5. Despite this statement, the court affirmed the dismissal of the complaint because it did not "plausibly allege that defendants did not believe the statements regarding goodwill at the time they made them." *Id.* at 112. Therefore, the subjective requirement is better understood as requiring plaintiffs to plausibly allege at pleading that the defendant did not believe her false or misleading statement, in contrast to a claim requiring scienter in which the plaintiff must plausibly allege at pleading that the defendant was motivated by fraud when making false or misleading statements.

Applying these principles to the facts of the case, the court found that the plaintiffs had failed to identify "an objective standard for setting loan loss reserves."[73] The plaintiffs similarly did not provide "an objective standard [by which] . . . Regions should have but failed to use in determining the value of [the acquired company's] assets" so as to value goodwill.[74] Accordingly, the court affirmed the district court's dismissal for failure to state a claim.[75]

B. Sixth Circuit Holds That Plaintiffs Must Plead Only Objective Falsity in Section 11 Claims: Indiana State District Council v. Omnicare

The *Omnicare* plaintiffs were a group of investors who purchased securities in a December 2005 public stock offering of the defendant corporation, "the nation's largest provider of pharmaceutical care services for the elderly and other residents of long-term care facilities in the United States and Canada."[76] Plaintiffs appealed the case to the Sixth Circuit after the district court dismissed the complaint for failing to state a claim because it had "not adequately pleaded knowledge of wrongdoing on the part of [d]efendants."[77]

The plaintiffs' central[78] section 11 claim alleged that defendants had made misleading material statements and omissions regarding the corporation's compliance with the law.[79] The registration statement provided that Omnicare

73. *Id.* at 113.

74. *Id.* at 110.

75. *Id.* at 113.

76. Ind. State Dist. Council v. Omnicare, Inc., 719 F.3d 498, 500-501 (6th Cir. 2013), *cert. granted*, 13-435, 2014 WL 801097 (Mar. 3, 2014).

77. *Id.* at 500.

78. Plaintiffs brought a second section 11 claim alleging that the registration statement contained material misstatements because it "substantially overstated the company's revenue." *Id.* at 501. The plaintiffs alleged that the defendants failed to comply with Generally Accepted Accounting Principles ("GAAP"), and suggested that this error led to the material misstatement. *Id.* The court found that the complaint failed to allege with particularity "the details of the accounting violations" so as to satisfy the pleading requirements of Rule 9(b); the court held that Rule 9(b) applied because "GAAP allegations are based on 'soft information'" and not objective data points. *Id.*

79. *Id.* at 504.

had entered into "legally and economically valid arrangements" with its suppliers and customers.[80] The plaintiffs argued that this statement and other similar statements asserting legal compliance concealed the company's illegal activities, which allegedly included kickback arrangements with its pharmaceutical companies and nursing homes, in violation of numerous federal laws.[81]

Plaintiffs argued that section 11 is a strict liability offense, and that the district court improperly dismissed their complaint because they did not have to plead knowledge or subjective falsity.[82] Accordingly, the plaintiffs argued that because the defendant's statement of legal compliance in the registration statement was objectively untrue and misleading, it violated section 11.[83]

The defendants argued that section 11 does not impose strict liability and that it parallels section 10(b) of the SEA, a general antifraud provision and implied right of action. The Sixth Circuit and other circuits have held that in actions under section 10(b), a plaintiff must plead both objective falsity and "any allegation that the [d]efendants knew that the . . . statements were false when made" to satisfy the subjective falsity requirement so as to adequately plead a complaint when the statement at issue involves an opinion or "soft information" such as assurances of legal compliance.[84] Accordingly, the defendants argued that because the plaintiffs' allegation involved a question of legal compliance, the court should apply this section 10(b) pleading requirement. Doing so, the defendants argued, should cause the court to affirm the dismissal because the plaintiffs had not alleged that the defendants knew that the statements of legal compliance were false at the time Omnicare issued the registration statement.[85]

Moreover, defendants argued that *Virginia Bankshares* was controlling and urged the court to adopt the Second Circuit's holding in *Fait*.[86] They argued that it was the correct interpretation of *Virginia Bankshares* as applied

80. *Id.* at 501 (emphasis omitted).

81. *Id.*

82. *Id.* at 503–04.

83. *Id.* at 503.

84. *Omnicare*, 719 F.3d 504.

85. *Id.* at 504–05.

86. *Id.* at 505.

to section 11 claims, and that the Sixth Circuit was "bound by Supreme Court precedent."[87]

The Sixth Circuit rejected the defendants' argument and held that section 11 is a strict liability offense. The court reasoned that section 10(b) "require[s] a plaintiff to prove scienter" while section 11 does not.[88] Therefore, pleading requirements for section 10(b) claims do not apply to section 11 claims, even when the facts underlying allegations under both sections are the same.

The court also found *Virginia Bankshares* inapplicable to section 11 claims. The court read the Supreme Court's majority opinion to stand for the rule that a plaintiff pleading only subjective falsity has failed to state a claim, because "a defendant's disbelief in his own statement is not enough, on its own, for a plaintiff to make out a claim for material misstatement" under section 14(a), which applies to proxy solicitations and, like section 11, provides relief to investors when an issuer provides false or misleading statements.[89] On the other hand, a plaintiff pleading objective falsity alone has adequately stated a section 14(a) claim. The Sixth Circuit also questioned the applicability of the law of pleading requirements of section 14(a) claims and others when those sections do not impose strict liability and are implied rights of action—unlike section 11.[90]

As to the issue of scienter, although the *Virginia Bankshares* Court reserved the issue of whether section 14(a) had a scienter requirement, the Sixth Circuit read the Court's dicta as having "tied the knowledge of falsity requirement to scienter."[91] The *Omnicare* court reasoned that section 11 has

87. *Id.* at 506.

88. *Id.* at 505.

89. *Id.* at 506. Section 14(a), which was the cause of action in *Virginia Bankshares*, "prohibits the use of any false or misleading statements or omissions of material information in connection with the solicitation of a proxy." PAUL, HASTINGS, JANOFSKY & WALKER LLP, *supra* note 4, at 133.

90. *Omnicare*, 719 F.3d at 507 ("Justice Souter carefully declined to discuss strict liability in his introduction to the majority opinion, and it would be unwise for this [c]ourt to add an element to § 11 claims based on little more than a tea-leaf reading in a § 14(a)case—a non-strict liability statute.").

91. *Id.* at 506.

no scienter requirement, citing to *Herman & Maclean v. Huddleston*,[92] because "the Court has already held [that section 11] create[s] strict liability."[93] Therefore, because scienter is not required, pleading knowledge of falsity is unnecessary.

