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CONTROL SHARE ACTS, CLOSED-END FUNDS, AND THE BATTLE FOR CORPORATE CONTROL

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Introduction

"Do Not Enrich Deutsche After They Have Stolen Your Right to a Fair Election!"[1] So read the subject line of a letter written in July 2010, by Arthur D. Lipson, the sole managing partner of Western Investment, to all the investors owning stock in the DWS Enhanced Commodity Strategy Fund. Earlier in the year, Lipson, who owned roughly 19% of the closed-end fund's outstanding shares, had written a letter to the general counsel of the DWS Fund expressing frustration at the fund's "generally poor performance, excess trading discounts to net asset value, [and] grossly inadequate . . . stock buy backs."[2] Deutsche Bank, which managed the DWS Fund, had long ignored or resisted Lipson's attempts to take seats on the fund's board, knowing his reputation as an activist investor with designs on terminating the fund's management agreement with Deutsche and liquidating its capital.[3]

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1. Letter from Arthur D. Lipson, Managing Partner, Western Investment LLC, to Shareholders of DWS Enhanced Commodity Strategy Fund, Inc. (June 28, 2010), *available at* http://fixmyfund.com/wi_gcs/Western_Investment_Letter_to_Holders.pdf.

2. Letter from Arthur D. Lipson, Managing Partner, Western Investment LLC, to Richard H. Walker, General Counsel, Deutsche Bank AG (June 9, 2010), *available at* http://www.businesswire.com/news/home/20100609006413/en/Western-Investment-Delivers-Letter-Richard-H.-Walker.

3. Western Investment, LLC, Presentation to the Annual Meeting of Stockholders of the DWS Enhanced Commodity Strategy Fund, Inc. 5 (June 28, 2010), *available at* http://fixmyfund.com/wi_gcs/Western_Investment_ Presentation_to_ISS.pdf.

For Lipson, the coup d'état occurred when the fund opted into the Maryland Control Share Acquisition Act (MCSAA).[4] The MCSAA allows corporations domiciled in Maryland to adopt a structure in which any investor who attains a "control share" will lose his voting rights unless two-thirds of the remaining stockholders vote to reinstate such voting rights.[5] An investor can trigger the "control share" clause by reaching any one of three thresholds defined in the statute, including acquiring one-tenth, one-third, or one-half of the firm's outstanding shares.[6] Moreover, if the acquirer of the control shares hopes to have his voting rights reinstated, the MCSAA requires the investor to file an "acquiring person statement" setting out his goals and to underwrite the cost of a shareholder meeting to vote for the restoration of his rights.[7] Thus, for an activist investor like Lipson, the MCSAA placed a number of obstacles in the path towards acquiring the fund, making it unsurprising that he would call the Deutsche Fund's decision to opt into the Act an example of "disdain [for] the most basic principles of American democracy."[8]

As Lipson's letter illustrates, the structure of investment companies like closed-end funds poses a particular problem in considering the appropriateness of their opting into antitakeover statutes like the MCSAA.[9] Unlike traditional operating companies, for which state corporate laws govern the antitakeover mechanisms they can adopt, closed-end funds fall

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4. DWS Global Commodities Stock Fund, Inc., Current Report (Form 8-K) (Sept. 11, 2009).

5. MD. CODE ANN., CORPS. & ASS'NS § 3-702(a)(1) (2010).

6. *Id.* § 3-701(d)(1)(i)-(iii).

7. *Id.* §§ 3-703, 3-704(a).

8. Letter from Arthur D. Lipson, Managing Partner, Western Investment LLC, to Shareholders of DWS Enhanced Commodity Strategy Fund, Inc. 1 (June 28, 2010),*available at* http://fixmyfund.com/wi_gcs/ Western_Investment_Letter_to _Holders.pdf.

9. An "investment company" is any entity, including a corporation, business trust, partnership, or limited liability company that "issues securities and is primarily engaged in the business of investing in securities." *Investment Companies*, SEC, http://www.sec.gov/answers/mfinvco.htm (last visited Sept. 4, 2011). A "closed-end fund" is a particular type of investment company that offers a fixed number of shares in an initial public offering that then trade on the secondary market, a significant point of contrast from other types of investment companies. *See Closed-End Funds*, SEC, http://www.sec.gov/answers/mfclose.htm (last visited Sept. 4, 2011); Part II, *infra*.

under the jurisdiction of the Investment Company Act of 1940 ("ICA"). The ICA, a federal statute intended to prevent "self-dealing, . . . misappropriation of fund assets, and misrepresentations to investors,"[10] contains a provision requiring that "every share of stock . . . issued by a registered [investment] management company . . . be a voting stock and have equal voting rights with every other outstanding voting stock."[11] On its face, the statute appears to make it impossible for closed-end funds to adopt takeover defenses that affect the voting rights of its shareholders – including opting into state control share acquisition acts.

Not surprisingly, the U.S. Securities and Exchange Commission ("SEC") recently opined on the MCSAA, finding that a closed-end funds that opts in is acting in a manner "inconsistent with the wording of, and general purposes underlying, Section 18(i) specifically and the Investment Company Act generally."[12] Specifically, the SEC argued in its recent no-action letter to Boulder Total Return Fund, Inc., that a closed-end fund's adoption of the MCSAA would "discriminate against certain shareholders by denying important voting rights and would contribute to the entrenchment of management."[13] However, there is no guarantee that courts will agree with the SEC's interpretation. Indeed, in *Neuberger Berman Income Fund v. Lola Brown Trust*,[14] the first case challenging an investment company's use of the MCSAA, Judge Andre Davis came to the opposite conclusion in finding that a fund's use of a similar antitakeover device was perfectly consistent with the ICA.[15]

As this Note will explore, the logic underlying Judge Davis's opinion and the arguments of the closed-end fund industry generally do not take into

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10. H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777, 781 (2004).

11. Investment Company Act of 1940 § 18(i), 15 U.S.C. § 80a-18(i) (2006).

12. Boulder Total Return Fund, Inc., SEC No-Action Letter, 2010 WL 4630835, at *2 (Nov. 15, 2010) [hereinafter "Boulder Fund No-Action Letter"].

13. *Id.*

14. 342 F. Supp. 2d 371 (D. Md. 2004).

15. The only other publicly reported case presenting a similar conflict between the Maryland statute and the Investment Company Act, *Full Value Partners, L.P. v. Neuberger Berman Real Estate Income Fund, Inc.*, also came before Judge Davis, who reached the same conclusion. *See* Full Value Partners, L.P. v. Neuberger Berman Real Estate Income Fund, Inc., No. Civ. AMD 04-3399, 2005 WL 885421, at *3 (D. Md. Apr. 18, 2005).

account two critical factors that militate heavily against allowing funds to adopt antitakeover defenses like opting into the MCSAA. First, closed-end funds differ from operating companies in fundamental ways that make the concerns state antitakeover provisions were intended to address largely irrelevant. Second, because the difference between the market value and the underlying value of a share of a closed-end fund is readily observable, the economic rationale for allowing companies to adopt antitakeover defenses – to maximize the price received by the incumbent shareholders – is largely inapplicable as well. In fact, such defenses may have the opposite effect because closed-end funds frequently trade at a discount relative to their net asset value, meaning that investors are deprived of the opportunity to liberate the underlying assets in the fund and capture their full value. Thus, while the Boulder Fund No-Action letter provides a strong argument against allowing closed-end funds to opt into the MCSAA using the text and several SEC staff interpretations of the ICA, it misses several critical policy arguments. This represents a missed opportunity for the SEC to define a framework for courts to consider the appropriateness of allowing closed-end funds to assume any other antitakeover structures in the future.

This Note will argue that courts should not allow closed-end funds to adopt antitakeover defenses that allow such funds to trade at a discount for an extended period of time. It will also argue that the SEC must take a more aggressive stance against closed-end funds trading at a discount that adopt antitakeover defenses through both enforcement and advocacy for the inclusion of "lifeboat provisions" in fund charters, which leave the question of whether to restructure a fund to its investors. Part I will provide an overview of the closed-end fund itself, including its structure and performance profile relative to the mutual fund, a more common investment company setup. Part II will examine the ways in which closed-end funds are regulated under the Investment Company Act of 1940. Part III will provide an overview of the antitakeover statutes currently in effect in Maryland, a state in which many closed-end funds are domiciled. Part IV will consider the underlying policy goals animating these state laws, including the protection of local interests and the maximization of value accruing to incumbent shareholders in the event of a takeover. Part V will demonstrate that neither of the purposes ascribed to takeover defenses properly apply to closed-end funds because of their unique structure and the ways in which they differ from ordinary operating companies. Part VI will offer a strategy for the SEC to enhance protections and maximize value for closed-end fund shareholders. Part VII will offer a brief conclusion.

Part I. Closed-End Funds and the Spectrum of Investment Companies

This section will draw a contrast between two of the major forms of investment companies prevalent in the United States – open-end funds (known more commonly as "mutual funds") and closed-end funds.[16] After highlighting the key similarities and differences in the structures of these investment companies, it will then shift to focusing on the financial performance of closed-end funds.

In general, investment companies engage in the business of investing and reinvesting in securities of other companies. From the perspective of the retail or institutional investor, the investment company serves as a medium through which to channel savings or capital into various investment opportunities for the purpose of diversifying risk and generating returns. For this reason, investment companies have been called the "poor man's investment counselor,"[17] although the multiplicity of investment vehicles available can make selecting one appropriate to an investor's needs quite challenging.

Mutual funds dominate the investment company industry, holding roughly ninety percent of the $12 trillion in assets held by American investment management firms. Of the remaining $1 trillion, $228 billion are

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16. The ICA also regulates two other types of investment companies – unit investment trusts (UIT) and face-amount certificate companies. UITs are fixed portfolios of securities with a defined life that are assembled by a sponsor and sold through brokers to investors. *See* Jay B. Gould & Gerald T. Lins, *Unit Investment Trusts: Structure and Regulation Under the Securities Laws*, 43 BUS. LAW. 1177 (1988). Face-amount certificate companies consist of a contract between an investor and an issuer in which the issuer guarantees a stated payment to the investor ("face amount") at some future date in exchange for a lump-sum payment or series of periodic payments from the investor. As more attractive investment vehicles have emerged, these types of investment companies have become increasingly rare, and so will not be considered in detail here. *See* INV. CO. INST., INVESTMENT COMPANY FACTBOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 9 (2010) (noting that UITs presently hold only $38 billion in assets), *available at* http://www.icifactbook.org/pdf/2010_factbook.pdf [hereinafter "ICI FACTBOOK"]; Larry D. Barnett, *The Regulation of Mutual Fund Names and the Societal Role of Trust: An Exploration of Section 35(d) of the Investment Company Act*, 3 DEPAUL BUS. & COMM. L.J. 345, 349 n.20 (2005) ("Few face-amount certificate companies appear to exist today.").

17. LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 48 (5th ed. 2003).

invested in closed-end funds.[18] Over the past twenty years, most growth in the fund industry has occurred in the mutual fund sector. Closed-end funds, by contrast, have fluctuated between $150 billion and $300 billion in assets under management during this period.[19]

Mutual funds and closed-end funds have a sophisticated operating structure that lends itself to oversight and active portfolio management. These investment companies are overseen by a board of directors that evaluates their investment performance periodically, ensures compliance with the ICA, and negotiates contracts with the fund's investment adviser, a legally distinct entity that provides managerial services. In reality, the relationship between a fund's board of directors and its adviser tends not to originate at arm's length – advisers typically set up funds first, and then select the membership of the fund's board of directors.[20] To prevent an adviser from being rewarded excessively by a board whose members the adviser selected, the ICA requires that at least sixty percent of boards be comprised of independent directors.[21]

These two types of investment companies differ, however, along the critical dimension of how they raise capital from investors. Mutual funds offer "redeemable securities," which consist of securities that entitle the "holder on demand to receive his or her proportionate share of the issuer's net assets or its cash equivalent," on a continuous basis so as to cover redemption requests and to generate fresh capital to invest.[22] This right to rapid redemption[23] makes mutual fund price deviations from net asset value virtually impossible to sustain (though the fund need only execute the

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18. ICI FACTBOOK, *supra* note 16, at 9. Another $777 billion is invested in exchange-traded funds, which are not discussed at length here. *Id.*

19. *Id.*

20. *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 92 (2010).

21. 15 U.S.C. § 80a-10 (2006). Nonetheless, "interested" and "independent" directors are typically held under state law to the same standards with respect to the duties of care, loyalty, and good faith. *See* Larry D. Barnett, *The Regulation of Mutual Fund Board Directors: Financial Protection or Social Productivity?*, 16 J.L. & POL'Y 489, 519 (2008).

22. LOSS ET AL., *supra* note 17, at 49.

23. Mutual funds must fulfill redemption requests within seven days. 15 U.S.C. § 80a-22(e) (2006).

redemption at the end of the trading day[24]). If a fund began trading at a premium, all of its investors would immediately redeem and the fund would soon run out of capital. Conversely, a discount would act effectively as a fee on redemption, and shareholders would gravitate towards funds trading at higher prices relative to net asset value until the price of the original fund adjusted upward.[25] The on-demand redemption feature also makes it "difficult for mutual funds to have illiquid investments, such as restricted securities, as illiquid investments cannot be readily transformed into cash when fund shareholders want to redeem their shares."[26]

This structural feature underlies the relative absence of activism or takeover attempts in the mutual fund arena, such as attempting to gain a majority of outstanding shares in an effort to oust the incumbent investment adviser.[27] Doing so would be costly and difficult to organize, and because the prices of mutual fund shares reflect purely the underlying assets and not the skill of the manager in any tangible way, no gains would accrue to the agitator.[28] Correspondingly, the tendency of mutual fund share prices to adjust back to net asset value eliminates any arbitrage opportunities that might otherwise entice an investor to initiate a proxy contest.[29]

By contrast, closed-end funds raise capital in a manner similar to a traditional operating company. Closed-end funds raise capital from conducting an initial public offering, after which point the shares trade on a secondary market like the New York Stock Exchange. For the retail investor, the key difference is that shares in closed-end funds cannot be redeemed for a portion (or the cash equivalent) of the underlying securities in the portfolio.[30]

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[24] *See Invest Wisely*, SEC, http://www.sec.gov/investor/pubs/inwsmf.htm (last visited Mar. 7, 2011).

25. *See* Morley & Curtis, *supra* note 20, at 104.

26. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1050 (2007).

27. Morley & Curtis, *supra* note 20, at 115-16.

28. *See id.*

29. *See* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 2015 (2010).

30. *Closed-End Funds*, SEC, http://www.sec.gov/answers/mfclose.htm (last visited Mar. 1, 2011). Note that this description excludes a particular class of closed-end funds, known as interval funds, which do not trade on the open market but do continuously offer their shares and make periodic repurchase offers at net asset value. *See* Repurchase Offers by Closed-End Companies, 17 C.F.R. § 270.23c-3 (2010).

As a result, the share prices for a closed-end fund can deviate from net asset value, since – unlike mutual funds – no arbitrage opportunities exist to force the fund's price back into line with the prices of its underlying assets. These differences are observable to the outside investor, as closed-end funds must also calculate and disclose their net asset values on a daily basis.[31] The absence of an immediate redemption requirement akin to that of a mutual fund also gives closed-end funds the flexibility to invest in more illiquid assets whose prices cannot be readily ascertained.[32] This can further obscure the connection between a closed-end fund's trading price and the market value of its portfolio components.[33] Finally, closed-end funds can and often do employ leverage, which amplifies and adds volatility to their returns.[34]

Sustainable deviations between the price of a closed-end fund's shares and the value of the fund's underlying assets create a stronger incentive for shareholder activism than in the case of mutual funds. In particular, if a closed-end fund's shares are trading at a discount relative to net asset value, a shareholder can initiate a hostile takeover attempt with the objective of converting the fund to a mutual fund and redeeming the shares at net asset

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31. *See* Pricing of Redeemable Securities for Distribution, Redemption and Purchase, 17 C.F.R. § 270.22c-1 (2010).

32. Typical examples of closed-end fund holdings include "securities of very small companies, municipal bonds that are not widely traded, or securities traded in countries that do not have fully developed securities markets." ICI FACTBOOK, *supra* note 16, at 54. *See also* Daniel N. Deli & Raj Varma, *Closed-End Versus Open-End: The Choice of Organizational Form*, 8 J. CORP. FIN. 1, 25 (2002) (showing that funds that invest primarily in illiquid assets tend to have a closed-end structure).

33. *See, e.g.*, Martin Cherkes, Jacob Sagi & Richard Stanton, *A Liquidity-Based Theory of Closed-End Funds*, 22 REV. FIN. STUD. 257 (2009) (suggesting that the premium or discount at which a closed-end fund trades is a product of the benefit of the investor gaining indirect access to illiquid assets through the fund balanced against the tradeoff of having to pay higher management fees to the fund's advisers). *But see* Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PA. L. REV. 1, 43-44 (2007) ("Some have suggested that the observed share price discount in closed-end funds is related to the illiquidity of the assets held by the fund. . . . However, the empirical evidence to support the illiquidity causal argument is weak.").

34. *See* Edwin J. Elton et al., Why Do Closed-End Bond Funds Exist? An Additional Explanation for the Growth in Domestic Closed-End Bond Funds (Feb. 7, 2011) (unpublished manuscript), *available at* http://pages.stern.nyu.edu/ ~eelton/ working_papers/ClosedEndBondFunds-2-7-11.pdf.

value.[35] Investors therefore have an incentive to monitor the trading price of a closed-end fund, relative to net asset value.

Despite the persistent presence of would-be arbitrageurs in the closed-end fund space, the prices of such funds follow a consistent pattern after their initial public offerings. While the stock prices of most operating companies tend to rise in the weeks following their initial public offering,[36] the share prices of closed-end funds tend to decline dramatically.[37] To be sure, the general pattern towards the degradation of closed-end funds' share prices is not consistent across all types of funds. For instance, some studies have found evidence that American closed-end funds investing in international securities outperform those that invest in domestic securities[38] and that British closed-end funds appear to generate better returns than their American counterparts.[39] More recent studies suggest that the size of the discount emerging for a closed-end fund relates closely to the point at which it may become possible to "open-end" the fund, or liquidate it and return the proceeds to its investors.[40] Nonetheless, the frequency with which closed-end

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35. *See* Symposium, *Mutual Fund Regulation in the Next Millennium*, 44 N.Y.L. SCH. L. REV. 509, 517-18 (2001).

36. *See* Jay R. Ritter, *The Long-Run Performance of Initial Public Offerings*, 46 J. FIN. 3 (1991) (finding that the initial return on the initial public offerings of operating companies is 16.4%, though over the long-run, the stocks of newly public companies tend to underperform those of established firms).