The Sixth Circuit, thus, did not find the distinction between scienter and subjective falsity that the Second Circuit had identified in *Rubke*. The Second Circuit defined scienter as fraudulent intent. It therefore considered knowledge of falsity to be a lesser standard than scienter—one that does not necessarily involve fraudulent intent. Accordingly, it was willing to require knowledge of falsity for section 11 claims because knowledge of falsity is not scienter—and section 11 does not require scienter. In contrast, the Sixth Circuit read *Virginia Bankshares* as finding scienter to include knowledge of falsity—even where that knowledge did not also include fraudulent intent. Therefore, because section 11 does not require scienter, the Sixth Circuit found that section 11 plaintiffs do not have to allege that the defendant had knowledge of falsity.

VI. Analysis of the Circuit Split

A. Federal Rules of Civil Procedure Cannot Modify Substantive Rights

One source of the divergent opinions as to whether section 11 is a strict liability offense originates in the difficulties courts have had applying the Rule 9(b) pleading requirements to section 11 claims. Because 9(b) permits a plaintiff to plead generally any allegations involving knowledge in fraud cases, the *Rubke* court appeared to believe that 9(b) overlaid a knowledge requirement on section 11 claims.[94]

92. 459 U.S. 375, 382-83 (1983) (noting that "section 11 places a relatively minimal burden [of pleading] on a plaintiff," while section 10(b) "requires a plaintiff to carry a heavier burden to establish a cause of action.").

93. *Omnicare,* 719 F.3d at 507.

94. "Because Rule 9(b) thus applies to Rubke's section 11 claims, her First Amended Complaint must 'state with particularity the circumstances constituting fraud.' . . . This requirement 'can be satisfied by pointing to inconsistent contemporaneous statements or information (such as internal reports) which were made by or available to the defendants." *Rubke*, 551 F.3d at 1161 (internal citations omitted). The court concluded that Rule 9(b) applied because the plaintiff's allegations sounded in fraud. The court then found that the fairness determinations at issue are opinions, and concluded that

Rule 9(b) cannot add a requirement to a substantive right. The Rules Enabling Act provides that the Federal Rules of Civil Rules "shall not abridge, enlarge or modify any substantive right. All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect."[95] Accordingly, any ruling that section 11 requires knowledge, if based in any part on 9(b), would run afoul of the Rules Enabling Act and, accordingly, raises serious constitutional issues.

Moreover, because section 11 provides for an express right of action, it is for Congress, not the courts, to modify a plaintiff's burden in proving her case under section 11. In this way, section 11 is meaningfully different from sections 10(b) and 14(a), which are implied rights of action and can appropriately be modified by courts and Congress alike. Therefore, if section 11 is to include a knowledge requirement, the statute must be amended.

B. The History of Section 11 and Congress's Intent Indicates that Section 11 is a Strict Liability Offense

In enacting comprehensive reform of the securities law and its regulatory form with the PSLRA in 1995, Congress's primary purpose was to "insure full, complete[,] and truthful disclosure to the public of information necessary to enable them to intelligently judge the value of securities and to place members of the public on an equal basis with insiders."[96] Congress sought to balance investors' rights with industry concerns about costly, reputation-damaging, and baseless strike suits.[97] Accordingly, in the PSLRA, Congress raised the pleading standards for certain implied causes of action that had been a magnet for strike suits.[98] But section 11 contains an explicit cause of action, and Congress in the PSLRA left it untouched. Therefore, raising the pleading standards beyond what section 11 specifies in its plain text places a burden on plaintiffs that runs contrary to both historical and recent congressional action.

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the objective and subjective falsity pleading requirements of *Virginia Bankshares* apply.

95. 28 U.S.C. §2072(b) (2006).

96. Morton S. Robson, *Liability Under the Securities Laws*, PUBLIC OFFERINGS: AN INTRODUCTORY COURSE 124 (1971).

97. H.R. Conf. Rep. No. 104–369, at 32 (1995).

98. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 928.

Historically, Congress enacted section 11 and its sister reforms as the country was slowly emerging from the Great Depression caused by the 1929 stock market crash. Congress embraced the idea that the injury to an investor was the same once a seller made a materially false statement to support the sale of a security, whether the falsehood was intentional or careless. Section 11 embodies Congress's belief that an *ex ante* approach that creates incentives for issuers to be accurate and truthful in registration documents is a powerful tool to encourage widespread investment in the stock market, to the benefit of both individual investors and the nation's economy.

Critics of the strict liability reading of section 11 may reasonably argue that such a view undermines the purpose of applying Rule 9(b) pleading standards to section 11 claims that sound in fraud, involve opinions, or reference soft information, namely, to discourage strike suits and other types of baseless, nuisance litigation. In its petition for certiorari in October 2013, defendant Omnicare argued that the Sixth Circuit's holding that section 11 is a strict liability offense would, if left undisturbed, "expose corporations, auditors, underwriters, and other professionals to a sharp increase in the cost of litigation, as certain federal securities claims . . . would become far more difficult to resolve at the pleading stage."[99] The petitioners in *Virginia Bankshares* articulated a similar argument.[100] They stated that allowing plaintiffs to pursue actions under the securities laws involving statements of opinion or belief "would invite wasteful litigation of amorphous issues outside the readily provable realm of fact."[101]

These parties may wish Congress had heightened the pleading requirements for section 11 when it did so for certain other rights of action under the federal securities laws. The trend in securities law generally has unquestionably been to heighten the pleading standards for plaintiffs. But Congress had an opportunity to modify the pleading standards of section 11 when it enacted the PSLRA, and it chose not to take that opportunity. Moreover, industry complaints about strike suits were a major impetus for the PSLRA. That section 11 was left unchanged suggests either that issuers and other would-be defendants were not as concerned about strike suits under this

99. Petition for Writ of Certiorari, Omnicare, Inc. v. Laborers Dist. Council, No. 13-435 (2013), 2013 WL 5532735, at *2.

100. Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1092 (1991) (noting that the petitioners supported their argument with policy rationales articulated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)).

101. *Id.* at 1092.

section as they were for others, or that Congress was not persuaded that the existing section 11 should be weakened.

VII. Conclusion

Section 11 had been long understood to impose strict liability.[102] But this view has eroded over the past few decades as a result of two different forces: first, the courts have begun to apply Rule 9(b) pleading requirements to section 11 claims in most circumstances, and second, the lack of clarity as to whether an opinion can ever be actionable as a false statement under the securities laws has left room for reinterpretation of section 11. But regardless of changes to pleading requirements in other provisions of the federal securities laws, or of the applicability of Rule 9(b) to other statutory provisions, section 11 as correctly read is a strict liability offense.