37. For the seminal study on the persistent underperformance of closed-end funds after their initial public offerings, see Kathleen Weiss, *The Post-Offering Price Performance of Closed-End Funds*, 18 FIN. MGMT. 57 (1989). A more recent review of the literature confirming a similar trend can be viewed at Elroy Dimson & Carolina Minio-Kozerski, *Closed-End Funds: A Survey*, FIN. MKTS., INSTITUTIONS & INSTRUMENTS, May 1999, at 1-2.

38. *See* Lena Chua Booth & Hassan Tehranian, *Aftermarket Performance of Closed-end Funds Invested in International Versus Domestic Securities*, 15 J. APPLIED FIN. 24 (2005).

39. *See* Mario Levis & Dylan C. Thomas, *Investment Trust IPOs: Issuing Behavior and Price Performance*, 19 J. BANKING & FIN. 1437 (1995).

40. *See* Gordon Gemmill & Dylan C. Thomas, *Noise Trading, Costly Arbitrage, and Asset Prices: Evidence from Closed-End Funds*, 57 J. FIN. 2571, 2590-91 (2002); *see also* Conrad de Aenille, *Discounts Beckon in Closed-End Funds*, N.Y. TIMES, Aug. 30, 2008, at BU6, BU6 ("Often, just placing a provision in a [closed-end] fund's bylaws mandating an open-end structure if the discount remains at a certain level for a certain time will help to narrow it.").

funds follow this path has led investment managers to advise their clients not to invest in such funds until they have attained a substantial discount, recognizing that the typical fund not exhibiting such a discount is likely headed in that direction.[41]

Scholars have often commented on the curious fact that shareholders continue to purchase closed-end fund shares in the primary market, even though the value of most of these funds eventually declines below net asset value. Joseph Grundfest, a former commissioner for the SEC, offered that despite the persistent systematic evidence to the contrary, rational investors may simply "believe that each new fund is sufficiently different from its predecessors that it will not trade to a discount even though its predecessors have."[42] An alternative, and perhaps more realistic model, though, is only some shareholders know about the typical path taken by a closed-end fund after its initial public offering. These investors will wait for the opportunity to invest in the fund at a discount; the remainder, unfortunately, may be easily persuaded to purchase shares in the fund upon its inception.[43]

Further exacerbating the challenge for uninformed investors may be the fact that their brokers receive higher commissions for selling shares in closed-end funds than in other investment vehicles.[44] Moreover, one study

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41. *See, e.g.*, Mike Taggart, *Debunking Five Closed-End Fund Rules of Thumb*, MORNINGSTAR, Feb. 17, 2011, http://www.morningstar.com/cover/video center.aspx?id=370989 (noting that many investment advisers adhere to the rule of thumb that an investor should "only buy a closed-end fund if [it is] trading at a 15% or more discount to its net asset value").

42. Registration Form for Closed-end Management Investment Companies, Investment Company Act Release No. 17091, 54 Fed. Reg. 32,993, 33,008 (Aug. 11, 1989) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274).

43. For studies of "noise" trading by uninformed investors and the concomitant impact on share prices, see, for example, Fischer Black, *Noise*, 41 J. FIN. 529 (1986); J. Bradford de Long et al., *The Size and Incidence of the Losses from Noise Trading*, 44 J. FIN. 681 (1989).

44. *See* Registration Form for Closed-end Management Investment Companies, Investment Company Act Release No. 33-6842, 54 Fed. Reg. 32,993, 33,009 & n.9 (Aug. 11, 1989) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274). Although no systematic study of brokerage fees for closed-end funds has been undertaken recently, recent articles continue to suggest that such fees remain quite inflated. *See, e.g.*, Edward S. O'Neal, Closed-end Fund IPOs 1 (2007) (unpublished manuscript),*available at* http://www.slcg.com/pdf/workingpapers/Closed%20 End%20Fund%20IPOs.pdf ("[I]nvestors at the IPO often pay a significant amount in commissions."); Dan Jamieson, *Closed-End-Fund IPOs: Is the Door Shutting?*,

suggests that the lead underwriters on the initial public offerings of closed-end funds tightly control the inventories of shares to stabilize prices immediately after the offering. Such underwriters do so by creating a net short position in the number of shares issued in the pre-market period and attempting to cover the short position using stabilizing purchases. Once the position is covered, the underwriter stops stabilizing the price, and the fund begins the precipitous drop common to many of its peers.[45] Stabilization efforts like these may obscure the typical paths taken by closed-end funds and entice investments from novices.

As this overview indicates, Congress and the SEC must protect investors on two fronts in the context of investment company regulation. First, shareholders must be protected from outright fraud and robbery on the part of fund managers. Second, shareholders require protection from their own lack of sophistication, which requires robust disclosure regimes to ensure that prospective investors understand the products they are buying. Part II will describe the ways in which the federal regulatory regime strives to achieve these goals in the closed-end fund arena.

Part II. Federal Regulation of Closed-End Funds

The ICA emerged in response to widespread fraud in the investment management industry that resulted in "fantastic abuse of trust by management and wholesale victimizing of investment company security holders."[46] In many respects, the Act continues to deal with the same abuses observed in the investment management industry eighty years ago, many of which arose from poor corporate governance structures that led to conflicts of interest within investment companies. For instance, in its landmark study presented to Congress shortly before passage of the ICA, the SEC presented evidence of widespread embezzlement, theft, and expropriation of fund

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INVESTMENT NEWS, July 25, 2005, http://www.investmentnews.com/article/20050725/ SUB/507250735 (quoting a broker as noting that the "underwriting costs and markups [on closed-end funds] are much higher than they ought to be").

45. *See* Kathleen Weiss Hanley, Charles M.C. Lee & Paul Seguin, *The Marketing of Closed-End Fund IPOs: Evidence from Transactions Data*, 5 J. FIN. INTERMEDIATION 127, 154 (1996).

46. Roy H. Steyer, Comment, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 441 (1941).

assets by managers.[47] Other allegations included improper transactions in securities conducted among close affiliates,[48] long-term agreements signed with advisers who extracted substantial penalty fees in the event of contract cancellation – even if the adviser had performed poorly, and general recklessness among fund managers in conducting oversight.[49]

Firms that come within the ICA's definition of an investment company must register with the SEC. To fall under the purview of the ICA, an investment company must "hold[] itself out as being engaged primarily . . . in the business of investing . . . or trading in securities" or must engage in such activities as a secondary source of revenue while holding "investment securities [with] a value exceeding 40 percentum of such [company's] total assets."[50] The company must also be an "issuer" of "securities;"[51] if the company is, the firm must register with the SEC by filing a prospectus before it can legally offer securities to the public.[52]

After registering, an investment company must abide by the ICA's three-part regulatory framework designed to protect shareholders. First, the ICA directly outlaws the most egregious forms of self-dealing, such as conducting fund transactions with affiliates.[53] It also imposes restrictions on trades that could create opportunities for fund managers to exploit pricing inefficiencies at the expense of their funds' shareholders. In particular, recognizing the frequency with which closed-end funds trade at discounts relative to net asset value, the ICA limits share repurchases by such funds. If repurchases are not limited, they would provide an endless array of arbitrage opportunities for

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47. SEC, INVESTMENT TRUST AND INVESTMENT COMPANIES, S. REP. NO. 76-1775, at 6 (1940) [hereinafter "SEC SENATE REPORT"].

48. Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 307 (1941).

49. SEC SENATE REPORT, *supra* note 47, at 6-7.

50. Investment Company Act of 1940 § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (2006).

51. *See id.* § 80a-2(a)(22) (defining an "issuer" as "every person who issues or proposes to issue any security, or has outstanding security which it has issued"); *id.* § 80a-2(a)(36) (defining a "security" to encompass a wide array of instruments, ranging from stocks and bonds to options and contracts to trade foreign currencies).

52. *Id.* § 80a-8.

53. *Id.* § 80a-17. The ICA defines an "affiliated person" as an individual who owns or indirectly controls five percent of the fund's voting securities, has either direct or indirect "common control" of the fund, or is an advisor or depositor of the fund. *Id.* § 80a-2(a)(3).

closed-end funds at the expense of their shareholders. Thus, section 23 of the ICA prohibits both an issuer's sale of its own securities at below net asset value and an issuer's purchase of its own securities generally unless the purchases occur on the open market or are subject to a tender offer made to all current shareholders.[54]

Second, Congress imposed a variety of disclosure requirements on investment companies. Filed and distributed to investors at various points in the year, these disclosures provide updates on the fund's financial performance, fees, and strategy. In its annual report, or "prospectus," a closed-end fund must make detailed disclosures covering the fund's financial status and capital structure, its investment objectives and policies, the composition of its board of directors, and the details of its contractual relationship with its investment adviser.[55] Quarterly reports focus primarily on detailed disclosures of a fund's portfolio; some reports also contain information about a fund's internal controls and procedures[56] or about a fund's code of ethics, board composition, investment adviser, and recent share buyback activity.[57] Disclosures of this nature are intended to assist investors making assessments about the quality of a fund's corporate governance, general management, and financial performance.[58]

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54. *Id.* § 80a-23(b)-(c). Rules 23c-1 and 23c-2 impose additional conditions on the repurchase of securities by a closed-end fund, including prohibitions on purchases from affiliates, on discrimination against any class of shareholders while making a tender offer, and on purchases while dividends payments are in arrears. *See* 17 C.F.R. §§ 270.23c-1 to -2 (2006).

55. *See* SEC, FORM N-2, *available at* http://www.sec.gov/about/forms/formn-2.pdf. The SEC has authority to require investment companies to make periodic disclosures pursuant to 15 U.S.C. § 80a-30(a) (2006), as implemented through 17 C.F.R. § 270.30e-1 (2006). Similarly substantial disclosures must be made in semiannual reports as well. *See* SEC, FORM N-SAR, *available at* http://www.sec.gov/about/forms/formn-sar.pdf

56. SEC, FORM N-Q, *available at* http://www.sec.gov/about/forms/formn-q.pdf.

57. SEC, FORM N-CSR, *available at* http://www.sec.gov/about/forms/formn-csr.pdf.

58. *See, e.g.*, Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734, 3734 (Jan. 16, 2001) (to be codified at 17 C.F.R. pts. 239, 240, 270, 274) (describing the purpose of new rules relating to fund board structure and reporting requirements as being "designed to enhance the independence and effectiveness of boards of directors of investment companies and to better enable investors to assess the independence of those directors").

Finally, the ICA includes several mechanisms intended to strengthen corporate governance within funds by fostering shareholder voting and participation in fund decision-making. For instance, shareholders must approve advisory contracts (including fees),[59] underwriting contracts,[60] changes to the fund's fundamental investment policies,[61] and must elect directors.[62] Congress believed that these voting rights would help prevent "flagrant abuses" and would give "dissatisfied stockholders sufficient opportunity to avail themselves of normal legal remedies."[63] Making this system work necessitates ensuring that all the shareholders in an investment company have equal voting rights, a requirement imposed by section 18(i) of the ICA.[64] Congress explicitly included this provision as a check against unscrupulous fund managers who, prior to the passage of the ICA, would use special classes of stock with different voting rights[65] or other "various devices of control" to deny public shareholders "any real participation in the management of their companies."[66] Without the power of oversight conferred on shareholders by equal voting rights, managers could misappropriate and divert their funds' assets in ways not aligned with maximizing shareholder returns.[67]

In addition to the ICA, closed-end funds are also governed by the laws of the state in which they are incorporated. Part III will highlight the antitakeover statutes that may allow funds to protect themselves from hostile takeover attempts, though potentially at the expense of complying with the letter (if not the spirit) of the ICA.

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59. 15 U.S.C. § 80a-15a(2) (2006).

60. *Id.* § 80a-15b(1).

61. *Id.* § 80a-13a.

62. *Id.* § 80a-16a.

63. Jaretzki, *supra* note 48, at 323-24.

64. 15 U.S.C. § 80a-18(i) (2006) ("[E]very share of stock . . . issued by a registered management investment company . . . shall be a voting stock and have equal voting rights with every other outstanding voting stock.").

65. Jaretzki, *supra* note 48, at 333.

66. SEC SENATE REPORT, *supra* note 47, at 7.

67. *See* Boulder Fund No-Action Letter, *supra* note 12, at 5-6.

Part III. State Law on Antitakeover Defenses

This Part will provide a brief overview of the types of antitakeover defenses available to firms domiciled in Maryland, a common state of incorporation for closed-end funds.[68] It will focus on the affirmative protections for local corporations created by the Maryland Control Share Acquisition Act and the Maryland Business Combination Act, and will also describe non-statutory antitakeover defenses permitted under Maryland law.

The Maryland Control Share Acquisition Act[69] creates procedural roadblocks for any shareholder seeking to obtain a large ownership position in a given firm. Closed-end funds must explicitly opt into the act to secure its protections, but can do so via board resolution, which does not require the approval of shareholders.[70] The act prohibits any person who attains over one-tenth, one-third, or a majority of a target's outstanding shares from voting unless such voting is authorized at a meeting of the target's disinterested shareholders.[71] Upon reaching any of these thresholds, the acquirer must file a statement with the target's board providing its identity and current ownership position, and may demand that the board call a special meeting of the stockholders (paid for by the acquirer) to consider whether the acquirer's voting rights will be restored. At this meeting, a supermajority of disinterested shares must be voted to restore the acquirer's voting rights.[72] If the acquirer succeeds in having his franchise reinstated, those shareholders who dissented retain appraisal rights.[73]

The Maryland Business Combination Act aims to compel a would-be acquirer to negotiate with the target's board of directors, rather than initiating a hostile takeover.[74] The act works by prohibiting target corporations from entering into a broad range of transactions with an acquirer after the acquirer

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68. Andrew J. Donohue, Director, Div. of Investment Mgmt., SEC, Keynote Address at the Independent Directors Council, Investment Company Directors Conference (Nov. 12, 2009), *available at* http://www.sec.gov/news/speech/2009/spch111209ajd.htm (last visited Aug. 27, 2011).

69. MD. CODE ANN., CORPS. & ASS'NS § 3-702(a)(1) (2010).

70. *Id.* § 3-702(c)(4).

71. *Id.* § 3-701(d)(1).

72. *Id.* § 3-702(a)(1).

73. *Id.* § 3-707(a).

74. MD. CODE ANN., CORPS. & ASS'NS § 3-602 (2010).

has become an "interested shareholder"[75] unless certain votes to approve the transactions have taken place. First, to achieve approval of a business combination (via charter bylaw amendment), eighty percent of outstanding shares must vote affirmatively.[76] Such supermajority voting requirements "increase the costs, and reduce the likelihood, of opting out of inefficient default rules without the board's cooperation" and may "practically eliminate shareholders' ability to opt out by amending the bylaws."[77] Second, should the acquirer fail to attain shareholder approval, the Maryland act imposes a five-year moratorium. Lastly, if the acquirer succeeds, the Maryland act creates "super-appraisal" rights[78] for dissenting shareholders that require compensation of such shareholders using a three-part "fair price" formula. Collectively, these provisions have the effect of creating a purchase price that is "likely to be well above the price paid to any stockholder during the tender offer," meaning that the statute's real purpose may be to "raise the cost of hostile takeovers and therefore encourage bidders to negotiate with the board of directors."[79]

Finally, Maryland law explicitly permits companies to opt into a variety of defensive structures intended to ward off would-be acquirers. Maryland directors must execute their duties only in good faith, in a manner that the directors reasonably believe advance the interests of the corporation, and with ordinary care.[80] Within the constraints of these standards, state law allows companies to adopt staggered board structures – even if doing so would contradict a charter or bylaw provision.[81] Other structures explicitly

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75. The act defines an "interested shareholder" as one holding ten percent of a target's outstanding shares. *Id.* § 3-601(j).

76. *Id.* § 3-602(b)(1). The Act also allows approval by two-thirds of holders of voting stock excluding those held by the interested stockholder. *Id.* § 3-602(b)(2).

77. Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 512 (2002) (referring specifically to the Maryland Business Combination Act).

78. *See* JAMES J. HANKS, JR., MARYLAND CORPORATE LAW § 13.2, at 391 (Aspen Publishers 2011).

79. *Id.* § 13.3, at 396-97.

80. MD. CODE ANN., CORPS. & ASS'NS § 2-405.1 (2010); *see also* Shenker v. Laureate Educ., Inc., 983 A.2d 408, 418-28 (Md. 2009) (describing the evolution of Maryland's standards of director conduct).

81. MD. CODE ANN., CORPS. & ASS'NS § 3-803(a) (2010).

authorized by Maryland state law include poison pills,[82] supermajority voting requirements,[83] and high shareholder approval thresholds (though not exceeding one-half of all outstanding shares) to call special meetings.[84]

Like many other states, Maryland enacted antitakeover laws in response to a different set of policy concerns from those animating the ICA. Part IV will consider the two most prominent rationales in this context.

Part IV. The Theory Underlying State Law on Takeover Defenses

State laws permitting companies to adopt antitakeover provisions serve to protect two distinct classes of stakeholders in the firm: shareholders and non-investors. This Part will examine the rationales for states to allow operating companies to adopt various antitakeover measures in the context of protecting both of these groups.

Subpart A. Protection of Investors

Despite a mixed canon of empirical evidence supporting the proposition, proponents of antitakeover defense statutes have argued that such laws give management the leverage to maximize the price paid by an acquirer for its shares. For instance, one classic argument holds that tender offers for the shares of publicly-held firms "can coerce shareholders into selling their shares at suboptimal prices."[85] Recognizing rationally that a prospective acquirer will offer a premium only on the number of shares necessary to ascertain control of the target, all shareholders will feel compelled to tender their shares at the onset.[86] Since the shareholders would have difficulty coordinating to hold out for a higher price, they may all be "coerced" into tendering at a suboptimal price.[87] This collective action dilemma would

82. *Id.* § 2-201(c).

83. *Id.* § 2-104(b)(4).

84. *Id.* § 2-502(d).

85. Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WIS. L. REV. 467, 476.

86. *Id.*

87. *See* Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 19-28 (1985).

militate in favor of state protections of incumbent managers (and shareholders) to maximize the price received in a tender offer. The Williams Act, adopted in 1968, was intended to address this problem on a federal level by ensuring the procedural fairness of tender offers. Relevant bidding rules include setting a minimum open time for tender offers, allowing shareholders to withdraw their tendered shares at any time before the end of the offer period, and guaranteeing that shareholders have a pro rata portion of their shares purchased by the tender offeror in the event that the offer is oversubscribed.[88] However, several scholars believe that the protections created by the Williams Act do not sufficiently guard against the coercion problem.[89]

In addition to the loss of value to the incumbent shareholder created by the collective action problem, some academics have argued that stockholders tend to sell at a discount relative to the "true value" of their shares due to market mispricing. This argument holds that "stock market prices do not necessarily reflect intrinsic share values, thus permitting bidders to buy targets at undervalued prices."[90] Such a mispricing would reflect a view that the market has not impounded all publicly available information about the firm, and that management has a more accurate view of the fundamental value of the firm.[91] The implication of this argument is that shareholders would realize higher gains from holding onto their shares for the long-term

88. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2006).

89. *See, e.g.*, Richard A. Booth, *The Problem with Federal Tender Offer Law*, 77 CALIF. L. REV. 707, 713-14 (1989) (arguing that the shareholder incentive to tender is exacerbated by the Williams Act because investors are guaranteed the highest offered price and, due to the proration requirement, are not penalized for tendering too early); Steven M. Davidoff, *The SEC and the Failure of Federal Takeover Regulation*, 34 FLA. ST. U.L. REV. 211, 251-52 (2007) (arguing that the Williams Act's exception for public companies seeking to go private has kept in place the problem of coercion that the Act was intended to address).

90. Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1949 (1991) (citing Michael Bradley et al., *Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3 (1988)).

91. *See* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 997-99 (2002) (arguing that the fundamental mispricing view of a target company's stock reflects a rejections of the Efficient Capital Markets Hypothesis).

and waiting for the market to properly value the firm, rather than acceding to the tender offer.[92]

As a result, the argument concludes, state antitakeover provisions should impose a high bar on would-be acquirers so as to protect incumbent shareholders from their own myopic tendency to take advantage of a short-term opportunity at the expense of long-term gains. Such a view would be strengthened if boards of targets generally possessed private information that was superior to that of the acquirer and the public, which would provide a further basis for asserting that shareholders are likely not to receive payouts that are commensurate with the true value of the firm.[93] If managers did possess such private information, antitakeover defenses might provide the leverage necessary to negotiate for a higher price that reflects the true value of the firm. Antitakeover defenses might also function as a way to increase the payout to incumbent shareholders – even in the absence of asymmetric information – by making it more expensive for the acquirer to launch a hostile bid.[94] This is the central idea behind the "bargaining power hypothesis"[95] and the notion that states should provide a structure under which unannounced takeovers should occur so as to protect incumbent shareholders.[96]

However, empirical research tends to support the proposition that shareholders generate greater wealth from tendering their shares. In general, when incumbent managers successfully ward off tender offers, investors experience a substantial decline in share value.[97] Moreover, long-term studies

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92. Gordon, *supra* note 90, at 1949-50.

93. *See* Bebchuk, *supra* note 91, at 999-1001.

94. The seminal article propounding the bargaining power hypothesis, Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979), was written by the originator of the poison pill defense and one of the founders of the leading law firm in the field, Wachtell, Lipton, Rosen & Katz.

95. *But see* Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621 (2003) (arguing that the "bargaining power" created by antitakeover defenses is relevant in only a small fraction of acquisitions).

96 *Cf.* Kovens v. Paul, No. 04-Civ.-2238(TPG), 2009 WL 562280, at *8 (S.D.N.Y. Mar. 4, 2009) (arguing, in an operating company context, that the Maryland Control Share Acquisition Act "appears designed to protect shareholders from unannounced takeovers, not to protect the participants in such takeovers").

97. James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. FIN. 63, 86 (1994).

suggest neither that the market fundamentally underestimates the value of the shares of target firms nor that the managers of target firms have private information that would enhance the value of the company's stock if made public. One such examination, for instance, concluded that, thirty months after a bid announcement, the shareholders of targets who had tendered their offers had performed significantly better than those who chose to remain independent.[98] Finally, empirical research suggests that the additional bargaining power conferred on management by antitakeover statutes does not translate into superior returns for incumbent shareholders. For instance, evidence that charter amendments adopted by shareholder vote produce superior returns for such shareholders "is at best equivocal."[99] In light of this body of evidence suggesting that antitakeover statutes yield neither short-term nor long-term incremental value for incumbent shareholders, it is not surprising that leading academics have argued that shareholders should "want management to be passive in the face of a tender offer."[100]

Subpart B. Protection of Local Industry

In addition to investor protection, state antitakeover statutes may also serve a broader social (and political) goal of preserving and protecting local industry. Although state legislators often cite investor protection as the goal driving the passage of antitakeover statutes, many local lawmakers also believe that such laws will "protect business entities and their dependents such as employees and local communities."[101] Some of the specific fears to which such legislators are responding – despite inconclusive empirical

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98. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 934-35 (2002).

99. Gordon, *supra* note 90, at 1950 (citing Gregg J. Jarrell et al., *The Market for Corporate Control: Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 58-61 (1988)).

100. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1201 (1981).

101. Lyman Johnson, *Minnesota's Control Share Acquisition Statute and the Need for New Judicial Analysis of State Takeover Legislation*, 12 WM. MITCHELL L. REV. 183, 190 (1986).

research regarding their underlying basis[102] – include plant closings and employee layoffs, which are believed to be more likely if an out-of-state company acquirers the local firm.[103] In light of the fact that federal regulation of takeover-related activity, such as the Williams Act,[104] focuses on the protection of investors,[105] state legislators are likely to view antitakeover statutes as being helpful adjuncts that extend protections to non-shareholder stakeholders as well.[106]

Not surprisingly, empirical research suggests that much of the passage of and strengthening in state laws allowing firms to adopt antitakeover measures has occurred in response to the impending threat of the takeover of a local company by an out-of-state acquirer. One study found a strong correlation between the number of tender offers launched by acquirers and the frequency with which antitakeover laws were passed by state legislatures. This relationship proved to be particularly robust during the heyday of hostile takeovers that dominated news headlines in the 1980s.[107] Some of this legislative response was undoubtedly motivated by a genuine desire to protect local economies and communities generally.[108] Other legislative

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102. *Compare* Sang V. Nguyen & Michael Ollinger, *Mergers and Acquisitions, Employment, Wages, and Plant Closures in the U.S. Meat Products Industries*, 25 AGRIBUSINESS 70, 84 (2009) (concluding that "meat and poultry mergers led to an increase in employment at acquired plants during 1977-1987" and that these "mergers had little impact on worker wages"), *with* ROBERT F. BRUNER & JOSEPH R. PERELLA, APPLIED MERGERS AND ACQUISITIONS 85-86 (2004) ("The destructive aspects of M&A are well documented in the press: plant closings, uprooting of managers and their families, layoffs, transaction-related lawsuits, and so on.").

103. Johnson, *supra* note 101, at 190-91.

104. Securities Exchange Act of 1934 §§ 13(d)-(e), 14(d)-(f), 15 U.S.C. §§ 78*l*(i), 78m(d)-(e), 78n(d)-(f) (2006).

105. For a brief overview of the shareholder-protection rationale undergirding the Williams Act, see Andrew Ross Sorkin, *The Future of Tender Offer Regulation*, N.Y. TIMES, June 6, 2008, http://dealbook.nytimes.com/2008/06/06/the-future-of-tender-offer-regulation/.

106. *See* Tom D. Harris, Comment, *Responding to* CTS Corporation v. Dynamics Corporation of America*: Should Texas Adopt a Control Share Acquisition Statute*, 40 BAYLOR L. REV. 249, 263 (1988).

107. Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 458-62 (1988).

108. *See, e.g.*, Alan E. Garfield, *State Competence To Regulate Corporate Takeovers: Lessons from State Takeover Statutes*, 17 HOFSTRA L. REV. 534, 562

responses to the rising tide of mergers and acquisitions may have arisen from general public mistrust of such transactions, believing that the adverse impact on local communities and employees outweighed any salutary effect on shareholder value.[109]

That many state antitakeover provisions, however, confer protection only on specific industries – or even particular companies – suggests a legislative motive tied more closely to effective lobbying by a leading firm domiciled in the state.[110] In contrast to the intuitive story that a broad coalition of labor unions, community groups, and political leaders would advocate for an antitakeover statute to protect a major local employer, one case study suggests that such laws can emerge from the lobbying of singular or small groups of firms.[111] If such laws are tailored in such a way as to affect only those firms lobbying for their passage, the case study implies, they will likely avoid resistance and pass quickly.[112] A similar model may have applied to the MCSAA. Indeed, in its no-action letter to Boulder Fund, the SEC implies that a recent amendment to the MCSAA may have been passed for the purpose of helping closed-end funds to evade narrowly section 18(i) of the

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(1989) (quoting various politicians characterizing their state shareholder protection laws as, in fact, being intended to protect local jobs).

109. *See* John C. Anjier, *Anti-Takeover Statutes, Shareholders, and Stakeholders*, 51 LA. L. REV. 561, 585 (1991) ("The general public tends not to trust corporate management or shareholders, and seems to like takeovers for their regulatory effects on management, but dislikes them because of the possibility of economic dislocations.").

110. *See, e.g.*, Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 375 (describing a Minnesota law as being "designed to thwart the Dart Group bid for control of Dayton Hudson," a locally-based company and the forerunner to Target Corporation); William Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998) (analyzing the influence of local managers and business groups in the creation of state antitakeover statutes); Garfield, *supra* note 108, at 561 (listing state statutes passed in the 1980s explicitly to help a local firm rebuff a hostile takeover attempt).

111. *See* Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 122-36 (1987) (describing Aetna Life and Casualty Insurance Company's lobbying efforts to secure passage of a Connecticut state law that imposed stringent shareholder voting requirements to approve an acquisition).

112. *Id.* at 124-25.

ICA.[113] Such an amendment could likely have been spurred only through the encouragement of Maryland's substantial closed-end fund industry.

Regardless of a legislature's motive in passing a state antitakeover statue, the Supreme Court has provided legal cover by explicitly recognizing a state's interest in preserving local industry using protections against out-of-state acquirers. In *Edgar v. MITE Corporation*,[114] a case in which the Supreme Court struck down a state statute requiring tender offerors to give the state's secretary of state twenty days notice prior to initiating an offer as violating the Commerce Clause, Justice Powell's concurrence suggests that acquirers may have "professional personnel experienced in takeovers as well as . . .capital . . . that vastly exceed those of the takeover target."[115] This "disparity," the concurrence implies, enhances the likelihood that a target's operations will be moved away after consummation of the acquisition, resulting in "adverse consequences in terms of general public interest."[116] For this reason, Justice Powell concludes, states should be able to pass "legislation designed to assure . . . greater protection to interests that include but often are broader than those of incumbent management."[117]

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Despite empirical research suggesting that antitakeover statutes may be counterproductive, there exist two reasons why it may be reasonable to expect a state to enact such a law: to maximize value for incumbent shareholders, and to protect non-investor stakeholders in local firms. However, even to the limited extent that antitakeover statutes do protect shareholders and local operating companies, the peculiarities of closed-end funds demonstrate that such laws would likely destroy the value investment companies. Thus, as Part V demonstrates, states that keep their antitakeover statutes in effect should still exempt closed-end funds from their purview.

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113. Boulder Fund No-Action Letter, *supra* note 12, at *11-*12.

114. 457 U.S. 624 (1982).

115. *Id.* at 646 (Powell, J., concurring in part). Examples of such harms to the public interest include management personnel, "many of whom have provided community leadership," having to move to a new city and the diminution of "[c]ontributions to cultural, charitable, and educational life." *Id.* at 646 n.1.

116. *Id.*

117. *Id.* at 647.

Part V. The Inapplicability of Takeover Defenses for Closed-End Funds

Subpart A. Protection of Investors

Antitakeover statutes would harm investors in closed-end funds in two ways that are unique to the fund world vis-à-vis typical operating companies. First, antitakeover statutes distort the heightened fiduciary duties owed by fund directors to their shareholders by providing an avenue for such directors to act in their own self-interest at the expense of their investors. Second, in ways that are specific to the structure of the closed-end fund, antitakeover statutes serve no valuable purpose with respect to giving fund directors leverage in the course of negotiating with a prospective buyer. As a result, antitakeover statutes are likely to harm incumbent investors in closed-end funds by preventing their being "open-ended," with the assets being returned at market value to the investors.

First, closed-end funds require a particularly high degree of fiduciary responsibility on the part of the board of directors. In contrast to operating companies, investment companies need a uniquely high level of oversight because the "assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable."[118] The liquid nature of an investment company's assets poses a particular problem because of the conflict of interest inherent in an investment company's structure. Investment companies generally consist of four legally distinct entities, including the fund itself, its investment adviser, the principal underwriter or distributor of the fund's shares, and the fund's custodian and transfer agent.[119] Oftentimes, however, the investment adviser proactively forms the fund itself and then selects its board of directors, which (unsurprisingly) then select the original investment adviser to provide managerial services to the fund. The board of directors also negotiates the

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118. SEC SENATE REPORT, *supra* note 47, at 4.

119. JAMES M. STOREY ET AL., MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK § 32.2 (2010).

amount of compensation to be paid to the adviser.[120] As the composition of the board, the entity charged with overseeing the fund for the benefit of its shareholders, is selected by the fund's adviser, the potential clearly exists for the fund's "liquid, mobile and readily negotiable" assets to be expropriated wrongly by the adviser. In response to this conflict, the ICA includes prohibitions on conflicted transactions, extensive public disclosure requirements, and requirements for the presence of independent directors.[121] However, if the ICA's corporate governance mechanisms fail, investors have a self-help solution in the case of mutual funds and UITs that does not exist for closed-end funds: share redemption at net asset value. Redemption serves the dual purpose of providing an avenue for shareholders to withdraw from an underperforming fund and disciplining underperforming investment advisers, whose compensation typically consists of a percentage of net assets under management.[122]

By contrast, without redemption, closed-end fund shareholders are dependent upon the secondary market to realize gains on their investments. For retail shareholders who purchase shares in a closed-end fund's initial public offering and then see their shares' value slip to a discount relative to net asset value, a tender offer may be the only avenue for receiving in cash the full value of their investment. Though tender offers and proxy fights are common in the closed-end fund context relative to other forms of investment companies,[123] the reality is that if "a fund is set up on a closed-end basis, dispersed investors have no recourse in the face of managerial misbehavior,

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120. William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much Is Too Much?*, 57 N.Y.U. L. REV. 1059, 1063-64 (1982) (describing the process of mutual fund formation, which, in matters relating to adviser and board selection, proceeds in a manner similar to that of a closed-end fund).

121. Courts and the SEC have envisioned such directors as "independent watchdogs" that safeguard the interests of investors. *See* Burks v. Lasker, 441 U.S. 471, 484 (1979); *see also* SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 253 ("The oversight function performed by investment company boards, especially the 'watchdog' function performed by the independent directors, has served investors well, at minimal cost."), *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

122. *See* Jeffrey L. Coles, Jose Suay & Denise Woodbury, *Fund Advisor Compensation in Closed-End Funds*, 55 J. FIN. 1385, 1389-90 (2000) (describing the compensation scheme for a typical closed-end fund advisor).

123. Morley & Curtis, *supra* note 20, at 119-20.

and may see their entire investment slowly eaten away."[124] From the perspective of the average retail investor, such "managerial misbehavior" may include abuses of fiduciary duty, such as those contemplated by the ICA,[125] and poor performance with respect to investment selection. Without redemption, closed-end fund shareholders depend upon the oversight of the fund's board of directors to a far greater extent than shareholders invested in open-end funds. This underscores the heightened responsibility closed-end fund boards of directors owe their shareholders.

Indeed, empirical studies of closed-end funds demonstrate the importance of buyouts as a critical avenue for incumbent investors to realize the full value of their shares. Recent research suggests that antitakeover defenses create substantial costs for shareholders and would-be arbitrageurs seeking to liquidate an underperforming closed-end fund. One study examined the impact of activist arbitrageurs' attempts to convert closed-end funds into mutual funds on the share price of the target fund. Finding that such activists seem to focus their efforts on deeply discounted funds, the study concluded that the magnitude of the discount tends to fluctuate in proportion to the market's perception that the activists will be successful.[126] By implication, antitakeover defenses that create roadblocks for would-be arbitrageurs impose direct costs on incumbent shareholders by diminishing the probability of the buyer's success. Indeed, the same study demonstrated that discounts tend to decline when incumbent managers respond to takeover attempts by "tak[ing] corrective actions such as a share repurchase, dividend increase, or change in investment advisors."[127]

State antitakeover provisions thus run directly contrary to the institutional need to impose greater fiduciary accountability on closed-end

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124. Jeremy C. Stein, *Why Are Most Funds Open-End? Competition and the Limits of Arbitrage*, 120 Q.J. ECON. 247 248 (2005). Professor Stein makes the point that information asymmetries may actually result in an excessive number of funds adopting an open-end structure because the comparative ease with which a shareholder can exit his investment in an open-end fund means that a fund manager can credibly signal his quality through such a structure.

125. *See supra* notes 120-122 and accompanying text; *see also* 15 U.S.C. § 80a-1 (2006) (providing the findings and purpose of the ICA); Harriman v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133, 159-60 (D. Del. 1975) (describing the abuses in the investment company industry that the ICA was designed to counteract).

126. Michael Bradley et al., *Activist Arbitrage: A Study of Open-Ending Attempts of Closed-End Funds*, 95 J. FIN. ECON. 1, 17-18 (2010).

127. *Id.* at 18.

fund managers by providing them a means of self-entrenchment that would further isolate them from market pressures. As shareholders cannot exit from a closed-end fund through redemption, laws that create roadblocks for would-be acquirers dramatically weaken the other remaining form of market pressure needed to discipline fund managers – particularly when they have such strong financial incentives to remain in control of the fund. Studies of the discount arising from undertaking antitakeover protections indicate that the pressure imposed by takeover attempts on closed-end funds forces the funds' management to engage in value-creating activities that raise share prices. To the extent that fund price discounts arise from agency costs, such as incumbent fund managers engaging in "misinvestment or expropriation,"[128] takeover attempts may bring the incentives of such managers back into line with the investors' interests. Antitakeover devices can only serve to inhibit the incentive for entrenched managers to act in this manner.[129]

It therefore is not surprising that the ICA strongly emphasizes shareholder participation in the governance of closed-end funds.[130] While the desire to incorporate a corporate democracy approach to fund governance underlies the voting requirements imposed on mutual funds,[131] the true interest animating such requirements is the need to create a robust oversight mechanism.[132] Nowhere is this need more pressing in the constellation of

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128. Reinier Kraakman, *Taking Discounts Seriously: The Implication of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 904 (1988).