102. Letter from Laurence H. Tribe & Thomas C. Goldstein to Elizabeth M. Murphy (Dec. 14, 2009), *available at* http://www.sec.gov/comments/s7-24-09/s72409-13.pdf.

EXPERT'S CORNER: WHY SELLING AGREEMENTS MATTER

Frederick Rosenberg

Perhaps the most overlooked document in cases involving Non-Conventional Investments (NCI) is the Selling Agreement, often called a "Placement Agreement." It is the agreement between the Sponsor of an NCI and the broker-dealer selling the investment. This document defines the contractual conditions under which the broker-dealer will sell units to the public. Buried deep in Selling Agreements are terms, clauses, and agreements which can help investors in claims against both the selling broker-dealer and Sponsor.

Third-Party Beneficiaries: Every investor is a third-party (intended) beneficiary of the Selling Agreement.

FINRA Rules and Regulations: Virtually every Selling Agreement requires the broker-dealer to abide by FINRA Rules. As third-party beneficiaries of the Selling Agreement, investors can assert a violation of those rules as a contractual breach under the Selling Agreement without concern for the tiresome defense that a violation of FINRA Rules does not create a private cause of action.

Covenants, Representations and Warranties. Every Selling Agreement contains various representations, covenants, and warranties that the broker-dealer must agree to when offering these securities to the public, including compliance with the terms and conditions of the offering and all securities laws, conducting due diligence, use of sales materials, training of sales representatives, and vetting qualified investors.

Remedies for Breach: Every Selling Agreement has provisions assigning liability for breach of the agreement, including money damages, legal fees, and reimbursements. The provisions open the door for third-party claims against the Sponsor for its misrepresentations and its failure to adequately monitor compliance with the Selling Agreement. These terms often create an additional avenue for recovery where the broker-dealer which sold the investment is no longer operating.

A PPM is Not a Prospectus: Registered offerings made by Prospectus go through a detailed compliance checklist of disclosures, audits, and controls that typically must be updated and reported regularly and publicly. They typically are offered through syndications with an independent lead underwriter who conducts the due diligence and signs selling and syndicate participations. An NCI is generally sold through a Private Placement Memorandum (PPM).

PPM's however, rarely if ever, comply with the standards and reporting requirements of public offerings, and typically none are offered through an independent underwriter conducting due diligence. Absent an underwriter, the broker-dealer is responsible for due diligence and that requires specialized expertise often lacking internally. It is the Selling Agreement that stipulates due diligence obligations between the BD and the Sponsor.

RECENT ARBITRATION AWARDS

Robert Van De Veire

"Your case is only as good as your jury." Time and time again, trial advocacy consultants, experts and law school professors will tell this to their customers, colleagues and students. In the case of arbitration, "Your case is only as good as your arbitrators."

Experienced attorneys who practice in FINRA arbitration, on both the Respondent and Claimant side, spend significant amounts of time and money conducting due diligence on their potential panelists before ranking and striking them. Typically, the search consists of reviewing an arbitrator's background, including past arbitration awards, to get a feel for whether or not this person will be receptive to your client's case. Yet, this is not the only burden related to arbitrator due diligence that practitioners and their clients bear.

Practitioners today must not only fear receiving a poor award from an arbitrator, but must also be wary of the potential for vacatur of a good award as a result of deficient arbitrator disclosures. FINRA Rule 12405 sets forth what disclosures are required of arbitrators. The cases discussed herein were decided in only the past few years and illustrate how much damage can be done to the parties to an arbitration when an arbitrator's disclosures are incomplete or misleading in violation of Rule 12405. By forcing the parties to court and then back to arbitration for a second time, vacatur of an arbitration award deprives the parties of arbitration's promised expedience and cost effectiveness.

Fortunately, deficiency of arbitrator disclosures is largely preventable. Unfortunately, it has yet to be effectively eliminated. So, unless and until something is done to ensure that arbitrator disclosures are complete and accurate, practitioners should endeavor to leave no stone unturned when it comes to an arbitrator's background.

D. Theodore Berghorst, Berghorst Snowbird LLC, Berghorst 1998 Dynastic Trust, Deborah, H. Berghorst, as Trustee of the Berghorst, 1998 Dynastic Trust, Vector Managed Holdings, L.L.C., v. Citigroup Global Markets, Inc. (d/b/a Smith Barney), Citigroup Alternative Investments LLC

FINRA Case No. 08-04466[1]

Claimants' Counsel: Jonathan L. Hochman, Esq. and Daniel E. Shaw, Esq., Schindler Cohen & Hochman LLP

Respondents' Counsel: Brian Amery, Esq., Alex J. Sabo, Esq. and Matthew Plant, Esq., Bressler, Amery & Ross, P.C.

Concurring Arbitrators: Eugene Michael Kennedy (Public Arbitrator), Mark Sidell (Non-Public Arbitrator)

Dissenting Arbitrator: Guy K. Stewart, Jr. (Public Chairperson)

Award: The Panel held Respondents liable to pay the Claimants $6,379,021.00 in compensatory damages. Respondent CGMI was held liable for 75% of that amount. Respondent CAI was responsible to pay the remaining 25%.

The over $6 million award in this case was ultimately vacated by the U.S. District Court for the Southern District of Florida. *Citigroup Global Mkts., Inc. v. Berghorst*, No. 9-11-cv-80250, 2012 U.S. Dist. LEXIS 76459 (S.D. Fla. 2012).

In vacating the award, the Court found Arbitrator "Sidell's responses to Questions 11 and 19 on the Arbitrator Disclosure Checklist were rendered materially incomplete by developments during the course of his service as an

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1. Claimants asserted the following causes of action: fraud; fraudulent misrepresentations; negligent misrepresentation; breach of fiduciary duty; negligence; breach of contract; violation of the Florida Securities and Investor Protection Act; violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder; and, violation of Section 20(a) of the Exchange Act. The causes of action relate to the purchase of shares of the MAT Two LLC, MAT Three LLC and MAT Five LLC funds in Claimants' accounts.

Unless specifically admitted in their Answer, Respondents denied the allegations made in the Statement of Claim, as amended, and asserted various affirmative defenses.

Claimants requested compensatory damages of not less than $ 12,000,000.00, costs, attorneys' fees, rescission or a rescissory measure of damages, and such additional equitable, injunctive, or other relief as deemed appropriate.

Respondents requested dismissal of the Statement of Claim, as amended, and that the costs associated with this proceeding be assessed against Claimants.

arbitrator.r[2] *Id* at *9-10. Vacatur was an appropriate remedy because "[g]iven the split decision rendered by the panel, Sidell's vote was outcome determinative." *Id*. at *15.