129. *Cf.* Bill B. Francis et al., *The Effect of State Antitakeover Laws on the Firm's Bondholders*, 96 J. FIN. ECON. 127, 130 (2010) (reviewing prior studies regarding the detrimental impact of state antitakeover laws on firm value and on manager behavior in the operating company context).

130. *See supra* notes 59-67 and accompanying text.

131. *See* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991) (examining the role of populist political forces in the passage of the Investment Company Act).

132. Tellingly, in response to criticism that shareholder voting does not always provide optimal oversight of investment companies, the SEC briefly considered a proposal in the early 1980s to allow certain mutual funds to operate either without shareholder voting or without boards of directors. The SEC explicitly argued that shareholders in investment companies other than mutual funds would be insufficiently protected without voting mechanisms because such investors "do not have the freedom to redeem their investment at current net asset value. . . . [S]uch investors must sell at a market price which may not, in their opinion, reflect the value their investment might have if the company's management were different." Advance

investment companies than in the case of the closed-end fund. State antitakeover statutes that provide an avenue for incumbent managers to entrench themselves without a corresponding increase in value to shareholders run directly contrary to this goal.

In addition, antitakeover statutes are an inapposite means for creating negotiation leverage specifically for closed-end fund managers seeking to maximize the amount paid to shareholders. As discussed in Part IV.A, *supra*, two theoretical arguments exist for providing incumbent managers of operating companies with additional leverage in the course of negotiating with a prospective buyer: the managers believe that the market is undervaluing the company's shares and that shareholders would realize higher returns from holding their shares in the long term, and the managers have private information about the true value of the corporation leading them to believe that the prospective buyer's offer is insufficient. In neither case, however, do the incumbent managers or the prospective buyers have an objective view of the value of the target's shares. Managers may be wrong in believing that their private information about the value of the company has not been impounded in the firm's stock price, depending on the presence of insider trading,[133] the likelihood of information leaks, and the efficiency of the market in which the company trades.[134] Even if management's

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Notice and Request for Comment on Mutual Fund Governance, Investment Company Act Release No. 12,888, 47 Fed. Reg. 56,509, 56,510 n.1 (Dec. 10, 1982). The proposal subsequently was not adopted. *See* Mutual Fund Governance, 54 Fed. Reg. 45,653, 45,654 (Oct. 30, 1989) (concluding that changes to mutual fund governance structures of the sort proposed in 1982 "should be effected through legislative rather than administrative action").

133. Empirical studies suggest that investors interpret sales of shares by insiders as signals that such insiders have private information suggesting that the company will perform more poorly than the public suspects. *See, e.g.*, Esther del Brio & Alberto de Miguel, *Dividends and Market Signaling: An Analysis of Corporate Insider Trading*, 16 EUR. FIN. MGMT. 480 (2010).

134. The efficient capital market hypothesis states that, at any given time, the prices on the market already reflect all known information and react quickly to reflect new information. In semi-strong-form efficiency, prices reflect only publicly available information, while in strong-form efficiency, prices reflect all public and private information. Stocks trading in markets exhibiting "weaker" efficiency thus may not reflect all publicly available information about the stock, thereby making it more possible for managers to have superior information about the true value of the firm. Eugene Fama of the University of Chicago formalized these varieties of the efficient capital market hypothesis in 1970. Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

information is truly private and not reflected presently in the share price of the company, incumbent managers cannot anticipate how the market will react to such news. For instance, the managers of a car company may know about their firm's imminent plans to enter a foreign market and believe that this venture will prove lucrative. However, upon learning of these plans, the market might react negatively and drive the car company's stock price down on account of the belief that the firm will not gain share in the foreign market and so will lose money. As a result of this uncertainty in a share's fundamental value, an argument could be made that the incumbent managers of an operating company might extract a higher price from buyers, given additional negotiation leverage.

However, neither of these arguments applies to closed-end funds because the objective value of a closed-end fund's share can be calculated with greater certainty. Closed-end funds "simply invest in securities [and] are not manufacturers or sellers of goods."[135] Although closed-end funds can and do trade in securities that are more illiquid than those held by mutual funds, which means that some of the assets held by the fund do not always have an immediate up-to-date market valuation, closed-end fund managers must disclose on a daily basis the net asset value of the fund's shares. Such managers must select a particular methodology for calculating the net asset value upon the fund's inception that accounts for the holdings' illiquidity and notify investors of any subsequent changes to the methodology.[136] As a result, shareholders in a closed-end fund have an objective view of the value of their fund's shares, one which can be checked simply by observing the prices of the fund's publicly-traded portfolio holdings in isolation. Thus, at the most basic level, closed-end fund managers cannot have the private information about their assets that could inform an argument in favor of their knowing more about the fundamental valuation of the fund's assets than the public.

Subpart B. Protection of Local Industry

The nature of the closed-end fund does not lend itself to the form of protectionism drafters of antitakeover statutes envision. Literature on the

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135. Expert Report of Tamar Frankel at 6, Neuberger Berman Income Fund v. Lola Brown Trust, 342 F. Supp. 2d 371 (D. Md. 2004) (Civil No. AMD 04-3056), 2005 WL 329249 at *6 [hereinafter "Frankel Report"].

136. *See* Pricing of Redeemable Securities for Distribution, Redemption and Repurchase, 17 C.F.R. § 270.22c-1(b)(1) (2010).

"first generation" of antitakeover statutes – that is, before one such law was invalidated in *Edgar v. Mite Corporation*[137] – hearkens back to an era of social concern for the place of the firm in the local community. Writers reflected on antitakeover statutes in the context of the belief that "locally based major businesses tend to be more involved in various aspects of their community than branch operations of comparable size."[138] Such a state of affairs would arise because "branch operations tend to be under the administration of a plant manager, or, at best, a vice-president of a national corporation who often sees his tour of duty in that plant as a step on a corporate ladder."[139] An analysis of an early antitakeover statute passed in Ohio revealed that the law was passed to protect certain key manufacturers with operations in the state,[140] without which local communities would undoubtedly suffer. Early court analyses of state takeover legislation saw locally-based companies as engaged community stakeholders that promoted worthwhile causes through the employment of local workers.[141] Indeed, public concern about the impact of mergers and acquisitions reflects the visibility of news about plant closings resulting in the wholesale dismissal of a workforce, even if such opinion is skewed by the relative infrequency with which news about takeovers unaccompanied by mass layoffs is reported.[142]

Even within the stylized story of antitakeover statute as defender of parochial economic interests, however, closed-end funds are particularly unlikely to play the role of community pillar and employer. First, the

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137. 457 U.S. 624 (1982).

138. Theodore R. Boehm, *State Interests and Interstate Commerce: A Look at the Theoretical Underpinnings of Takeover Legislation*, 36 WASH. & LEE L. REV. 733, 745 (1979).

139. *Id.* at 745-46.

140. A.A. Sommer, Jr., *The Ohio Takeover Act: What Is It?*, 21 CASE W. RES. L. REV. 681, 682-83 (1970).

141. *See, e.g.*, Great W. United Corp. v. Kidwell, 577 F.2d 1256, 1282-83 (5th Cir. 1978) (recognizing a state's interest in promoting and protecting local corporations that contribute meaningfully to local life through charitable contributions or commitments to environmental and worker safety initiatives), *rev'd*, 443 U.S. 173 (1979); *see also* Romano, *supra* note 111, at 121 (reflecting on the outcry over the acquisition of Gulf Corporation by Standard Oil Company of California in 1984 on account of concerns that community charitable interests and the "local economy would be adversely affected if Gulf's corporate headquarters were transferred after the control change").

142. *See* Romano, *supra* note 107, at 496-97.

evidence on the efficacy of antitakeover statutes as a form of parochialism appears mixed.[143] Second, and more specifically, closed-end funds do not produce tangible goods and often have "no employees but only officers, usually associated with the investment manager or original sponsor of the fund."[144] Such officers and investment managers need not be located in the domicile state of the fund. Moreover, the economic interests of closed-end funds extend well beyond the borders of their home state. Both the shareholders in and the investments of closed-end fund are likely to reside globally,[145] and so any disruption in the operation of the fund would not be felt with any particularly acute impact by its home state. Indeed, the contemporary closed-end fund market includes funds that invest in a highly diverse array of international securities and issue shares to investors globally.[146]

As a result, closed-end funds represent a poor-fitting target for the protection of parochial economic interests by state legislatures. They neither employ local workers, nor contract with local suppliers, nor require any particular physical connection to their domicile state to operate effectively. It thus seems unlikely that a successful tender offer for a closed-end fund's shares would disrupt meaningfully any local communities. To the extent that state antitakeover statutes are intended to protect such groups or interests, closed-end funds should therefore be exempted from their purview.

Part VI. Recommended Policy Response

In light of the misalignment between state antitakeover statutes and closed-end funds, this part will present an approach for the SEC to police funds that adopt antitakeover defenses using a combination of litigation and an educational campaign to encourage investors to advocate for the inclusion of "lifeboat provisions" in the charters of their funds. It will also address

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143. *See supra* notes 107-109 and accompanying text.

144. Frankel Report, *supra* note 135, at 6.

145. *Id.* (citing SEC SENATE REPORT, *supra* note 47, at 4).

146. *See* ICI FACTBOOK, *supra* note 16, at 55 fig. 4.2 (indicating that 23% of closed-end fund net assets were invested in global/international bonds and equities as of the end of 2009); *id.* at 56 fig. 4.3 (showing that the majority of share issuance proceeds to closed-end funds investing in equities in 2009 went to those funds focusing on global/international securities).

counterarguments to the general theory that closed-end funds trading at a substantial discount should have access to antitakeover defenses.

Subpart A. A Long-Term Strategy for the SEC

In light of the degree to which state antitakeover statutes harm closed-end fund investors, the SEC should adopt a more aggressive stance when closed-end funds adopt defensive structures akin to the MCSAA. In particular, the SEC should pursue a two-prong strategy, including first initiating enforcement actions against closed-end funds that opt into the MCSAA (and filing amicus briefs in support of plaintiff-investors seeking to open the closed-end funds), and then engaging in a broader campaign to publicize and support the inclusion of "lifeboat provisions" in the charters of closed-end funds. This strategy will help the SEC argue in favor closed-end fund shareholder protection in the courts and to ensure that investors are educated about the ways in which they can discipline underperforming closed-end fund managers.

The investment industry's response to the Boulder Fund No-Action Letter suggests that the SEC will soon have the opportunity to test its position in the courts. Shortly after the release of the no-action letter, the partners leading the ICA practice at one multinational law firm questioned whether "enforcement of this view [expressed in the no-action letter] of Section 18(i) voting rights will become a priority" and intimated that the degree of deference courts would accord it might be limited.[147] The attorneys representing an investor holding 9.2% of the outstanding shares of a closed-end fund published a letter to the fund's representatives inquiring whether the fund plans to remain opted into the MCSAA in light of the Boulder Fund No-Action Letter.[148] Lastly, as the no-action letter explicitly references twenty-

147. *See* Douglas P. Dick, Karl J. Paulson Egbert & Sean R. Murphy, *SEC Staff Indicates the Maryland Control Share Acquisition Act Conflicts with the Investment Company Act*, DECHERT ON POINT, Feb. 2011, at 3 & nn.12-13 (citing N.Y.C. Emps. Retirement Sys. v. SEC, 45 F.3d 7, 12-13 (2d Cir. 1995) (arguing that SEC no-action letters should be accorded less deference than rulemaking orders or formal policy announcements)), *available at* http://www.dechert.com/library/FS_2_02-11_SEC_Staff_Indicates_the_Maryland_Control.pdf.

148. *See* Letter from John M. Baker, Of Counsel, Stradley Ronon Stevens & Young LLP, to R. Darrell Mounts, Partner, K&L Gates LLP, Nov. 29, 2010, *available at*

five state statutes it views as being sufficiently similar to the MCSAA as to implicate section 18(i) of the ICA, there are numerous jurisdictions in which litigation over the substance of the no-action letter could begin.[149] In short, the SEC should prepare to push back on closed-end funds seeking to opt into state control share acts either through enforcement actions or through intervening on behalf of plaintiff-investors whose voting rights are at issue.

In addition, the SEC should publicize more widely the use of "lifeboat provisions," which "help rescue shareholders when a fund's share price sinks as a result of a wide discount to net asset value."[150] Such provisions may be characterized as "soft" or "aggressive," which denotes whether the provision may be exercised through a vote of the board of directors or the shareholders, respectively.[151] In either case, funds often provide lifeboat provisions in highly specific terms so as to entice investors with concrete protections against poor performance. As an example of a "soft" lifeboat provision, one fund's prospectus contains a "mandatory tender offer" to purchase its shares at a price equal to net asset value if it trades at a discount of prescribed magnitude and time length.[152] A different fund includes an "aggressive" provision that allows for a shareholder referendum on whether a fund should convert to open-ended status, provided that at least ten percent of the fund's outstanding shares request that the fund consider open-ending itself.[153] The inclusion of an aggressive lifeboat provision in a closed-end fund's charter

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http://www.investmentpartners.com/downloads/Activism/11-29-2010-Letter%20to%20Foxby%20Board%20MCSAA.pdf.

149. *See* Boulder Fund No-Action Letter, *supra* note 12, at *1 n.1; *see also Investment Services Regulatory Update*, VEDDERPRICE, Feb. 1, 2011, at 8, *available at* http://www.vedderprice.com/docs/pub/ca5f114e-c294-4984-b85f-0529886f3a15_document.pdf (noting the "broad applicability" of the Boulder Fund No-Action Letter).

150. Earl D. Weiner & James J. Hanks, Jr., *Directors' Duties and the Discount*, 8 INVESTMENT LAWYER 9, 10 (2001).

151. Yul W. Lee & Keith M. Moore, The Premium-Discount Puzzle of Closed-End Bond Funds: An Empirical Examination of the Dividend Yield Preference Hypothesis 7 (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=410184.

152. *See* ROBERT A. ROBERTSON, FUND GOVERNANCE: LEGAL DUTIES OF INVESTMENT COMPANY DIRECTORS § 12.03[1], at 12-20 (2001).

153. Lee & Moore, *supra* note 151, at 7.

would create a valuable check for shareholders against the entrenchment of underperforming fund managers.[154]

Several aspects of an aggressive lifeboat provision would assist closed-end fund shareholders in a position of holding shares trading at a discount. First, because aggressive lifeboat provisions credibly commit a board to opening a fund in the event that the fund's poor performance persists, their addition to a fund's charter frequently causes any existing discount to narrow.[155] Second, aggressive lifeboat provisions effectively obviate the strike at shareholder democracy caused by antitakeover defenses by bringing the question of how best to deal with a persistent discount to the group the discount affects must acutely – the fund's investors. Indeed, a direct vote on whether to convert a fund to open-ended status would allow all the fund's shareholders to consider for themselves whether they believe it likely that the closed-end fund's share price will recover to net asset value. If the shareholders still have faith in the incumbent managers, then they can vote to keep the fund closed; if not, they can open the fund and enjoy the benefits of value appreciation as the fund's discount to net asset value narrows. Taking this critical decision out of the hands of management – particularly when so many structures, including control share acts, allow for managers to entrench themselves[156] – would represent a valuable tool for closed-end fund investors.

Moreover, lifeboat provisions would effectively render moot the obstacles created by state antitakeover statutes. As discussed in Part II, the shareholders of closed-end funds that have been trading at a persistent discount can obtain the most benefit when their fund converts to open-ended status, which results immediately in the closure of the discount gap. In the absence of a mechanism for shareholders to obtain this benefit for themselves, however, they are left only with the prospect of a takeover attempt launched by a dissident shareholder. The state antitakeover provisions outlined in Part

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154. *Cf.* Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy*, 104 YALE L.J. 367, 414 (1994) (arguing, in the context of the design of a trust fund structured as a closed-end fund, that the trust shares "should embody limited voting powers to enable shareholders to replace incompetent or dishonest managers").

155. *See* Bradley et al., *supra* note 126, at 9; *see also* ROBERTSON, *supra* note 152, § 12.03[1], at 12-21 (calling into question the effectiveness of lifeboat provisions at narrowing persistent discounts when there exists "skepticism that the funds actually would undertake the actions described" by the lifeboat provisions").

156. *See* William Gleeson et al., *Strategies for Closed-end Funds When Dealing with Proxy Contests and Hostile Tender Offers*, K&L GATES, Jan. 14, 2009, http://www.klgates.com/files/upload/01_14_09_Handout_Closed_End_Funds_Webinar.pdf.

III are all intended to obstruct this process, which is particularly problematic given the absence of incentive for any incumbent fund managers to support a takeover attempt. In short, lifeboat provisions would circumvent the challenge of a fund negotiating with a prospective buyer by allowing all the fund's shareholders to vote on whether to obtain for themselves the benefits they would obtain if the takeover were successful – without having to vote on the takeover itself. This makes lifeboat provisions a particularly valuable tool in the context of closed-end funds.

Subpart B. Policy Rationale

Closed-end fund managers have advanced two key arguments in favor of keeping their funds closed when confronted with activist investors. These include the fund structure's conduciveness to deferral of capital gains taxes and ability to invest in illiquid assets without having to keep cash available for redemption requests as mutual funds must. However, while each of these arguments provides a theoretical rationale for preserving the structure of the fund, empirical research demonstrates that none of these arguments fully explains the magnitude of the discounts that typically emerge after a closed-end fund makes its initial public offering. As a result, closed-end fund investors – especially those who purchase shares in the primary market – often have no avenue for realizing the full value of their shares, short of open-ending the fund. This makes it imperative that the SEC police funds trading at persistent discounts that have adopted antitakeover defenses, as such defenses may harm the funds' shareholders.

Fund managers and academics frequently emphasize the tax deferral benefits that are unique to the structure of a closed-end fund. In 2007, for instance, the Pioneer Municipal and Equity Income Trust sought to defeat a tender offer launched by an activist investor by arguing that the tender would create a taxable event for shareholders by compelling the realization of gains.[157] This argument echoed the perspectives taken by other prominent closed-end funds in similar situations – particularly the Zweig Total Return Fund.[158] This argument is underscored by some theoretical research behind

157. Pioneer Municipal and Equity Income Trust, Solicitation/Recommendation Statement (Schedule 14D-9) (Nov. 14, 2007), at 5, *available at* http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=5545376&SessionID= zgW7Hjuc9vn9i77.

158. *Open-End or Closed-End Fund: That Is the Question*, ADVISORONE, May 10, 2004, http://www.advisorone.com/2004/05/10/openend-or-closedend-fund-that-is-the-question.

the origin of the closed-end fund's discount. In theory, the magnitude of the discount at which a closed-end fund trades should rise as the fund's assets rise in value, which, in turn, creates additional unrealized appreciation for the shareholder.[159] This unrealized appreciation represents a future tax liability for the fund's investors, thus diminishing the present value of the fund's shares. On this basis, closed-end funds whose underlying assets have performed well should have a compelling argument justifying a large trading discount – and for wanting to protect their fund from shareholders who would like to liquidate it.

Nonetheless, the argument that closed-end funds can help investors to defer taxes does not typically provide a strong rationale for keeping the fund closed. Empirical research has presented conflicting results on whether unrealized appreciation influences the discounts at which closed-end funds trade at all.[160] As a result, closed-end fund shareholders – particularly those who purchased the fund's shares in the primary market before a discount emerged – may be holding assets whose values are unduly penalized by the market, relative to the deferred tax liability.[161] This weakens the argument that closed-end funds need antitakeover defenses to protect unrealized capital gains.

In addition, it is worth noting that the viability of the tax-related arguments that closed-end funds advance in favor of retaining antitakeover defenses depend upon the unique circumstances of their investors. After highlighting its tax-advantaged status, for instance, the Pioneer Municipal and Equity Income Trust added parenthetically that its trustees "recognize that certain investors may seek to take advantage of the [tender offer] as part of an arbitrage or other investment strategy."[162] Academic research into the

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159. *See* Burton G. Malkiel, *The Valuation of Closed-End Investment-Company Shares*, 32 J. FIN. 847, 847-50 (1977); *accord* Morris Mendelson, *Closed-End Fund Discounts Revisited*, 13 FIN. REV. 48 (1978).

160. *Compare* Malkiel, *supra* note 159, at 849-50, 857 (finding a modest positive correlation between unrealized appreciation and discount magnitude), *with* James Brickley et al., *The Tax-Timing Option and the Discounts on Closed-End Investment Companies*, 64 J. BUS. 287, 309 (1991) (finding a negative correlation between unrealized appreciation and discount magnitude, and noting that such "findings are opposite conventional wisdom that unrealized gains represent a tax liability that increases the discount").

161. *Id.*

162. Pioneer Municipal and Equity Income Trust, Solicitation/Recommendation Statement (Schedule 14D-9) (Nov. 14, 2007), at 5, *available at*

origin of the closed-end fund discount also emphasizes that the "amount of discount that can be justified by unrealized capital gains . . . applies only to investors who desire to buy into the fund," rather than those "who have owned shares of the fund for some time and are not being taxed on a return of capital when gains are realized."[163] As a result, antitakeover defenses – particularly control share acquisition acts – fly in the face of arguments couched in the collective welfare of shareholders by making it possible for a small minority of shareholders to veto a transaction that would enhance value for the majority.

In addition to tax-related arguments, closed-end fund managers often also contend that their fund structure enables long-term investments in illiquid assets in ways that the mutual fund structure does not permit. Because closed-end fund investors cannot redeem their shares for the underlying value of the assets in the fund, as mutual fund investors can, closed-end funds need not retain substantial cash reserves on hand to meet such redemption requests. Faced with a takeover attempt by an activist investor, one fund argued in its proxy statement that in volatile markets, the closed-end fund structure "allows the portfolio management team to act quickly with the knowledge that the [f]und is not subject to the potentially unlimited redemptions that an open-end fund might encounter."[164] A well-known advocate for the closed-end fund industry has also argued that the absence of a redemption feature makes the fund structure "particularly advantageous for investing in less liquid securities or markets, venture capital opportunities, real estate and private placements."[165] Some empirical research suggests that the absence of redemption allows closed-end funds to provide retail investors with access to illiquid assets, such as foreign stocks and

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http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=5545376&SessionID=zgW7Hjuc9vn9i77.

163. Matthew A. Walker, An Agency Explanation of the Closed-End Discount 12-13 (May 192) (unpublished Ph.D. dissertation, Texas Tech University), *available at* http://etd.lib.ttu.edu/theses/available/etd-02262009-31295006974033/unrestricted/31295006974033.pdf.

164. DWS Global Commodities Stock Fund, Inc., Proxy Statement (Schedule 14A) (Sept. 2, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1296115/000095012308010516/e64875defa14a.htm.

165. James J. Hanks, Jr., *Control Share Acquisition Statutes, Section 18(i) and Closed-End Funds*, 18 INVESTMENT LAWYER 1, 18 n.50 (2011).

bonds, at reduced cost by aggregating the purchase of such assets[166] and by eliminating the threat that a fund must sell some illiquid assets prematurely to meet redemptions.[167]

The justification that closed-end funds need antitakeover defense to preserve their relative ease of access to illiquid assets presents a key challenge. Although it is difficult to price an illiquid security objectively, empirical research suggests – as in the case of tax deferral valuation – that closed-end funds trade at a discount that varies significantly from that which the illiquidity of their underlying portfolios would suggest.[168] In the absence of a more compelling explanation, researchers frequently ascribe this excess discount to investor irrationality[169] or, at least, factors not related to "pricing theories that are based on fundamentals."[170] This suggests that shareholders frequently "overpay" for the benefit of an investment vehicle designed to facilitate exposure to thinly-traded assets.

In short, the benefits that fund managers ascribe to maintaining a closed structure often prove not to be worth the loss in shareholder value created by persistent discounts. Moreover, many of the arguments relating to the tax deferral features of the closed-end structure depend upon the particular circumstances of the fund's investors, which makes it all the more logical to take the decision of whether to open a fund from the hands of management and to put it into those of shareholders. As a result, the SEC should prepare to litigate on behalf of the rights of shareholders to challenge incumbent closed-end fund managers and to advocate for the inclusion of aggressive

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166. *See* Cherkes et al., *supra* note 33, at 263-64 (citing Lawrence E. Harris & Michael S. Piwowar, *Secondary Trading Costs in the Municipal Bond Market*, 61 J. FIN. 1361 (2006)).

167. *See* Robert Edelsen, *Investor Flows and the Assessed Performance of Open-End Mutual Funds*, 53 J. FIN. ECON. 439 (1999).

168. *See supra* note 33; *see also* Burton G. Malkiel & Yexiao Xu, The Persistence and Predictability of Closed-End Funds Discounts 12 (unpublished manuscript), *available at* http://www-stat.wharton.upenn.edu/~steele/Courses/956/ Resource/ CEF/MalkielXu.pdf (describing the ambiguous impact of illiquidity on a closed-end fund's discount).

169. Charles M.C. Lee, Andrei Schleifer & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 46 J. FIN. 76, 84 (1991) (arguing that "it seems necessary to introduce some type of irrational investor to be able to explain why anyone buys [closed-end] fund shares at the start").

170. Jeffrey Pontiff, *Costly Arbitrage: Evidence from Closed-End Funds*, 111 Q.J. ECON. 1135, 1136 (1996).

lifeboat provisions in fund charters as a bulwark against antitakeover defenses.

Part VII. Conclusion

Andrew J. Donohue, a recent director of the Division of Investment Management at the SEC, recently attempted to strike a balanced chord in discussing the appropriateness of closed-end funds employing various tactics to frustrate takeover attempts:

> To be fair, it must be acknowledged that a fund's proposed response to certain challenges, particularly in the closed-end space, may have a salutary purpose, such as to defend against arbitrageurs attempting to make a short-term profit in funds trading at a discount to net asset value potentially at the expense of long-term investors. In this situation, the interests of arbitrageurs may conflict with the interests of long-term fund investors and the funds must perform a difficult balancing act. In reacting to these challenges, fund boards must be prudent in their responses in order to fulfill their fiduciary duty to the fund and its shareholders.[171]

Donohue's cautious tone reflects the audience he was addressing: the Independent Directors Council "serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors," with a particular emphasis on corporate governance issues.[172] Though the Council has suggested support for the elimination of antitakeover provisions in the charters of funds,[173] the relative paucity of proposals to eliminate antitakeover positions in spite of their commonality suggests that fund

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171. Donohue, *supra* note 68.

172. *About the Independent Directors Council*, INDEP. DIRS. COUNCIL, http://www.idc.org/idc/about_idc (last visited Mar. 8, 2011).

173. *See, e.g.*, *Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders*, 14 INV. CO. INST. RESEARCH PERSP. 1, 3 (2008) (characterizing proxy proposals to eliminate "provisions that could prevent value-enhancing takeover attempts" as being "in the interests of fund shareholders"), *available at* http://www.ici.org/pdf/per14-01.pdf.

directors prioritize other issues more highly.[174] Indeed, the tone of the Boulder Fund No-Action Letter suggests that the SEC may assume a more aggressive posture in monitoring the antitakeover postures that closed-end funds adopt in the future.[175]

The SEC's lack of forcefulness up until the present, however, may already have allowed courts to defer to antitakeover statutes in the closed-end fund context without considering their economic consequences. This story is reflected in the end of the tail of the DWS Enhanced Commodity Strategy Fund and the subsequent release of the Boulder Fund No-Action Letter, discussed in the introduction. Ultimately, DWS investors won a small victory when, in the face of euphemistically-termed "potential disruptive actions by a dissident shareholder," the fund's directors elected to opt out of the MCSAA.[176] However, all the evidence points to successes like proving to be short-lived, with more challenges around the corner.[177]

If and when such challenges do materialize, the SEC should move firmly to defend the stance taken in its no-action letter to Boulder Fund. Only by doing so will the incumbent shareholders of closed-end funds have an opportunity to maximize the value of their shares, which likely will rise to their net asset value only if a buyer can make a serious effort to open-end the fund. Indeed, the text of the ICA requires it, the principles of effective fund governance compel it, and the rights of shareholders demand it.

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174. *Compare id.* at 4 *with id.* at 8 (indicating that antitakeover-related proxy proposals comprised only eight percent of management-led proposals versus fifteen percent of shareholder-led proposals).

175. *See, e.g.*, Boulder Fund No-Action Letter, *supra* note 12, at 8 (implying that the exercise of the MCSAA to closed-end funds would result in a form of "coercion" with respect to acquiring shareholders); *id.* at 11 (implying that such exercise of the MCSAA would undermine the ICA's "meaningful protection[s] against unfair discrimination").

176. Press Release, DWS Enhanced Commodity Strategy Fund, Inc. Announces Election To Opt Out of the Maryland Control Share Acquisition Act (July 21, 2010), *available at* https://www.dws-investments.com/EN/docs/about-us/press-releases/GCS_Election_to_Opt_Out_of_the_Maryland_Control_Share_Act_72010_Final.pdf.

177. *See supra* notes 147-149 and accompanying text.

DRAFTING A SECURITIES ARBITRATION CLAIM: THE PEN IS (STILL) MIGHTIER THAN THE MARKET[1]

Melanie S. Cherdack[2]

I. When Do You Prepare a Statement of Claim

In a perfect Claimant lawyer's universe, an in-house attorney would, after reading your client's statement of claim, dab the tears from his or her eyes, call the general counsel and plead for more than your statutory damages to settle your particularly sad and egregious case without delay. In the current climate in 2012, however, the early resolution of claims is becoming a rarity as brokerage firms are flooded with thousands of customer complaints. The number of filings at FINRA is escalating proportionate to the post 2008 market meltdown. The swift decline in the markets exposed countless improprieties including product failures for which risks were not properly disclosed, ill advised market strategies, Ponzi schemes, and garden variety fraud and negligence, which had been masked for years during a long market rally. So many lost so much so fast that it is easy to see why defense attorneys are becoming desensitized to the chronic cries of the financially battered. And, with corporate earnings of the remaining investment houses and affiliated banks on a downswing, because publicly held broker dealers have shareholders to answer to, only the unusually horrific wrong is redressed early in the arbitration process. That being said, it is still not a bad idea to attempt to settle a particularly noxious case pre-filing. Even if you decide to go this route, a fully articulated statement of claim provided to the broker-dealer but stamped "draft for settlement purposes only," will go a long way in assisting the decision makers in an early evaluation of your client's claims.

A well-drafted statement of claim is a necessity even where you are aiming for a pre-filing resolution. There is simply no substitute for putting the facts down in a narrative fashion so that everyone can see just how badly your

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1. This article is an update of an article that appeared in the PIABA 11th Annual Meeting Book (2002).

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client was wronged, by whom, and in what compensable way. Drafting a statement of claim can also help you refine your case. Working with your client to get all of the salient facts on paper will focus the issues and allow you to see many of the strengths and weaknesses of your claim at this early stage in the process. In this way, you, as the Claimant's attorney, are better equipped to evaluate the case from a settlement standpoint.

A. Know Your Audience

When distilling the facts and law of your securities action into a final written statement of claim, Claimant's counsel must keep in mind just who the ultimate audience will be. You are not just drafting for the Respondents themselves, but rather a whole host of readers, any of whom might influence the ultimate decision in your action. These readers may include: (1) in-house counsel; (2) (outside) defense counsel; (3) broker-dealer management; (4) an insurer; (5) three diverse arbitrators; and (6) regulators. Each audience has a different agenda, and each will view aspects of your claim from a different perspective from the others. Remembering who your readers will be can assist you in focusing your attention on the areas that each party will likely seize upon in making a decision in your case.

While there are no guarantees as to the route your claim will follow, the astute Claimant's attorney can measure certain variables in drafting a claim to anticipate how the case will be "triaged" when it lands at the Respondent brokerage house. What happens to your claim, and who handles it, will affect the pace at which it is resolved, the manner in which it is resolved, and how much (if any) the offered resolution may be.

B. Who will get your case: Inside Lawyer or Outside Law Firm?

When drafting the claim, the Claimant's attorney should be aware that certain allegations may make it more likely for the case to go to outside counsel. In-house counsel must make a decision early on how your case will be defended. Will it retain outside counsel who will be compensated hourly for defending the action and therefore have an incentive to spend more time and effort in litigating the case? Or, will it be handled in-house, along with the crush of dozens of other cases and perhaps plod along in a different fashion without getting as much individual attention? With the deluge of new cases, many more arbitrations are being referred to outside attorneys whose marching orders are to defend vigorously and whose continued employment

by the broker-dealer depends on their performance in each new case. While transferring your case to outside attorneys may insure that your case gets more individual attention, it may also mean more costly and combative tactics. In most cases, it also means that there is little hope for an expeditious resolution as the defense bar, too, has kids to put through college. You should determine early whether you believe that in-house or outside counsel will be most effective in the final resolution of your case, and if possible tailor your claim accordingly. When drafting a claim, Claimant's counsel should be aware that certain situations may make it more likely for a case to go "outside."

(1) Size matters

The sheer size of a claim is a factor. A million dollar claim is more likely to justify the use of an outside lawyer from a pure cost perspective. If your client has lost a million, but the compensable portion of the claim is really only a fraction of this, you may want to consider keeping your claims narrowed to the limited issue and demand the more realistic number to keep the case in-house. This, of course, will earn you credibility with Respondents and the arbitrators, and may streamline any proceedings and shortcut anticipated defenses, making it easier for the case to stay in-house.

Exotic or failed investment products also may warrant the use of outside counsel. Structured products, synthetic securities, derivative investments, complex investment strategies, annuities, or the use of affiliated credit facilities or reverse repurchase agreements for the financing of securities are not the standard fare of securities arbitrations. Similarly, problem products such as proprietary investments or funds gone bad may make your claim susceptible to being kicked to outside lawyers. Well publicized problem investments that "blew up" such as Lehman Brothers Principal Protected Notes, Citibank's MAT V, and the Schwab YieldPlus Investor Fund also raise the likelihood of outside counsel involvement. In these circumstances, you may want to include a separate section on the everyday products, as well.

(2) Don't give away your age

The apparent age of the claim may also be reason for a case to go "outside." If the claim is drafted so that it appears on its face to fall outside of the six-year FINRA eligibility rule, outside counsel may be retained to file a motion to dismiss in order to prevent the matter from being arbitrated at all. Claimant's counsel must be careful to allege an ongoing fraud, wrongdoing

after the purchase of the investment, or another continuing wrong (where the facts justify this) so that it is clear from the your statement of claim that the claim falls within the six-year eligibility period. For example, fraud claims may go on for years, may span several brokerage firms, and may not be detected until a market downturn. Likewise, until there is a product failure, the improprietyof an investment, may not have been detectable until well after the purchase date. An ongoing fraud lulling the claimant into a false sense of security should be pleaded where applicable to avoid an obvious eligibility defense. Likewise, a hold recommendation in the face of clear evidence that a recommendation to sell should have been made may breathe new life into an older claim. In a scenario where an investment was purchased more than six years prior to the claim, the astute Claimant's counsel knows to uncover such facts as to demonstrate subsequent wrongdoing. Additionally, facts demonstrating the separate tort of fraudulent concealment within the six-year eligibility period (such as carrying a false value of an investment on a monthly statement) may also assist in avoiding a motion to dismiss.

(3) Beware of the possible conflict

There are times when the Respondent firm will hire an outside firm to represent a broker individually due to a potential conflict. In this situation, the firm will either retain two separate law firms (one for the broker and one for the firm), or hire outside counsel for the broker and continue to represent just the firm in-house. In either case, this occurrence is certain to complicate the proceedings in that each time there is a motion or objection by the Respondents, they will have two sets of lawyers briefing and arguing the issues. This opportunity to "double team" is a pitfall that creates havoc at prehearing conferences, allowing the Respondents to get several bites at the apple.

This scenario may be avoided through careful pleading. A Claimant's attorney should be aware that certain claims, such as those demonstrating that the broker has intentionally concealed something from his employer (e.g. selling away or taking money from a client), or has acted in a criminal or quasi-criminal manner, may increase the odds that the broker will be represented by a separate attorney from the firm. Likewise, in cases of fraudulent activities such as theft from an account, forgery, or outside business dealings, the Respondent firm may be required to argue that the fraud was perpetrated on it as well, placing the blame on the individual broker. In these situations, the Claimant's attorney should attempt to allege as many facts as possible establishing the brokerage firm's knowledge of, and complicity in,

the wrongdoing. For example, if firm letterhead was used for an outside business deal, or if faxes or emails came in and out of the firm's offices relating to the fraud or misconduct, these would assist in establishing joint liability and tend to show that "the shooter did not act alone." Facts establishing the involvement or approval at the firm's management level may also assist in this regard. This type of evidence also obviously assists in establishing any negligent supervision or respondeat superior claims against the brokerage house itself.

Finally, if it appears from the broker's U-5 that there was a termination for cause, you should anticipate that the broker will be represented by separate counsel. When you know that this is the case, and you have enough ammunition against the firm, you should consider not naming the broker at all to try and avoid the multiple representation issue.