Arbitrator Sidell completed his Arbitrator Disclosure Checklist in March of 2009, two months prior to filing an arbitration against his employer, Wells Fargo, related to investments in his Wells Fargo IRA. That December, Wells Fargo terminated Sidell, prompting him to amend his arbitration complaint to include retaliatory termination claims for $20 million in compensatory and punitive damages. None of this was found to have been disclosed to the parties.

Rather, the court found that during the pendency of the arbitration, Sidell made only "selective updates," stating that he stopped working at Wells Fargo and that he had an "Affiliated Firm Conflict" with "Wachovia Securities, Inc." *Id*. at *6. Sidell also omitted that Wachovia had foreclosed on his home seven months prior to the start of the hearing. Notably, when asked if he had any further disclosures on the first day of the hearing, Sidell replied, "none for Sidell." *Id.* at 7.

Because Citigroup had requested the recusal of one of Sidell's co-panelists upon disclosure of a potential conflict with that arbitrator in the same arbitration, the court reasoned that Sidell was aware that Citigroup would be willing to request his recusal if a conflict or potential conflict came to light. Ultimately, the court found Citigroup's rights had been prejudiced since they were deprived of the opportunity to ask Sidell to recuse himself or request of the FINRA Director of Arbitration that Sidell be removed, warranting vacatur.

The case was retried before a different panel, which awarded Claimants $2,000,000 jointly and severally against Respondents. This award was issued nearly five years after the original Statement of Claim was filed.

It should come as no surprise that a party to an arbitration has an interest in knowing her arbitrators' respective litigation histories. Have they ever been a party to a litigation or arbitration? Have they represented a party in a litigation or arbitration? How recently or long ago? If so, were they prosecuting the action, or were they defending against it? These are questions that should be answered before arbitrator appointment.

In this case, Mr. Sidell's litigation history came about during the pendency of the arbitration on which he sat as a panelist. The curious thing about this

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2. Questions 11 read, "Have you ever, as a party to an arbitration or litigation, named a brokerage firm, or been named by a brokerage firm in any civil lawsuit were arbitration proceeding?" and Question 19 read, "Has your conduct and issued an arbitration or litigation proceeding (other than a proceeding in which he served as the arbitrator)?" *Id.* at 3-4.

particular situation is that Mr. Sidell's personal dispute with Wells Fargo was not filed publicly in court, but rather, was filed in FINRA arbitration. This put the parties in a disadvantaged position to discover the deficiencies in Mr. Sidell's disclosures, since even the most diligent searches would have been unlikely to turn up Mr. Sidell's pending arbitration with Wells Fargo.

At the same time, FINRA was in the optimal position to reveal this deficiency to the parties. This unfortunate, but avoidable situation is one more illustration of the need for additional diligence on arbitrators and real-time safeguards concerning their disclosures by the forum, itself.

Athena Venture Partners, L.P. v. Goldman Sachs and Company, Eric W. Gettleman, and Scott T. Scheffer

FINRA Case No. 09-04771[3]

Claimant's Counsel: David R. Moffitt, Esq., Saul Ewing LLP

Respondent's Counsel: Edward M. Posner, Esq., Drinker Biddle & Reath LLP.

Arbitrators: Demetrio S. Timban, Jr. (Public Arbitrator), Kathleen K. Murphy (Public Chairperson), Edward T. Borer (Non-Public Arbitrator)

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3. Claimant asserted the following causes of action: misrepresentation, fraud, violation of the Securities Exchange Act of 1934, failure to supervise, breach of fiduciary duty, and suitability. The causes of action relate to the investment in the Goldman Sachs Liquidity Partners 2007, L.P. by the Claimant.

In the Amended Statement of Claim, Claimant asserted the following causes of action: misrepresentation, fraud, violation of the Securities Exchange Act of 1934, failure to supervise, breach of fiduciary, suitability, and conflict of interest.

Unless specifically admitted in their Answer, Respondents denied the allegations made in the Statement of Claim and Amended Statement of Claim, and asserted various affirmative defenses.

In the Statement of Claim and Amended Statement of Claim, Claimant requested compensatory damages in the amount of $ 2,411,156.00, punitive damages in the amount of $ 2,411,156.00, interest in the amount of $ 1,800.00, attorneys' fees, costs, and such further relief as may be deemed appropriate by the Panel.

At the close of the hearing, Claimant requested compensatory damages in the amount of $ 1,366.180.66.

In their Statement of Answer and Amended Statement of Answer, Respondents requested dismissal of the Statement of Claim and Amended Statement of Claim, costs, expungement of the CRD records of Gettleman and Sheffer, and such other and further relief as the Panel deems just and proper.

Award: The Panel denied Claimant's claims and recommended the expungement of the complaint from the records of Respondents Gettleman and Scheffer. Only Arbitrators Murphy and Borer signed the Award.

The award was ultimately vacated by the U.S. District Court for the Eastern District of Pennsylvania. *Goldman Sachs and Co. v. Athena Venture Partners, L.P.,* No. 13–MC–130, 2013 U.S. Dist. LEXIS 107966, 2013 WL 3955136 (S.D. Pa. 2013). The court based its finding that vacatur was proper on the basis that "[Athena was] prejudiced by Mr. Timban's misbehavior and, as a consequence, the arbitrators here so imperfectly executed their powers that a mutual, final and definite award was not made." *Id.* at 27.

The misbehavior of Mr. Timban addressed by the court related to allegations of the unauthorized practice of law in the state of New Jersey. Per the decision, Mr. Timban was a licensed attorney in the states of New York and Michigan, but not New Jersey. Nonetheless, a New Jersey grand jury indicted Mr. Timban for unauthorized practice of law stemming from allegations that he opened a law office in Cherry Hill, New Jersey under the name of Timban Law Group, LLC and operated it for approximately a year, potentially longer. Michigan's Attorney Discipline Board also filed two complaints against Mr. Timban, the first related to the unauthorized practice of law in New Jersey; and the second for knowingly writing a check for which there were insufficient funds related to a probate matter in Michigan.

Mr. Timban made only a minimal amendment to his FINRA disclosures, which the court found this to be "grossly misleading and incomplete." In it, he indicated that he was charged with unauthorized practice of law, but that it was an oversight and related only to helping a family friend in municipal court. This disclosure was circulated to the parties, neither of which petitioned for Timban's removal from the panel.

Ultimately, Timban did not sign the award rendered in the arbitration. Therefore, the court found vacatur warranted because the "FINRA rules clearly entitled [Athena] to a panel composed of at least three qualified arbitrators (unless they agreed to proceed with two) and to have those arbitrators answer truthfully the questions posed to them in the requested disclosure checklists," which they did not receive. *Id.*at 27.