C. The Regulators

Claimant's counsel should also be aware that certain facts may make it more likely that the regulators will get involved in your case. If your action involves any of the following: (1) a broker with a checkered CRD (three or more customer claims); (2) a problem branch office; (3) serious allegations of theft or forgery; (4) Ponzi schemes; (5) market manipulation or other fraud on the market theories; (6) elder abuse issues; or (7) problem investments in the press, it is possible that a regulatory inquiry may be instituted as a result of your claim.

The firm is required to amend the broker's U-4 or U-5 with FINRA and report your claim whether it is formally filed as an arbitration or merely comes in as a letter of complaint. Once it is reported, the Regulators may become interested and open an investigation into the conduct of the broker and firm. Regulators can be valuable to the extent that Claimant's counsel may be able to subpoena records and disciplinary action information from them. Public documents in enforcement actions may also help you add evidence of the bad acts alleged in your claim. Additionally, Regulators may provide you information "off the record" to assist in your case.

If a claim has resulted in regulatory action, a brokerage firm may be more likely to settle the matter in order to appear to the regulators that it has "done the right thing." This is particularly true in the case of a notorious product or broker. In the garden variety fraud claim, however, the brokerage firm may be just as likely to litigate the matter to prove to the Regulator that the broker (and firm) did not act improperly. Accordingly, the savvy Claimant's attorney should carefully include all FINRA, SEC, state and Federal securities

violations clearly and concisely in the body of the claim if the action is one that may appear to lead to a regulatory investigation or inquiry.

Attaching evidence of your allegations may also help in a quicker resolution of your claim. If the branch office is one that has had repeated violations, state this in the claim. Similarly, if the broker has a CRD that reads like a phone book–attach it to the statement of claim. If you have registration issues such as failure to blue sky the security in your state, or the broker was not registered in your state when he or she sold to your client, attach the public document to show this. Finally, if there has been an AWC (Acceptance Waiver and Consent) entered into by the broker or firm relating to the product or conduct as issue, or if any other sanction has been issued by a Regulator, attach this to the claim as an exhibit. Individual state attorneys general have been active in instituting actions against brokers or firms in their own jurisdictions following the lead of Eliot Spitzer who famously began crusading against New York firms, including Merrill Lynch, in 2002. You should research your problem broker or product to see if there exist any such state investigations, actions, or sanctions, as well.

D. Broker-Dealer business people: "We make money the old fashioned way...."

Brokerage firms are in the business of making money. Not only for their customers, but for themselves and their shareholders. At the end of the day, a settlement check is a business decision based on an evaluation of several factors. When drafting the statement of claim, the Claimant's attorney must keep in mind that the resolution of your claim is driven by certain tangible and intangible business factors. These concerns include: (1) a balancing of the defense costs verses likelihood of success of the claim; (2) whether an important broker or manager has been implicated; (3) value of confidentiality clause in settlement due to possible negative public relations; (4) concern there may be other claimants with the same complaint; (5) the identity of the named claimant; (5) the overall financial health of the respondent brokerage firm; (6) the availability of insurance coverage; and (7) the firm's fiscal year versus the time of year of the settlement. There are some firms which refuse to settle claims above a certain threshold (such as 50% of out of pockets damages) simply because they want to establish the reputation of being a difficult target. Sometimes a firm may require that the Claimant file their claim with FINRA prior to discussing settlement. You should take the time to understand these business issues prior to trying to settle a claim pre-suit.

E. Claimant: Who Am I and Why do We Care?

While the Claimants' counsel has no control over the firm's financial health at the time he or she files a claim, to the degree there is a particular intangible variable that you want management to look at early on, highlight it in your statement of claim. If you represent a member of a prominent local family, and you know all of the arbitrators will know this family, the broker-dealer's management team (located in another region of the country) may not know this fact just from the name alone. Spell it out for them such as: "Casey Jones is a descendant of the Jones family who settled Jonesville in 1776. He was the hometown hero of the Jonesville Jaguars baseball team when they clenched the World Series in 1952. His chain of fast food restaurants, 'Jones' Wingbones,' employs 50% of Jonesville residents. His stockbroker, and former son-in-law, Johnny Camarreri, lost the entirety of his family fortune at the Jonesville branch office, and Casey had to sell his World Series ring in order to pay for his kidney transplant." This paragraph alone should let the home office know what to do with this case. Enough said.

F. The Arbitrators

While you will not know who your arbitrators are until months after filing your claim, you do know that, in the typical customer case, you will have the option of an all public panel of three arbitrators or the choice to make one of your three arbitrators an industry representative. In either circumstance, you also can assume that, while you may have at least one attorney on the panel, other panel members may not be lawyers. Following these assumptions, you must draft your claim to explain clearly: (1) your investment and operational issues to the non-industry people; and (2) your legal issues to the non-lawyers. Define your issues in layman's terms to the extent possible.

In the investment and operational context, explain the nature of the securities or investment strategy. Then, to the extent possible, draw an analogy for the non-industry arbitrators. For example, in explaining varying levels of risk in options strategies you might include something like this: "Covered calls are like buying an insurance policy–they protect the investor in the event that the market moves in a particular direction. Naked options, on the other hand, are like putting your money on 'black' at a roulette wheel -- it is an all or nothing proposition."

Legal issues should, as well, be put in simple terms for the non-lawyers. For instance, rather than simply stating that the account investments were

unsuitable, you might spell out what constitutes "unsuitability" or "overconcentration" in the context of your claim. If your 90 year old client living on social security was invested 100% in the preferred stock of one financial institution, you might say "[I]n order for the account to earn 5% a year rather than the CD rate of 2% which Mrs. Garcia had at her credit union, the account was concentrated 100% in Bear Stearns preferred stock. When the firm failed, she was left with nothing---and no way to generate future income. Had 100% of her funds not been put at risk in one stock, she would not have lost all of her retirement savings" Non-lawyers can easily understand this example of the legal claim, rather than just a label. This can go a long way in educating the non-lawyers as to what your client's claim is all about.

G. "Insure" a good result

Finally, the broker or broker-dealer may have insurance for particular claims. While the existence of insurance is often a closely guarded secret, even in cases where the insurer is paying part of a settlement, there are certain scenarios that are likely to bring an insurer into the picture. There is often coverage for the firm in cases of broker theft or forgery. So, if you have hard evidence of this, attach it to your statement of claim. Other policies, on the other hand, may be written to cover the individual broker's conduct and generally contain clauses excluding intentional wrongdoing. For this reason, including a negligence count in your statement of claim may be enough to bring your action within this type of insurance coverage. Generally, until a claim is filed with FINRA, the duties of the insurer to defend and pay any award will not be invoked.

II. Anatomy of a Claim

Once you know what audience you will be addressing in your claim, you are ready to begin drafting. The body of your claim should contain five separate sections: (1) the case caption; (2) jurisdictional allegations; (3) the fact section; (4) the legal argument; and (5) damages. In order for the reader to find a particular portion of your claim easily, it is good practice to break up the four sections into smaller sections divided by headings. This also has the effect of making your claim appear easier read and follow – an important feature, as many arbitrators in the pool are retirees.

A. The Caption of the Case: What's In a Name?

Do not underestimate the significance of determining who will become respondents in your action. There are several schools of thought on this issue. Some believe that the scorched earth, name everybody in the zone of danger approach is best. There are times when this may be appropriate. For example, if you have a "serial broker" who has hopscotched from firm to firm leaving a trail of mass destruction in his or her wake, naming multiple firms can help. This may cause each of the respondent brokerage firms to blame the other for the losses, causing infighting in front of the arbitrators and thus adding more credibility to your claims. Also, a quick settlement with one respondent early in the case may help fund the remainder of your client's case. And, if you must try your case against the other non-settling respondents, the fact that another respondent has chosen to settle with you might make it appear to the arbitrators that your claims have serious merit.

The downside to this strategy is that at all of your prehearing conferences there will be numerous respondents' counsel, each of which will get a chance to oppose any discovery or other motions you make and further complicate the proceedings. The numerous respondents will also be able to get more far reaching financial and investment history on your client as the relevant time frame gets broadened with each additional respondent. Remember, that the further back you allege, the further back respondents will try to obtain discovery into your client's finances. Make sure you evaluate the client's investment behavior in the earlier years when determining how far back you want to allege the claims. Another factor you might want to consider when there are multiple firms involved is whether you will be able to allege an ongoing fraud to defeat any eligibility arguments the earlier brokers may raise.

There are also times when you will consider naming fewer than all responsible parties. It is becoming more common for claimant's attorneys to forego suing the individual brokers for several reasons. First, particularly in the case of an egregious wrong, there is the chance that the arbitration panel may chose to allocate losses between the parties, rather than enter a joint and several award. You want to avoid the situation where the panel allocates 90% of your award to the broker and only 10% to the firm. Your client may never get a recovery in this situation. Therefore, if you are certain that your respondeat superior and/or failure to supervise claims are airtight, consider not naming the broker if you fear the looming fault allocation and collectability issue. Certainly, in a product failure case it is best to forego naming the individual broker who probably had no idea that what he or she was told to peddle was in fact risky or inherently unsuitable from the inception. Not

naming the individual broker may also make the broker more likely to cooperate with you or be a more friendly witness. While the broker will still want to prove his or her innocence (because the firm may still have to report the claim on his U-4), as a witness the broker will be less hostile if you are not after his or her funds personally. Remember, though, that the firm can still seek contribution from the broker for any sums it is required to pay your client if there was actual broker wrongdoing.

Naming the individual broker may have benefits, too, in other situations. If, for instance, the broker is a big producer and important to the firm, the firm may have some incentive to settle the action and seek your client's cooperation with, or at least agreement not to contest, a U-4 hearing for expungement in connection with the settlement. Remember, however, that you should name the individual broker only if the broker actually committed the wrongdoing. In the situation where the broker has simply sold a bad product, or the firm has bad back office procedures, Claimant's counsel should name only the firm.

If the claimant has named a broker who is not the real party at fault, this may only engender sympathy from the panel when the broker takes the stand, and may not assist your case unless the broker points the finger at his current employer (which is unlikely if they are providing the broker with a defense). Similarly, the branch manager or other control persons should be named only where there is evidence that they actively participated in the wrongful conduct through some deliberate or grossly negligent means.

B. What are You Doing Here?: The Jurisdiction and Venue

FINRA's jurisdiction, as well as the jurisdiction of any particular self-regulatory organization ("SRO") such as the National Futures Association ("NFA") or Commodities Board Options Exchange ("CBOE"), is a creature of contract or of the SRO's own mandate. First, to determine where jurisdiction is proper, ask your client for his or her arbitration provision (contained in the new account forms or margin agreement). That provision will generally set forth the arbitration forums that are available to your client.

If your client held a securities account at a FINRA member firm, FINRA will likely be the specified forum. If there is no arbitration contract, your client is still given the right to bring an arbitration action by virtue of the respondent firm's membership in FINRA. *See* Rule 12200, FINRA Code of Arbitration Procedure. FINRA similarly has jurisdiction over the individual broker because the broker is "associated with a member organization." *See id.* Allege the jurisdictional basis at the beginning of your statement of claim. FINRA has jurisdiction only if the "dispute arises in connection with the

business activities of the member or the associated person." *Id.* There is an exception for "disputes involving the insurance business activities of a member that is also an insurance company." *Id.*

Also be sure to include your choice of venue. FINRA provides arbitration hearing locations in each of the 50 states, Puerto Rico, and London. Unless you specify a choice of venue (and sometimes even if you do specify a choice), FINRA will assign your action to the venue where the client resided during the time the account at issue was open. You may wish to request a different venue if your client has since moved, or if your client has multiple residences, or simply if you wish to choose a more claimant-oriented venue that has some ties to the dispute at issue. For example, if the broker's office was located in Florida, but the client resided in Washington, D.C. (a venue that some practitioners believe has a large pool of conservative defense-oriented arbitrators), you might wish to allege that venue is proper in Florida for a host of reasons including that Florida law governs and that most of the defense witnesses reside there.

C. Just the Facts Ma'am: The Narrative Part of Your Statement of Claim

The beauty of arbitration is that it is a fact-driven process, as opposed to one that is based substantially in the law. Remember that, in general, the majority of your arbitration panel will not be attorneys. The readers of your claim will give much more focus to the fact section of your claim than they will to the legal section. This is not to say that the law is not important to your claim, but drafting pages and pages of legal jargon setting forth the legal bases of your claims is simply not warranted, or even required, in an arbitration proceeding. Claimant's counsel should draft the claims in a narrative fashion, and make the facts both interesting and easy to read. Many headings breaking apart the different mini-sections of your narrative section can help the reader get through it and go back to any particular portion to facilitate ease of reference. The facts should address the who, what, when, how, how much, and in which compensable way

1. Who: Know Your Client and Witnesses

Just as the brokerage firm is required by FINRA Rule 2090 to "know your customer," you, as his or her counsel, should know your client. And you should know them better. Nothing is more humbling than first learning from your opposing counsel about your client's notorious career as a Las Vegas ranked player, or about the Internet start-up she formed with her investment banker pals. In this regard, a thorough interview with your client in which you ask the questions that the broker should have asked is the starting point. Give your clients the FINRA Rule 2111 (know your customer) and FINRA Rule 2090 (suitability) examination by asking their: age, marital status, education, employment experience, prior trading history, investment acumen, risk tolerance, investment horizon, number of dependents, where the money originally came from and the like. This investment interview should be followed up by a review of your client's relevant tax returns, monthly statements and new account forms from the respondent brokerage firm, as well as other outside brokerage account statements and new account forms. If your client does not have these documents in his/her possession, have that client sign a letter to be sent to all of the firms at which securities accounts were maintained authorizing the release of these statements and new account forms to you. If you are representing someone who gave a power of attorney to another, you must interview the power of attorney, as well, and obtain the relevant documents from both individuals.

If your client is an entity such as a Trust, you must understand the nature of the Trust, and the powers and duties of the Trustee, as well as any trading restrictions on the Trustee. Similarly, if your client is an entity, the Claimant's attorney must delve into the finances of the entity, the prior trading history of the controlling officers of the entity, and understand who has authority over the entity or could approve the opening of the account or the trading in the account. If your client is a business, the same analysis should be done of the controlling officers and investment advisors.

By determining the scope of authority prior to drafting the claim, other violations by the brokerage firm may become apparent to you as the Claimant's attorney, such as lack of the entity's authority to engage in certain securities transactions, or the lack of the agent's authority to effect the transactions at issue. This will also assist you in deciding who should enter into any fee agreement with you on behalf of any Trust or entity.

In addition to knowing the investment background and sophistication of your client, you must also probe your client on the aspects of his or her personal life that may become relevant in the arbitration. When drafting a statement of claim, the importance of personalizing your client cannot be

overemphasized. Ask your potential client about the personal aspects of his or her life that may make this claimant more appealing or sympathetic. For example, information that a client was on antidepressants or was coping with an ill family member during the relevant time period may not only assist with the "sympathy" factor, but can form the basis of a "heightened" fiduciary duty standard if the broker was aware or should have been aware of these facts. Learning these personal details can also help you early on in the action when choosing your arbitrators, since you will be selecting them with the hope that they will relate to and like you client.

During the interview stage, you must also determine whom you will call as potential witnesses to support any facts you allege. To the extent that your case may turn on the testimony of any third-party witness, you should contact those witnesses (to the degree that the witness is not a current employee of the respondent) prior to filing. After these interviews, you can then decide whether to use these facts in the statement of claim, or opt to hold back on their use until some later time in the action for strategic reasons.

There may be times when it is best to hold back helpful facts from the statement of claim. In the fortunate event that you are able to get a "smoking gun" document or other evidence through these pre-filing interviews and investigations, the question then becomes: What to do? A savvy claimant's lawyer does not always play out the entire hand in a statement of claim. In this instance, the old adage "less is more" may apply. This is especially true where you believe that the respondents may take a position that you are certain you can refute with strong evidence. For instance, if you are sure that the brokerage firm will argue "the broker called the client before every trade" and you have a documents such as passports or airplane boarding passes proving your client was out of the country in a remote area and not accessible by internet or phone during the relevant time, you might want to wait until the brokerage firm commits to their position in its answer. Or, if the broker made notes or sent an e-mail to the client confirming that an investment was "guaranteed" in writing, you may simply state that "the broker guaranteed the investment" and wait for an answer denying this fact before disclosing evidence of its existence. While the facts you present in your claim will not change by withholding this document from the initial claim, the credibility of the denying respondent may be dramatically undermined when its position is solidly refuted.

2. Know your Broker and Branch Manager

Other than your own client, the most important witness will be your client's broker. Prior to drafting your claim, look up the Central Registration Depository ("CRD") record of your broker. The Web CRD, operated by FINRA, is the central licensing and registration system for the U.S. securities industry and its regulators. It can be accessed at www.finra.org/Investors/ ToolsCalculators/BrokerCheck. It contains the registration records of more than 6,800 registered broker-dealers and the qualification, employment, and disclosure histories of more than 660,000 active registered individuals, including branch managers. All reportable customer complaints and regulatory actions against your broker will also appear on this site. Terminations are reported on the CRD, as well as the list of states in which your broker is or was licensed and the dates of such licensing. You want to review these dates to determine if your broker was licensed in the state in which your client was living when the products were sold by the broker.

Individual states likewise have their own securities broker data bases that may contain additional helpful information. These public records should be requested and reviewed as well. Some states provide more information than others, so the savvy practitioner may wish to request CRDs from certain other states in which the broker is licensed, even if neither the client nor broker lives in that state.

3. What was Sold: Know Your Investments

In addition to knowing your claimant well, you should also know and understand your investment. The claim should clearly identify and explain the investments or strategy at issue. Because two and possibly three arbitrators are not "industry" people, a Claimant's attorney should identify the investments at issue and explain the nature of the investments involved. Even with the most common investments, such as stocks and mutual funds, it is helpful if the arbitrators can be educated. An astute Claimant's attorney will identify the particular investment vehicle and explain its characteristics. Of course, this is even more important in the case of a complex product. Many cases today involve the new and creative vehicles that have not been the routine fare of brokers and individual customer such as structured products, exchange traded funds, notes, reverse repurchase agreements, and other derivative investments that are tied to the performance of another security or index. You should identify the product long with an explanation of how it works and what the investment terms mean. Thus, rather than just alleging "the respondents sold

Claimant risky principal protected Notes in Lehman Brothers," the Claimants attorney can add "Respondents represented to Claimant that principal protected notes were a 'guaranteed' investment, never disclosing the risk that if Lehman Brothers collapsed, so did the guarantee. Principal protected notes are dependent on the credit of the issuer. As an underwriter of the offering, Respondent knew these risks, but failed to disclose them."

With respect to more exotic investments, explaining their nature and dangers can go a long way. Creatures such as auction rate securities, structured products, variable annuities, CMOs, CDOs, leveraged notes, and private placements should be clearly explained in a separate section. Similarly, particular investment strategies such as the use of credit facilities of affiliated banks, hedging, income from preferred stocks as a funding source, short selling, collars, dollar cost averaging, and the use of margin and the like should be explained for the non-industry arbitrators. The characteristics may be set out in a separate section entitled "A Primer on" whichever investment or strategy you are explaining, including definitions and explanations of risks and dangers from reputable financial publications. If possible attach such articles or give the url address for internet sources.

4. How was it Sold and What Did Respondents Get?

The Statement of Claim should detail the facts surrounding the sale of the offending product. You should also be clear as to what representations were made and by whom. You need to articulate both the broker and the firm's involvement in the transaction at issue. There are certain investments for which FINRA and SEC have issued sales guidelines. Structured products, leveraged exchange traded funds, inverse exchange traded funds, variable annuities bond and bond funds and mutual fund switching fall into these guidelines. Check the FINRA notices to members for the particular investment at issue to ascertain whether there have been sales guidelines articulated by the regulators. Importantly, investment strategies as well as products can be the subject of a claim. FINRA has made clear that brokers must ensure that investment strategies, as well as the securities themselves, are suitable. *See* FINRA Notice to Members 11-02.

Establishing a motive can go a long way in setting forth a credible claim. The arbitrators will all want to know: what did the respondents get out of this? A prepared Claimant's attorney will have a commission and cost analysis completed prior to filing the action and will be able to state with some reasonable certainty the remuneration paid to the respondents, at least to the degree that compensation has been disclosed through confirmations,

prospectuses, or other offering documents. One strategy that is effective is to set out the commissions, fees and costs as compared to the total investment return to the client or as compared to the average equity in the account. The comparison can be compelling, for example, where you can state: "claimant lost $250,000 in the account while the Respondents made approximately $250,000 in commissions, fees and margin interest" or "the cost of the investment strategy to claimant was 25% of the average equity in the account–meaning claimant's account had to earn 25% just to break even." Annuities and life insurance products often contain mind numbing sales charges and should always be reviewed prior to the filing of a claim. Be mindful that although commissions are part of the equation, other sales charges such as management fees or wrap fees can sometimes be charged in addition to the commission.

Other fee generating situations should be highlighted. Point out that the respondents were market-makers charging mark-up, which can often be as much as 5% or higher. Similarly, underwriters or placement agents can make fees on the sale of new issues. Where it appears that there was no investment purpose other than to generate commissions, such as mutual fund switching among similar funds, spell this out. Finally, if the investment is proprietary one created and sold by the firm at which your client bought it, explain this fact. Allegations establishing financial motive can greatly enhance your claim.

5. How Could it have been Prevented or Detected?

Finally, remember that you are drafting to recover from the brokerage firm who is generally the "deep pocket" in the case. Although the broker is often the primary wrong-doer, the firm is liable for his or her acts under two different sets of facts: (1) under the respondeat superior theory, the brokerage firm, as the principal, is liable for the acts of the broker, acting as its agent; and (2) the brokerage firm can be liable for negligent supervision or negligent hiring. With respect to the principal/agent issues, be certain to allege facts showing that the broker was acting within the scope of his or her employment. Any actions by the broker in connection with providing investment advice, or in connection with the purchase or sale of any investment, should meet this criteria.

With regard to negligent supervision, the Claimant's attorney should set forth facts demonstrating both the lack of communication with the client, and the apparent failure to monitor the accounts at issue. Where there is a particularly active account or an account with large losses, overconcentration

in a particular security or sector, or large margin or loan positions, the claim should explain how the obvious lack of oversight allowed the conduct of the broker. The claim should state clearly in what ways the firm is fault and how the bad acts could have been prevented or detected earlier.

D. Your Legal Section: I Fought the Law and the Law Won

As a Claimant's attorney, you must be able to explain how a statute, common law principle or regulation was violated by the actions of the Respondents. This should be done in an easy to read and concise fashion. The claims should be identified and the basic elements set forth so the arbitrators can see how your facts fit into the legal theories of your case. The typical claims in a securities arbitration are: Federal Securities Act violations; State securities law violations; breach of fiduciary duty; negligence (predicated on violations of FINRA or SEC regulations); common law fraud; breach of contract, respondeat superior; negligent supervision and negligent hiring. Some states have elder abuse laws which may also come into play.

The state securities statutes vary, but most are modeled on the Federal law, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j (the "Exchange Act"). Some states, like Florida for example, have less stringent standards and do not require the Exchange Act's "intent or scienter" element. Other state securities statutes are desirable in that they provide for the award of attorney's fees to a successful plaintiff. You should also carefully review your state's securities law statute to determine if it has a "fee shifting" provision, which provides attorney's fees to the prevailing party and, if so, carefully explain to your client the risks associated with including such a claim in your pleadings.

Respondeat superior, negligent hiring, and negligent supervision are important to the outcome of your case in that they confer liability on the brokerage firm. The doctrine of respondeat superior confers liability on a corporation for the acts of its agents committed while acting in the scope of their employment. Rule 3030(b) of the FINRA Rules, *Supervisory Policies*, requires:

Annual Certification Requirement

Each member shall have its chief executive officer(s) (or equivalent officer(s)) certify annually,[1] as set forth in paragraph (c), that the member has in place processes to establish, maintain, review, test and modify written

compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations, and that the chief executive officer(s) has conducted one or more meetings with the chief compliance officer(s) in the preceding 12 months to discuss such process.

The supervisory duties imposed on a member firm are, of course, specifically designed and intended to enable the firm to discover and thereby stop or prevent the intentional or negligent mishandling of customer's accounts by the broker whose activity the manager is required to supervise. If there are facts supporting a claim for failing to satisfy this obligation, be sure to include them.

E. Damages: When to say "when"

Finally, the claim must notify the firm, FINRA and the arbitrators what your client is seeking to recover and the theories for this recovery. This is important for several reasons. First, the damages portion of your claim determines the amount of the filing fees your client will be required to pay. FINRA's website includes a link to a filing fee calculator to prevent the miscalculation and consequential delay as a result of sending the statement of claim with the incorrect filing fees. http://apps.finra.org/Arbitration Mediation/ArbFeeCalc/1/Default.aspx. Many claimant's attorneys also send a cover letter along with their statement of claim stating the amount of damages they are seeking (exclusive of interest, costs and attorney's fees) and enclosing a check for the filing fee that was calculated using this figure. This may prevent FINRA intake clerks from assessing your client additional fees based upon their personal reading of your damage theories, and the delays associated therewith. If you represent an indigent client, FINRA also has a procedure in place to request a fee waiver. http://www.finra.org/ ArbitrationAndMediation/Arbitration/Fees/FeeWaivers/index.htm.

The amount of damages at issue dictates whether your claim qualifies for simplified arbitration under Rule 12800, which allows for a single arbitrator in smaller cases and the option to have the case decided on the papers rather that at an in person final hearing. There are a number of factors to consider when determining whether to proceed on the papers alone, and it is a decision that should be discussed extensively with your client.

The damages section of your statement of claim also notifies the brokerage firm and the regulators how significant the case is in terms of the potential financial exposure. The brokerage firm is required to state how much your claim seeks when reporting it to FINRA and the amount sought will

ultimately appear on the broker's U-4 or U-5. Publicly traded brokerage firms usually set up a reserve to pay claims made against it in the event that the firm settles or is required to pay an award or judgment .

The damages section should state your client's different theories of damages such as, but not limited to: "compensatory damages," which are meant to compensate the claimant for the wrongdoing; "benefit of the bargain damages," which are meant to place the claimant in the position represented to him or her when the investment was sold; "well managed account damages," which award claimant the amount the account should have returned had it been properly managed; or "churning damages," which include well managed account damages and the disgorgement of ill gotten commissions.

Your claim should also address exemplary or punitive damages and the basis for this. You should set forth your clients' claims for pre- and post-judgment interest, but without specifying any statutory rate, as this can be done at the final hearing and may change during the course of the case. Finally, any claims for attorney's fees and costs and the basis for these claims should be spelled out in the statement of claim. In Florida and other jurisdictions, the parties must both agree to whether the arbitrators have the authority to assess an amount of an attorney's fee award as opposed to just the entitlement to one. To the extent that you do not want the arbitrators to assess the amount of attorney's fees, but only your client's entitlement to them (the amount to be later determined by a court), you may wish to specify this request in the claim so that there is no argument that your request for a fee award waived this right to proceed to court on the assessment of fees.

A well articulated damage portion of your claim alerts the firm (and the regulators) to the potential exposure of your case. This is not to say that you should make unrealistic damage claims in your pleadings. Overinflated claims for damages may backfire when you are in front of arbitrators and damage your credibility. Outlandish claims can also turn off in-house and defense lawyers, causing them to believe that the case can never settle at a reasonable number. While you should be a zealous advocate for your client, remember that your claim for damages will often be a starting point in any settlement negotiations, and defense counsel expects that your demand will go down from the number alleged. Taking these facts into consideration, the seasoned claimant's counsel knows when to say "when." Or, put another way, how to ask for damages that reasonably fall within the parameters of accepted legal theory without going overboard.

CONCLUSION

While there is no magic formula to drafting a securities arbitration claim, making the statement of claim interesting to the readers and setting it out in an easy to understand fashion for non-lawyers and non-industry personnel can be quite effective. The statement of claim is often the first look any decision maker has of your client's case, be it opposing counsel, arbitrators, or regulators, and preparing a well drafted and supported document may place your client in an excellent position to resolve the claims prior to a full hearing. While brokerage firms often say that nobody has a crystal ball to predict markets, you may be able to help predict the outcome of your client's case through effective use of your most powerful weapon – your pen!

SELECTING THE APPROPRIATE BLUE SKY LAW(S) UNDER WHICH TO BRING A CLAIM - A CASE STUDY

Benjamin R. Picker[1]

Introduction

As seasoned securities practitioners know, every state, as well as the District of Columbia, Guam, Puerto Rico, and U.S. Virgin Islands, has a securities anti-fraud statute, also known as a "Blue Sky law," containing provisions aimed at curtailing the sale or purchase of securities based on fraudulent misrepresentations or omissions. Most Blue Sky laws are modeled after the Uniform Securities Act of 1956, the Uniform Securities Act of 1985, or the Uniform Securities Act of 2002, or a combination of the foregoing. Moreover, every such Blue Sky law, except New York's "Martin

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Act," provides a private right of action[2] to those who have been defrauded or deceived in connection with the sale and/or purchase of securities.[3]

However, these Blue Sky laws often times differ in three important respects, including: (1) whether a state's or territory's law applies to a particular transaction; (2) the availability of attorneys' fees to an injured investor; and (3) the applicable statutes of limitations.

Understanding these three factors, and how the various Blue Sky laws differ in these respects, will permit claimant's counsel to select the proper Blue Sky law or laws under which to assert a claim. This article suggests how to analyze and select the Blue Sky law or laws under which to assert a claim arising from fraudulent or deceptive acts or omissions of a registered representative and/or broker-dealer, by focusing mainly on the foregoing aspects.

Hypothetical Fact Pattern

Imagine a scenario with the following facts:

> (1) a registered representative sells securities from his home office in Boca Raton, Florida;
>
> (2) a New Jersey resident, while visiting family in Pennsylvania, is convinced to purchase a security over the telephone through the registered representative;
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> (3) however, the registered representative makes material misstatements and omissions regarding the attributes and risks of the investment in selling the security;

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2. In 1996, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA"). It has been argued from time to time by the securities industry that the NSMIA somehow preempts state securities claims, including common law and Blue Sky law claims. Courts have rejected this argument, holding that the NSMIA's savings clause, 15 U.S.C. 77r(c)(1), and its legislative history, permit states to retain jurisdiction over fraudulent conduct. The case of *Zuri-Invest AG v. Natwest Finance, Inc.,* 177 F.Supp.2d 189 (S.D.N.Y. 2001), provides a helpful discussion of the foregoing.

3. The Blue Sky laws also impose requirements regarding registration of securities and those selling securities. This article does not examine causes of action or liability based on the failure to adhere to any registration requirements imposed by the Blue Sky laws.

(4) the registered representative is supervised from the broker-dealer's branch in Connecticut, which is where the registered-representative previously worked before moving to Florida several years before;

(5) all of the customer's trade confirmations and account statements are sent to the customer's New Jersey residence and they state that the Connecticut branch is the, "office serving [the customer's] account";

(6) the broker-dealer's principal place of business is in New York;

(7) a year and a half after discovering, using reasonable care and due diligence, that she had purchased the securities based on fraudulent misrepresentations and omissions, the claimant has decided that she wants to sue in arbitration to recover her losses; and

(8) the FINRA arbitration regarding the securities transaction at issue will take place in New York.

Applicability of Particular States' Blue Sky Laws

The first question that arises is which states' securities laws can apply?

An attorney's first instinct may be to conduct an amorphous conflict of laws analysis,[4] the rules for which differ from state to state, to attempt to

4. Many brokerage agreements contain "choice of law" provisions that often select New York law for various reasons, including its lack of a private right of action under the Martin Act. Whether such a choice of law provision prevents the application of an otherwise pertinent Blue Sky law depends on the law of the jurisdiction. Courts that decline to enforce the choice of law provision often do so based on public policy (because such laws are intended to protect investors and the investing public) and/or based on the Blue Sky law's anti-waiver provision. *See e.g., R & L Ltd. Investments, Inc. v. Cabot Inv. Properties, LLC*, 729 F.Supp.2d 1110, 1113-14 (D. Ariz. 2010); *Hall v. Superior Court*, 150 Cal. App. 3d 411, 197 Cal. Rptr. 757 (4th Dist. 1983); *State ex rel. Geil v. Corcoran*, 623 S.W.2d 557 (Mo. Ct. App. E.D. 1981); *Pursuit Partners, LLC v. UBS AG*, 2009 WL 3286011at *3-4 (Conn. Super. 2009); *Gilbert v. Atlantic Trust Co., N.A.*, 2006 WL 1049707 (D.N.H. 2006); *Ito Int'l Corp. v. Prescott, Inc.*, 83 Wash. App. 282, 288–89, 921 P.2d 566 (1996); *Brenner v. Oppenheimer & Co. Inc.,* 273 Kan. 525, 44 P.3d 364 (2002). Other courts hold that certain, usually inartfully drafted, contractual choice of law provisions only govern a cause of action sounding in contract. *See e.g., Klock v. Lehman Bros. Kuhn Loeb, Inc.*, 584 F.Supp. 210, 215 (S.D.N.Y.1984).

determine which law applies. However, in most jurisdictions, such a conflict of laws analysis is, and should be, unnecessary with regard to the Blue Sky laws. Although a minority of courts utilizes a conflict of laws analysis, most jurisdictions that do not have a jurisdictional limitation provision in their Blue Sky laws permit a claimant to assert a claim under any states' Blue Sky law having a sufficient factual nexus to the securities transaction at issue.[5,6]

However, as one might expect, some courts take the opposite position that a choice of law provision is fully enforceable and can prevent application of Blue Sky laws. *See e.g., Berckeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 224 fn. 28 (3d. Cir. 2006); *Costa v. Carambola Partners, LLC*, 590 F.Supp.2d 1141, 1151-53 (D. Minn. 2008); *Organ v. Byron*, 435 F.Supp.2d 388, 391-93 (D. Del. 2006); *WTM, Inc. v. Henneck*, 125 F.Supp.2d 864, 867-68 (N.D. Ill. 2000). Of course, the choice of law clause may not be enforceable in any event based on FINRA Rules and Rule interpretations. *See* FINRA Rule 2268(d) (formerly NASD Rule 3110(f)(4)); NASD NTM 95-16; NASD NTM 95-85 (reiterating the provisions of NASD NTM 95-16); NASD NTM 05-09; SEC Release No. 34-26805 at Pg. 23 (1989); and Report of Arbitration Policy Task Force to the NASD (Jan. 1996).

5. The first court to adopt the "sufficient factual nexus" test for Blue Sky laws in a published opinion was *Lintz v. Carey Manor Ltd*., 613 F.Supp. 543 (W.D. Va. 1985). In that decision, the Court relied mainly on law review articles by Professor (and PIABA member) Joseph C. Long, and by Professor Louis Loss (who drafted the original Uniform Securities Act), as well as upon the underlying purposes of state securities acts, which are protecting its citizens in the purchase or sale of securities and regulating and controlling securities activities deemed to have taken place at least partially within the borders of the state. The court explained that applying multiple overlapping states' Blue Sky laws to a single securities transaction serves the purposes of such laws and does not conflict with them. *See also, Simms Inv. Co. v. E.F. Hutton Co., Inc.*, 69 F.Supp. 543 (1988) ("Simms II") and *Barnebey v. E.F. Hutton & Co.,* 715 F.Supp. 1512 (M.D. Fla. 1989). Most of the later decisions adopting the "sufficient factual nexus" test for Blue Sky laws have cited to *Lintz, Simms II* and/or *Barnebey. See e.g., Chrysler Capital Corp. v. Century Power Corp.*, No. 91 Civ. 1937, 992 WL 163006 (S.D.N.Y. June 24, 1992).

The first modern era court to *reject* the "sufficient factual nexus" test in favor of a conflict of laws analysis was *Simms Inv. Co., v. E.F. Hutton & Co.,* 688 F.Supp. 193 (N.D.N.C. 1988) ("Simms I"). However, on a motion for reconsideration, that court reversed its previous decision and applied the "sufficient factual nexus" test. *Simms Inv. Co. v. E.F. Hutton Co. Inc.,* 699 F.Supp. 543 (1988) ("Simms II").