Noteworthy in this decision is the court's chastisement of both the parties and FINRA, itself, in dicta in footnote 7. Specifically the court's opinion read, in pertinent part, "[t]his Court finds it remarkable that neither of these parties nor, more particularly, FINRA saw fit to conduct any investigation or due diligence into Mr. Timban's qualifications after he revealed that he was the subject of a complaint by the State of New Jersey for unauthorized legal practice." The court described "FINRA's June 21, 2013 announcement that it will now conduct annual background checks on its arbitrators and additional review before appointment" as "an important step in the right direction, albeit 'too little too late' in this case."

The court's point is a valid one in both respects. The diligent practitioner should take this as a lesson that as a matter of practice, one should be following up on updated disclosures provided by arbitrators, even if there appears to be a reasonable explanation. It should not come as a surprise that a man who has been charged with the unauthorized practice of law would be less than forthright in a document that not only serves as an arbitrator disclosure, but which could also readily double as a statement against interest in a future proceeding against him.

Nonetheless, the integrity of the arbitrator pool is critical to the integrity of FINRA's arbitration forum. Therefore, it is up to FINRA to maintain the same, as it is in the best position to do so.

CASES & MATERIALS

Joseph Wojciechowski

***Mosher, et al. v. DeWaay Financial*, No. 13–1007, 2015 Iowa App. LEXIS 272 (Mar. 25, 2015).**

After numerous FINRA arbitration claims were filed against DeWaay Financial alleging, *inter alia*, unsuitability, failure to perform due diligence, misrepresentations, omissions, various other breaches of duty in connection with the sale of dozens of private placements and direct participation programs, plaintiffs filed a class action lawsuit seeking limited-fund non-opt-out certification under Iowa RCP 1.267(1)(b). The class plaintiffs and defendants submitted a proposed settlement to the court, which consisted mostly of proceeds from an insurance policy, although the settlement did not exhaust the limits of those policies. Those investors whose FINRA arbitrations were stayed as a result of the pending class action settlement intervened in the Class case, seeking discovery into DeWaay's finances to determine the sufficiency of the settlement versus the funds available to DeWaay. After the court approved both the settlement and certified the class, the FINRA investor-intervenors appealed. In applying the standards set forth in *Ortiz v. Fibreboard*, 527 U.S. 815 (1999), the Iowa Court of Appeals ruled that there was insufficient evidence submitted for the district court to determine the limit and the insufficiency of the funds available for settlement, under the limited fund theory as espoused in FRCP 23(b)(1)(B). The court held that the district court abused its discretion in certifying a limited fund non-opt-out class action, and remanded to the district court for further proceedings.

***People v. Barclays Capital Inc.*, 1 N.Y.S.3d 910 (Feb. 13, 2015).**

The New York Attorney General brought a Martin Act claim against Barclays for misleading clients into believing its "dark pool" alternative trading platform would protect them from high frequency trading. According to the Attorney General's allegations, the "dark pool" served the opposite purpose – to prey upon investors for the benefit of traders. In moving to dismiss, Barclays argued the Martin Act only applies to misrepresentations about specific securities, and could not be extended to apply to the "dark pool" itself. The court disagreed and denied Barclays' motion to dismiss, holding, in a case of first impression, that the alleged misrepresentations were sufficiently alleged to be in connection with buying and selling of securities that the AG could bring suit under the Martin Act. Notably, the court provided no insight into whether the pleading was sufficient. The court was also skeptical of the Attorney General's rhetoric about High Frequency Trading.

***Northstar Financial Advisors v. Schwab Investments, et al.*, 779 F.3d 1036 (9th Cir. 2015).**

This case involves a class action on behalf of investors alleging that managers of a mutual fund failed to comply with the fundamental investment objectives and limitations contained in both the Fund's prospectus and registration statement. The investors alleged that the Schwab Total Bond Market Fund invested more than the allowed allocation (25%) into "one industry," namely Mortgage Backed Securities, and, as a result, the fund suffered losses during the financial crisis, and also failed to track the benchmark index identified in the prospectus. The case had been dismissed by the district court. The Ninth Circuit Court of Appeals reversed and reinstated causes of action for breach of contract – holding that the prospectus and/or registration statements were contracts – and breach of fiduciary duty against the fund trustees and advisor. The court also reinstated a third-party beneficiary claim, holding that fund shareholders are third-party beneficiaries of the contract between the fund and its advisor under California law. The court specifically held that the fund's Statement of Additional Information (SAI) did not provide adequate notice of changes to the prospectus, saying "it is reasonable to assume that there are many ordinary shareholders who do not read the SAI."

***State v. Marsh & McLennan Cos., Inc*. 269 Ore. App. 31 (Feb. 11, 2015).**

The State of Oregon, argued successfully to the Oregon Supreme Court in 2012 that the "fraud on the market" presumption applied to violations of the Oregon Securities Act anti-fraud provision. *State v. Marsh & McLennan Cos.,* 353 Ore. 1, 23 (2012) (*Marsh II*). The Oregon Supreme Court remanded the case to the Court of Appeals to consider whether the lack of a scienter requirement put the Oregon Securities Act at odds with the federal statutory scheme implicating preemption and therefore rendering the law unconstitutional as applied to defendants. The Oregon Court of Appeals ruled that consistent with analogous federal law, a purchaser has the burden of proving scienter under ORS 59.137(1).

***Aegis Capital Corp. v. Mangin,* No. 14-cv-06739-PBT (E.D. Pa. Jan. 14, 2015).**

Mangin filed a FINRA Arbitration claim against Aegis and Segal, a registered representative, who was alleged to have engaged in a Ponzi scheme. Aegis filed an injunction seeking to stay the arbitration, arguing that Mangin was not its "customer," that no arbitration agreement existed between the parties, and that, therefore, Aegis Capital could not be compelled to arbitrate. Aegis specifically asked the court to follow the decision in *Citigroup v. Abbar*, 761 F.3d 268, 275 (2d Cir. 2014). The court denied the motion for preliminary injunction, following FINRA's reiteration of its position that "selling away" claims are arbitrable under the Code. *Order Approving Proposed Rule Change*, 74 Fed. Reg. 731, 736 n. 37 (Jan. 7, 2009). The court sided with numerous other jurisdictions in ruling that an investor can bring an arbitration claim against the broker/dealer if the investor was a customer of the associated person.

***Omicare, Inc. v. Laborers District Counsel Construction Industry Pension Fund*, 575 U.S. ___ (2015).**

The U.S. Supreme Court held that statements expressing the company's opinion that the registration statement was in compliance with federal and state laws does not give rise to liability under § 11 of the Securities Act of 1933, 15 U.S.C. § 77a, *et seq.*, even if the opinion turns out to have been wrong. The court went on to provide some guidance however, stating that statements of opinion are not always immune from liability. In the event the speaker of the opinion does not actually hold the stated belief, then the opinion can become an untrue statement of fact, if that fact is untrue (i.e., if the opinion expressed is not sincerely held). Further, opinion statements can also give rise to § 11 liability if facts embedded in said statements are untrue. Because Omnicare's sincerity was not contested, and because the statements at issue were pure opinion, the Fund cannot establish § 11 liability for an "untrue statement of fact." However, if the registration statement omits material facts about the issuer's inquiry into, or knowledge concerning, a statement of opinion, and if those facts conflict with what a reasonable investor, reading the statement fairly and in context, would take from the statement itself, then § 11's omissions clause creates liability. A reasonable investor may understand an opinion statement to convey facts about the speaker's basis for holding that view or opinion, like facts implied about the inquiry the issuer conducted or the knowledge it had when making the opinion statement. If the real facts are contrary, but not provided, then the opinion statement misleads by omissions. The Court vacated and remanded for further proceedings to determine whether the Fund stated a viable omissions claim and ordered the court to review the complaint to determine whether it is alleged adequately that Omnicare omitted some specific fact from its registration statement that would be material to a reasonable investor.

***Municipal Workers Compensation Fund v. Morgan Keegan,* __ So. 3d ___ (Ala. Apr. 3, 2015).**

MWC appealed from an order of the circuit court denying its motion to vacate a FINRA arbitration award based on the arbitrators' failure to disclose information. Specifically, one arbitrator failed to disclose that he was a defendant in five separate cases involving allegations including breach of fiduciary duty and mismanagement, and therefore answered question 11(a) ("Have you, your spouse, or an immediate family member been involved in a dispute involving the same or similar subject matter as the arbitration?") on the updated arbitrator disclosure report incorrectly. Further, a second arbitrator failed to disclose his company's relationship with Morgan Keegan on numerous securities offerings and failed to disclose his company's relationship with Morgan Keegan's counsel Greenburg Traurig. The Alabama Supreme Court overruled the circuit court and vacated the arbitration award, holding that the second arbitrator's failure to disclose information amounted to evident partiality under 9 U.S.C. § 10(a)(2). The court did not reach a determination about whether the other arbitrator's disclosures were insufficient. The court concluded that the failure to disclose created a reasonable impression of bias or partiality and remanded the case for further proceedings.

***Wright v. Northwestern Mutual, et al*., No. 4:15–mc–00041, 2015 U.S. Dist. LEXIS 14426, 2015 WL 507434 (E.D. Mo. Feb 6, 2015).**

Wright filed a motion to compel compliance with third-party subpoenas issued in FINRA arbitration. The parties were involved in a FINRA arbitration action over an employment dispute. The Panel issued a subpoena to produce documents to the Missouri Department of Insurance (MDOI) and a subpoena for testimony to an investigator at the (MDOI). The MDOI represented that it would not comply with either subpoena, so Wright filed a motion with the court seeking to compel compliance pursuant to 9 U.S.C § 7. The court overruled arguments made as to privilege of the documents and testimony of the MDOI, and instead modified the subpoena to allow for production of the documents to the Panel at the hearing location. The court further ordered that the investigator be available to provide testimony to the Panel so that the Panel could determine whether any materials or testimony are indeed privileged. The Court also overruled the objection made regarding the 100-mile geographical limitation of FRCP 45(c)(2)(A). The court held the 2014 version of the FRCP 45(c) now provides that a subpoena must issue from the court where the action is pending, not from the court where the production is to be made.

***Whistleblowers: In the Matter of KBR, Inc.*, Adm. Proc. File No. 3-16466 (Apr. 1, 2015).**

This was a proceeding specific to the whistleblower protection provisions of Section 21F of the Dodd-Frank Wall Street Reform Act. KBR adopted a procedure prior to Dodd-Frank in which it used a form confidentiality statement in conjunction with its internal investigations. That form was not required by policy, although it was enclosed with the KBR Code of Business Conduct Investigations Procedures manual. Firm investigators had witnesses sign the form at the beginning of an interview. It stated in part that "I understand that in order to protect the integrity of this review, I am prohibited from discussing any particulars regarding this interview and the subject matter discussed . . . without the prior authorization of the Law Department." The SEC Cease and Desist Order alleges that this violates Exchange Act Section 21F and Rule 21F-17 thereunder. Subsection A of Rule 21F-17 states that "[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." KBR has since amended its confidentiality agreement and agreed to pay a fine of $130,000.

***Lex v. Weiner*, No. 13mc96, 2015 U.S. Dist. LEXIS 41288, 2015 WL 1455810 (E.D. Pa. March 31, 2015)**

Lex, a former securities broker for McGinn Smith sought to vacate and arbitration award in favor of Weiner, an investor. The FINRA Panel awarded Weiner damages and pre-judgment compound interest. Lex moved to vacate because the award was procured by fraud, the Panel improperly allowed certain evidence into the record, and because Pennsylvania Law does not provide for compound interest. The court denied the petition to vacate in part and granted it in part. The Court ruled that FINRA arbitrators have broad authority to introduce evidence as they see fit so long as the process is not fundamentally unfair. Further, the court held that the petitioner did not carry the high burden of vacating an award allegedly procured by fraud. The court did grant the motion to vacate in part and ordered the Award to be amended to allow for the recovery of simple interest, not compound interest, ruling that by ordering compound pre-judgment interest the arbitrators acted in "manifest disregard of the law."

***Costigan v. John Hancock Insurance Company*, No. 5:14CV1002, 2015 U.S. Dist. LEXIS 38555, 2015 WL 140076 (N.D. Ohio Mar. 26, 2015)**

Plaintiff asserted causes of action against John Hancock for fraudulent inducement, professional negligence, negligent misrepresentation, breach of contract, and breach of the implied covenant of good faith and fair dealing. The Plaintiff's allegations were in regard to a Universal Life insurance policy with a premium spike on the 21st year of the policy. John Hancock moved to dismiss under FRCP 12(b)(6) and also moved to dismiss arguing the claims were released as part of a class settlement 16 years prior, in *Friedman v. Manufacturers Life,* 3:96cv230 (S.D. Cal. Dec. 21, 1998). The court granted the motion in part and denied it in part. It denied the motion insofar as the class settlement was concerned, finding the Plaintiff's claims were not subsumed by the class settlement. The court granted the motion regarding all fraud allegations, stating Plaintiff failed to plead fraud with the required specificity pursuant to FRCP 9(b). The court discussed in great length the statute of limitations for professional negligence under Ohio law (R.C. 2305.09(D)). The court struggled with the concept that a cause of action for negligence does not accrue or come into existence until all of its elements are established – including damages. The "delay-damages theory" however, has been expressly rejected by the Ohio Supreme Court when applied to professional negligence cases, citing *Flagstar Bank v. Airline Union's Mortgage Co.*, 128 Ohio St. 3d 529 (2011), holding a cause of action for professional negligence accrues on the date the negligent act is committed. Thus, the court dismissed Plaintiff's negligent misrepresentation claims as untimely. Lastly, the court dismissed the breach of the covenant of fair dealing count, and denied the motion as to Plaintiff's breach of contract claim.

***Atlas One Financial Group, LLC. v. Alarcon*, No. 12–23400–Civ, 2015 U.S. Dist. LEXIS 31880, 2015 WL 1191211, (S.D. Fla. Mar. 16, 2015), *appeal docketed*, No. 15-11613 (11th Cir. Apr. 15, 2015).**

Alarcon brought an arbitration action against Atlas One. The parties settled the case and entered into a confidential settlement agreement and release. After executing the settlement agreement, Alarcon filed a second statement of claim before FINRA against Pershing, LLC, the firm that cleared for Atlas One (Clearing Firm), alleging that Pershing ignored various red flags in connection with Atlas One's mismanagement of Alcaron's accounts. Pershing moved to dismiss the FINRA claim on the grounds that the settlement agreement barred the claims. The motion was denied by the FINRA panel and the case settled. Pershing then filed a statement of claim against Atlas One, seeking indemnification and reimbursement for the settlement between Pershing and Atlas One, along with attorney's fees and costs. Atlas One and Pershing settled that claim.

Atlas One then sued Alarcon for breach of contract, common law indemnification, and declaratory judgment. Atlas One claims the release barred Alcaron from pursuing the action against Pershing. The Court agreed with Atlas One and granted summary judgment in its favor. The court determined the release unambiguously encompasses all existing and potential causes of action regarding the Alcaron accounts, which clearly includes the action against Pershing. The Court also held Pershing was Atlas One's "agent" for purposes of the release.

Notes & Observations

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 Joseph Peiffer at jpeiffer@praclawfirm.com, Hugh Berkson at hberkson@hcsattys.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 SR-FINRA-2015-003* was submitted to the Securities and Exchange Commission by Joseph C. Peiffer on March 9, 2015 (prepared with the assistance of Benjamin P. Edwards and Marnie C. Lambert).

Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2015-003 – Proposed rule change to amend the
Codes of Arbitration to increase the late cancellation fee

Dear Mr. Fields:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and arbitration forums, while also advocating for public education about investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA"). I write to comment on the proposed cancellation fee rule.

FINRA has filed with the Securities and Exchange Commission ("SEC" or "Commission"), a proposed rule change to amend FINRA Rules 12214 (Payment of Arbitrators) and 12601 (Postponement of Hearings) of the Code of Arbitration Procedure for Customer Disputes ("Customer Code"), as well as FINRA Rules 13214 (Payment of Arbitrators) and 13601 (Postponement of Hearings) of the Code of Arbitration Procedure for Industry Disputes ("Industry Code"). The overall effects of the proposed rule change would be to: (1) require parties to postpone or adjourn a final hearing session one week earlier than the current three day notice necessary to avoid being assessed a per-arbitrator postponement fee; and (2) require parties to pay $500 dollars more than the current amount of $100, per-arbitrator, when such postponement fee is assessed.

Despite our concerns about the effects of the fees on the parties, PIABA generally supports the aims of the proposed rule changes. PIABA supports increasing the length of time before a final hearing session that a party must seek postponement or adjournment to avoid the "per-arbitrator" postponement fee (also referred to in the SEC's Notice as a "late cancellation" honorarium).

Similarly, PIABA supports the proposed changes increasing the "per-arbitrator" late cancellation fee. These changes may more effectively compensate FINRA arbitrators that typically set aside time for final hearing sessions months in advance of those hearing sessions. More specifically, these changes would address what PIABA understands to be a significant concern of FINRA arbitrators – having late cancellations results in a loss of income because they had to forgo other opportunities while holding the dates. PIABA is committed to improving the quality and quantity of arbitrators that FINRA is able to attract and these changes may support those efforts.

Despite our general support, PIABA remains concerned about the current rule and the proposed rule changes. In particular, we are concerned about applying fees inequitably to all postponements without any distinction for the reason provided for the postponement request. There are primarily two types of postponements: (1) those necessary due to party, witness or attorney availability or a lack of preparedness by at least one party; and (2) those necessary to accommodate a mediation (or other settlement efforts) or because a case has been settled.

PIABA believes that the proposed rule changes should only be applied to the first type of postponement and, even then, they should be accompanied by a reminder to arbitrators that the rules involved specifically acknowledge that there can be "extraordinary circumstances" that can excuse a late cancellation such that it would not be appropriate to penalize a party by charging a late cancellation fee. In order to further reinforce the need for arbitrators to give appropriate consideration of parties' requests for a waiver of late cancellation fees in extraordinary circumstances, and given the requirement of "verification" of the extraordinary circumstances, PIABA suggests that FINRA provide additional arbitrator training on what types of extraordinary circumstances and verification would be appropriate.

At the least, given the fact that the parties are typically innocent in situations where true extraordinary circumstances arise, PIABA believes that FINRA should also modify the rules to state that FINRA will bear the financial responsibility for the late cancellation honoraria in those limited situations where it is appropriate for the arbitrators to waive the honorarium. In that way, arbitrators are still being fairly compensated for, but the innocent parties are not responsible for the payment. PIABA fears that without FINRA guaranteeing the honoraria to the arbitrators, the proposed changes would create a conflict of interest—the arbitrators would lose their honoraria if they granted a waiver motion. This conflict-generating proposed rule could significantly impair arbitrator judgment and cause them to deny relief. Parties should not fear losing motions for relief on account of an arbitrator's personal, financial conflict of interest.

PIABA is also concerned that, given the significant size of the per-arbitrator late cancellation fee increase, there will likely be pro se claimants that are unaware of the existence of the rule calling for late cancellation fees, the circumstances in which it would apply, and the amount it may mean they would have to pay for an unexcused late cancellation. PIABA suggests that FINRA provide additional education to pro se claimants so that they can make informed decisions about postponing final hearing sessions.

Finally, PIABA believes that FINRA should modify the proposed rule changes with respect to the second type of postponement (i.e., to accommodate mediation/settlement efforts or because a case has been settled) so that there is no additional cost to claimants. These types of postponements are always the result of agreement of the parties, but it is not fair to make them equally bear the financial burden for two reasons. First, the financial impact of the increase in the amount of the per-arbitrator fee in the proposed rule change, as between a typical individual claimant and a large broker dealer, is too disparate to claimants, who will "feel" the impact of the fee much more than broker dealers will. Second, claimants have no effective control over whether or when respondents seriously consider settlement. Since it is respondents that get to keep their dollars in their pockets until a given claimant's case is over (by settlement or award), it is respondents that need incentives to "address issues earlier in their cases." Claimants should not have to rely on respondents' good will concerning the allocation of late cancellation fees caused by a late settlement.

PIABA asks that FINRA reconsider its proposed rule changes and modify them in the manner set forth above. We thank you and the Commission for giving PIABA the opportunity to comment on these important proposed rule changes.

Very truly yours,
Joseph C. Peiffer, President
Public Investors Arbitration Bar Association

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The following PIABA Comment Letter regarding the *Proposed FINRA Rule Relating to Regulatory Notice 14-52* was submitted to the Financial Industry Regulatory Authority by Hugh D. Berkson on January 12, 2015 (prepared with the assistance of Christine Lazaro and William B. Young, Jr.).

Via Email Only @ pubcom@finra.org
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 14-52; Proposed FINRA rule that would require firms to disclose additional information on customer confirmations for transactions in fixed income securities.

Dear Ms. Asquith:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure.

FINRA has requested comment on a proposed FINRA rule that would require firms to disclose additional information on customer confirmations for transactions in fixed income securities. Specifically, FINRA is proposing for same-day, retail-size principal transactions in corporate or agency debt securities, firms disclose on the customer confirmation: the price to the customer, the price to the member of a transaction in the same security, and the differential between those two prices.

While PIABA generally applauds any effort to provide more transparency in the securities trading arena, we believe the fixed income confirmation proposal as written is unnecessarily limiting. FINRA is proposing to amend FINRA Rule 2232 to require customer confirmation disclosure of same-day pricing information for customer retail size transactions in corporate and agency debt securities. Specifically, where a firm executes a sell (buy) transaction of "qualifying size" with a customer and executes a buy (sell) transaction as principal with one or multiple parties in the same security within the same trading day, where the size of the customer transaction(s) would otherwise be satisfied by the size of one or more same-day principal transaction(s), confirmation disclosure to the customer would be required. That disclosure would entail: (i) the price to the customer; (ii) the price to the firm of the same-day trade; and (iii) the difference between those two prices. The rule would define "qualifying size" as a purchase or sale transaction of 100 bonds or less or bonds with a face value of $100,000 or less, based on reported quantity, which is designed to capture those trades.

The proposed rule only applies to trade confirmations for purchase or sale transactions of 100 bonds or less or bonds with a face value of $100,000 or less. We understand that FINRA studied these sorts of transactions in the third quarter of 2013 and found that 60% of the sales to customers had corresponding principal trades on the same trading day, with 88% of those events involving principal and customer trades occurring within thirty minutes of each other. Thus, while there are certainly a large number of customer orders being sourced from same-day principal transactions, PIABA does not see the rationale for the quantity/price boundaries and believes the rule should apply to all retail transactions. FINRA Rule 2232(a) cites SEA Rule 10b-10 for the requirement of what information must be disclosed in an equity trade confirmation. SEA Rule 10b-10 requires disclosure of the fee paid to the broker, whether the transaction is on an agency or principal basis.[1] The number of shares and dollar value of the equity security transactions are irrelevant under the rule requiring disclosure of the remuneration

1. See Rule 10b-10(a)(2)(i) and 10b-10(a)(2)(ii), noting that the fee paid need not be disclosed in an agency transaction if the fee paid is pursuant to a written agreement and is not on a per-transaction basis.

paid, and there is no valid reason that the size of a debt security transactions should be a trigger for a similar disclosure.

Further, PIABA would like to see fixed income trade confirmations disclose the actual markups/markdowns and not only for riskless transactions but for all fixed income retail transactions. As the rule stands now, the markup/markdown disclosure would be required only if there are corresponding trades on the same day. Regulatory Notice 14-52's example 13, for example, would not require disclosure where Firm A sold 100 XYZ bonds to its customer on Day 2, with those 50 of bonds having been sourced at 15:30:00 PM on Day 1 and 50 of them having been sourced at 10:00:00 AM on Day 2. PIABA would prefer that all of the pricing information be disclosed, regardless of whether the bonds sold to the customer were sourced on Day 1 or Day 2. However, at a bare minimum, pricing information should be provided for the 50 bonds that were sourced on Day 2 – the day on which the bonds were sold to the client. Absent such a requirement, there is a meaningful incentive for member firms to game the system by sourcing a single bond for each customer sale from old inventory, thereby avoiding entirely the need to disclose the markup/markdown.

Also, pricing should be disclosed in real time so all customers will have easy access to the markups and markdowns, not limited to the more sophisticated clients with access to advanced pricing data. The current system and the attendant lack of transparency opens the door for exploitation and abuse. Therefore, the disclosure of real time pricing and markups/markdowns for all retail fixed income transactions will ultimately benefit and protect the public retail investor, which protection is and always will be PIABA's primary goal.

Abuse of undisclosed markups and markdowns is not a hypothetical problem. The last few years have seen FINRA pursue a number of disciplinary actions against member firms concerning excessive markups and markdowns of debt instruments. For example, in 2012, FINRA fined Citi International Financial Services LLC $600,000 and ordered more than $648,000 in restitution and interest to more than 3,600 customers for charging excessive markups and markdowns on corporate and agency bond transactions. In 2013, FINRA fined StateTrust Investments, Inc. over $1 million for charging excessive markups and markdowns in corporate bond transactions and ordered the firm to pay more than $353,000 in restitution and interest to customers who received unfair prices. FINRA found that 85 of the transactions, in particular, operated as a fraud or deceit upon the customers. Also in 2013, FINRA fined Morgan Stanley Smith Barney LLC and Morgan Stanley & Co. LLC $1 million and ordered $188,000 in restitution plus interest for failing to provide best execution in certain customer transactions involving corporate and agency bonds, and failing to provide a fair and reasonable price in certain customer transactions involving municipal bonds.

Had the pricing information been available to the customers on the confirmations, perhaps the customers would have been charged fair prices. To be clear: PIABA supports the amendment to rule 2232 insomuch as it creates greater transparency in retail fixed income trading. However, PIABA requests the amendment not be limited to 100 bonds or a face value of $100,000 or less but apply to all retail fixed income transactions. There is nothing to indicate that unfair pricing or excessive markups and markdowns only occur when the size of the transaction is limited in size or the transaction is sourced from a same-day principal trade.

Thank you for the opportunity to comment on the rule proposal.

Very Truly Yours,
Hugh D. Berkson
Executive Vice-President/President-Elect, PIABA