Other courts to reject the "sufficient factual nexus" test have been limited to those within the 6th and 7th Circuits. For instance, in *McInnis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 706 F.Supp. 1355 (M.D. Tenn. 1989), the court applied a conflict of laws analysis relying on the decision in *Simms I* while ignoring the fact that the decision had been reversed upon reconsideration in *Simms II*. In *In re*

Rospach Securities Litigation, Nos. 1:90-CV-805 and 1:90-CV-806, 1992 WL 226912 (W.D. Mich. July 8, 1992), the Court held that it would be "impractical, confusing and unfair to apply more than one state [Blue Sky] law to a claim … [because it] could require both plaintiff and defendants to deal with conflicting theories of liability or defenses … [and] would undoubtedly promote jury confusion." The Rospach court relied mainly on the Supreme Court's decision in *Lampf, Pelva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991), wherein it was held that there was a uniform statute of limitations for all federal securities claims. Although it is unclear, at best, why *Lampf* would be relevant to *state* securities claims, nonetheless *Lampf* was overruled when Congress passed Public Law 102–242 § 476, which explicitly applied state statutes of limitation to federal securities claims. In *Brenner v. Oppenheimer & Co. Inc.,* 273 Kan. 525, 44 P.3d 364 (2002), the Supreme Court of Kansas utilized a choice of law analysis in connection with the Blue Sky laws without even mentioning the "sufficient nexus to the transaction" test, presumably because the plaintiff brought claims only under the Kansas Securities Act and the issue was whether Kansas law could apply despite a contractual choice of law provision selecting New York law. In *Greenberg Traurig of New York, P.C. v. Moody*, 161 S.W.3d 56 (Tex. App. 2004), the court decided to utilize New York law, including the Martin Act, instead of Texas or Pennsylvania law, through a conflict of laws analysis without ever mentioning the "sufficient factual nexus" test. Lastly, in *Anderson v. Aon Corp.,* No. 06 C 6241, 2008 WL 4865574 (N.D. Ill. June 16, 2008), the court refused to apply both the Blue Sky laws of Illinois and California where Illinois did not recognize the cause of action at issue while California did. The court explained that since the two laws "do not overlap" and instead "directly conflict" it would utilize a conflict of laws analysis and apply Illinois law.

For further discussion of the "sufficient nexus to the transaction" test versus conflict of laws analysis, *see* J. McClard, *The Applicability of Local Securities Acts to Multi-State Securities Transactions*, 20 U. Rich. L. Rev. 139 (Fall, 1985); J. Long, 1985 Blue Sky Law Handbook § 3.02 (1985); J. Long, *The Conflict of Laws Provisions of the Uniform Securities Acts*, 31 Okla.L.Rev. 781 (1978); and L. Loss, *The Conflict of Laws and the Blue Sky Laws*, 71 Harv. L. Rev. 209 (Dec. 1957).

6. It has been argued that the application of a particular state's Blue Sky law to an interstate securities transaction violates the commerce clause and fourteenth amendment. However, courts have upheld the ability of states to regulate such transactions, generally based on a state's ability to reasonably exercise its police power, so long as the conduct being regulated did not occur wholly outside of the regulating state's borders. *See Houston v. Seward & Kissel, LLP*, 2008 WL 818745 (S.D.N.Y. 2008) (*citing*, *Merrick v. N.W. Halsey & Co.,* 252 U.S. 568 (1917), *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917), *Caldwell et al. v. Sioux Falls Stock Yards Co. et al.*, 242 U.S. 559 (1917), and *A.S. Goldmen & Co. v. New Jersey*, 163 F.3d 780, 789 (3d. Cir. 1999)).

Despite this general rule, many states and territories have provisions in their Blue Sky laws jurisdictionally limiting the applicability of their statute to transactions having a closer connection to the state.[7] Although Connecticut and Florida[8] do not have a jurisdictional limitation provision in their statutes and, therefore, would likely apply the "sufficient nexus to the transaction" test, New Jersey and Pennsylvania each have a jurisdictional limitation provision in their Blue Sky laws.[9]

In the scenario set forth above, it is possible that the securities laws of Connecticut, Florida, New Jersey, New York, or Pennsylvania could apply. As explained hereinabove, New York can quickly be crossed off the list quickly because New York's "Martin Act" does not provide a private right of action. Notwithstanding this fact, New York has a weak nexus to the *transaction*. Therefore, we are left with the Blue Sky laws of Connecticut, Florida, New Jersey, and Pennsylvania as possibilities under which to sue.

It is likely that a court or arbitration panel would find that the Blue Sky laws of both Connecticut and Florida have a sufficient factual nexus to the transaction at issue in the fact pattern. With regard to Florida, the registered representative made the sale and the misrepresentations from Florida. With regard to Connecticut, the registered representative was supervised out of the broker-dealer's Connecticut branch and the Connecticut branch was the branch servicing the claimant's account.

New Jersey's Blue Sky law is likely inapplicable under the fact pattern based on the jurisdictional limitation provision in its statute. New Jersey's jurisdictional limitation provision states as follows:

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7. These states and territories are Alaska, Arizona, Arkansas, California, District of Columbia, Florida, Georgia, Guam, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, U.S. Virgin Islands, Utah, Vermont, West Virginia, Wisconsin, and Wyoming. Please note that the author did not examine any jurisdictions' long arm statutes or other sources of law to determine any other general limitations on jurisdiction that may apply.

8. Although Florida's securities act section relating to boiler rooms, F.S.A. § 517.312, limits its applicability to those who, "offer or sell, *in this state or from this state*, any security or investment when such offer or sale is [fraudulent or deceitful]," there is no jurisdictional limitation applicable to Florida's general civil anti-fraud provision, F.S.A. § 517.211.

9. *See*, N.J.S.A. 49:3-51 (New Jersey); and 70 P.S. § 1-702 (Pennsylvania).

> (a) [The provision providing a private right of action for securities fraud applies] to persons who sell or offer to sell when (1) an offer to sell is made in this State, or (2) an offer to buy is made or accepted in this State;
>
> (b) [Other provisions, including an anti-fraud provision for which it appears there is no private right of action][10] apply to persons who buy or offer to buy when (1) an offer to buy is made in this State, or (2) an offer to sell is made or accepted in this State;
>
> (c) For the purpose of this section … an offer to sell or to buy is made in this State, whether or not either party is then present in this State, when the offer (1) originates from this State or (2) is directed by the offeror to this State and received at the place to which it is directed (or at any post office in this State in the case of a mailed offer);
>
> (d) For the purpose of this section, an offer to buy or to sell is accepted in this State when acceptance (1) is communicated to the offeror in this State and (2) has not previously been communicated to the offeror, orally or in writing, outside this State; and acceptance is communicated to the offeror in this State, whether or not either party is then present in this State, when the offeree directs it to the offeror in this State reasonably believing the offeror to be in this State and it is received at the place to which it is directed (or at any post office in this State in the case of a mailed acceptance).

Despite the fact that the claimant is a New Jersey resident, it is unlikely that New Jersey's Blue Sky law will apply in the fact pattern because the claimant was in Pennsylvania for the telephone call with the registered representative wherein the misrepresentations were made and wherein she received and accepted the offer to sell the securities at issue. In other words, the New Jersey statute probably does not apply because the offer to sell did not originate from New Jersey and the claimant did not accept the offer in New Jersey.

Pennsylvania's Blue Sky law is likely applicable based on the language of its jurisdictional scope provision, which states:

> (a) The provisions of this act concerning sales and offers to sell apply to persons who sell or offer to sell when (i) a

10. *See,* N.J.S.A. 49:3-32.

> sale or offer to sell is made in this State or when (ii) an offer to purchase is made and accepted in this State. The provisions concerning purchases and offers to purchase apply to persons who buy or offer to buy when (i) a purchase or offer to purchase is made in this State or when (ii) an offer to sell is made and accepted in this State.
>
> (b) For the purpose of this section, an offer to sell or to purchase is made in this State, whether or not either party is then present in this State, when the offer originates from this State or is directed by the offeror to this State and received by the offeree in this State ….
>
> (c) For the purpose of this section, an offer to purchase or to sell is accepted in this State when acceptance is communicated to the offeror in this State, and has not previously been communicated to the offeror, orally or in writing, outside this State; and acceptance is communicated to the offeror in this State, whether or not either party is then present in this State, when the offeree directs it to the offeror in this State reasonably believing the offeror to be in this State, and it is received by the offeror in this State.
>
> (d) An offer to sell or to purchase is not made in this State when the publisher circulates, or there is circulated on his behalf in this State, any bona fide newspaper or other publication of general, regular and paid circulation which is not published in this State, or a radio or television program originating outside this State is received in this State.

Since the registered representative directed the offer to the claimant while the claimant was in Pennsylvania, it is likely that Pennsylvania's Blue Sky law will apply.

Therefore, the claimant may bring a claim pursuant to the anti-fraud provisions of the Blue Sky laws of Connecticut, Florida, and Pennsylvania. The question is: should she?

Remedies, including Attorneys' Fees

Once a practitioner determines the Blue Sky law(s) under which the claimant may bring a claim,[11] he or she must then analyze whether a particular Blue Sky law provides helpful remedies, such as attorneys' fees.

Although the specific measure of damages permitted by each of the states' Blue Sky laws is beyond the scope of this article,[12] under most Blue

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11. Be sure that you are reviewing and relying on the correct version of the applicable Blue Sky law(s). A. Blue Sky law that has been recently replaced with a new or significantly amended version often has a transition provision stating that the prior version remains applicable to all actions or proceedings pending on the effective date of the new law, or which may be instituted on the basis of conduct occurring before such effective date. Blue Sky laws that have been replaced or significantly amended since 2003, and which contain a transition provision, are as follows (state and effective date are in parentheses): Ga. Code Ann. § 10-5-90 (Georgia, Jul. 1, 2009); HRS § 485A-701 (Hawai'i, Jul. 1, 2008); I.C. § 30-14-701 (Idaho, Sept. 1, 2004); IA Legis. 1161 (2004) (H.F. 2257) (Iowa, Jan. 1, 2005); K.S.A. § 17-2a703 (Kansas, Jul. 1, 2005); 32 M.R.S.A. § 16702 (Maine, Dec. 31, 2005); M.C.L.A. 451.2703 (Michigan, Oct. 1, 2009); M.S.A. § 80A.90 (Minnesota, Aug. 1, 2007); Miss. Code Ann. § 75-71-701 (Mississippi, Jan. 1, 2010); V.A.M.S. 409.7-703 (Missouri, Sept. 1, 2003); N.M.S.A. § 58-13C-701 (New Mexico, Jan. 1, 2010); 71 Okl.St.Ann. § 1-701 (Oklahoma, Jul. 1, 2004); Code 1976 § 35-1-701 (South Carolina, Jan. 1, 2006); SDCL § 47-31B-703 (South Dakota, Jul. 1, 2004); VT Legis. 11 (2005) (H. 128) (Vermont, Jul. 1, 2006); and W.S.A. 551.703 (Wisconsin, Jan. 1, 2009).

12. Although also beyond the scope of this article, in addition to common law claims, Blue Sky law claims, and claims under Section 10(b) of the Securities Exchange Act of 1934, practitioners should consider a claim under any relevant and applicable state consumer protection statute. Many states have promulgated consumer protection statutes providing a private right of action to consumers who have been subjected to fraudulent or deceptive conduct. To the extent that such statutes, by their plain terms or as interpreted by the courts, apply to the purchase or sale of securities and/or the provision of brokerage or investment services, they often provide for significant remedies, such as treble damages and attorneys' fees. For example, see the Pennsylvania Unfair Trade Practices and Consumer Protection Law, 73 P.S. §§ 201.1, et seq. (the "UTPCPL"), which provides an award of actual damages, up to treble damages, and attorneys' fees, for consumers harmed by fraudulent or deceptive conduct, including the provision of deceptive brokerage services. *See e.g., Denison v. Kelley*, 759 F. Supp. 199, 202 (M.D. Pa. 1991) (UTPCPL applies to brokerage services, including, churning investors' accounts and purchasing inappropriate investments); *Algrant v. Evergreen Valley Nursery Limited Partnership*, 126 F.3d 178, 187-88 (3d. Cir. 1997) (Although UTPCPL does not apply to sale of securities because securities are not "goods," UTPCPL does apply to

Sky laws, if the claimant has been defrauded and continues to own the security at issue, she may recover the consideration paid for the security, together with interest at the rate set forth in the statute from the date of payment, costs and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security.[13] *See e.g.*, C.G.S.A. § 36b-29(a) (Connecticut). Under most Blue Sky laws, if the claimant no longer owns the security (for instance, if the claimant sold it at a loss in an attempt to mitigate damages or access needed funds), she may usually recover "damages." *Id.* The majority of Blue Sky laws define "damages" as "the amount that would be recoverable upon a tender [of the security], less the value of the security when the buyer disposed of it, and interest at the statutory rate from the date of disposition."[14] *See e.g.,* M.C.L.A. 451.2509(2)(c) (Michigan).

In addition, nearly all Blue Sky laws permit the recovery of reasonable attorneys' fees in an action for rescission or damages under state Blue Sky laws. The only jurisdictions that do not permit recovery of attorneys' fees are California, New Jersey, New York (which does not permit a private right

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conduct relating to the brokerage services); *Perry v. Markman Capital Management*, No. 02-744, 2002 WL 31248038 (E.D. Pa., Oct. 4, 2002) (UTPCPL applies to claims arising from the investment services provided, including, investing beyond authority granted, investing outside of plaintiff's goals, and failing to inform plaintiff of the risks involved). The author intends to make a survey of state consumer protection statutes vis-à-vis securities fraud the subject of a subsequent article.

13. Note that many Blue Sky laws permit the seller of the securities at issue to make a qualifying settlement offer to the customer, which can result in the loss of the right to bring a claim under the Blue Sky Law. An example of this potential pitfall is set forth in Connecticut's Blue Sky Law, which provides the following:

> No person may bring an action … (1) If the buyer received a written offer, before suit and at a time when he owned the security, to refund the consideration paid together with interest at six per cent per year from the date of payment, less the amount of any income received on the security, and he failed to accept the offer within thirty days of its receipt, or (2) if the buyer received such an offer before bringing a cause of action and at a time when he did not own the security, unless he rejected the offer in writing within thirty days of its receipt.

C.G.S.A. § 36b-29(g).

14. Unlike other jurisdictions, Utah's Blue Sky law permits a claimant to recover, *inter alia*, three times the consideration paid for the security upon a showing that the violation was reckless or intentional. U.C.A. 1953 § 61-1-22(2).

of action), Ohio, Pennsylvania, and Tennessee. Of the jurisdictions permitting recovery of attorneys' fees, Florida mandates an award of attorneys' fees to the prevailing party unless such an award would be unjust,[15] Oregon permits an award of reasonable attorneys' fees to the prevailing party except in class actions,[16] Illinois mandates an award of reasonable fees and expenses of the plaintiff's attorney,[17] and Texas permits an award of reasonable attorneys' fees unless such recovery would be inequitable under the circumstances.[18] The remaining states and territories either mandate or permit an award of attorneys' fees, but only specify that such award must be "reasonable." A practitioner should review the statute and pertinent case law to determine whether the Blue Sky law mandates, or merely permits, the court or arbitrators[19] to award attorneys' fees.

With regard to the three states that remain relevant to the fact pattern, Pennsylvania follows the "American Rule"[20] and does not have a provision

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15. F.S.A. § 517.211.

16. O.R.S. §§ 59.115(10) and (11), 59.127(10) and (11), and 59.137(4) and (5).

17. 815 ILCS 5/13(A).

18. Vernon's Ann.Texas Civ.St. Art. 581-33(D)(7) and 581-33-1(B)(4).

19. Interestingly, the Blue Sky laws of Georgia, Hawai'i, Idaho, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, Nevada, New Mexico, Oklahoma, Rhode Island, South Carolina, South Dakota, the U.S. Virgin Islands, Vermont, and Wisconsin permit an award of reasonable attorneys' fees as "determined by the court" with no mention of the ability of arbitrators to provide an award of attorneys' fees. Likewise, Florida permits an award of attorneys' fees to the prevailing party unless the "court" finds that such an award would be unjust. F.S.A. § 517.211. Moreover, Illinois' Blue Sky law states that the "court" shall assess reasonable attorneys' fees and expenses of plaintiff's attorney if the purchaser shall prevail in any action. 815 ILCS 5/13. Furthermore, Texas permits an award of reasonable attorneys' fees if the "court" finds that such recovery would be equitable under the circumstances. The foregoing is in contrast to Indiana's Blue Sky law, which permits an award of reasonable attorneys' fees as "determined by the court or arbitrator." IC 23-19-5-9. The author has been unable to find any cases wherein a court held that arbitrators cannot award attorneys' fees under Blue Sky laws because the statute only permits a "court" to assess such fees. Any decision holding that arbitrators cannot entertain a Blue Sky law claim or award attorneys' fees under those statutes would be suspect given the fact that "arbitrators possess the power to fashion the same relief as courts." *Johnson v. West Suburban Bank*, 225 F.3d 366, 374 (3d. Cir. 2000).

20. The "American Rule" provides that each party is responsible for paying its own attorneys' fees, unless specific authority to award attorneys' fees is granted by statute

in its Blue Sky law permitting the recovery of attorneys' fees, Connecticut permits the claimant to recover reasonable attorneys' fees, and Florida permits the *prevailing party* to recover attorney's fees unless it would be unjust to do so. As such, Connecticut law is the best choice, and Florida law, although it awards attorneys' fees to the prevailing party, may be an additional selection in a strong case.

Statutes of Limitations

Another potential issue to be aware of is the applicable statute of limitations. Although some courts do not apply their state's statutes of limitations in arbitrations,[21] many do. Those states that do not apply their statute of limitations to arbitrations generally do so because their statutes state that the statute of limitations only applies to "actions" and arbitrations are not "actions."

Assuming that statutes of limitations can apply in arbitration proceedings, Blue Sky law statutes of limitation vary greatly from state to state. For instance, both Connecticut's and Florida's Blue Sky law provides a statute of limitations of two years after the date when the fraud or misrepresentation is discovered or in the exercise of due diligence should have been discovered, but with an overall maximum of five years from the

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or contract. Note that all states that provide a private right of action but do not permit an award of attorneys' fees in their Blue Sky laws (California, New Jersey, Ohio, Pennsylvania, and Tennessee) follow the "American Rule."

21. *See e.g., Clayton v. Unsworth*, 188 Vt. 432, 440-41, 8 A.3d 1066, 1073 (2010); *Raymond James Fin. Servcs, Inc. v. Phillips*, No. 2D10-2144, 2011 WL 5555691 (Fla.App. 2 Dist. Nov. 16, 2011) (unreported); *Broom v. Morgan Stanley DW Inc.,* 169 Wash.2d 231, 240-45, 236 P.3d 182, 186-88 (2010); *Skidmore, Owings & Merrill v. Connecticut Gen. Life Ins. Co.,* 25 Conn. Supp. 76, 197 A.2d 83 (1963); *Lewiston Firefighters Assoc. v. Lewiston*, 354 A.2d 154 (Me. 1976); *Worcester v. Park Constr. Co.,* 361 Mass. 879, 281 N.E.2d 600 (1972); and *Har-Mar, Inc. v. Thorsen & Thorshov, Inc.*, 300 Minn. 149, 218 N.W.2d 751 (1974). Nonetheless, be aware that even if the statute of limitations does not apply, the arbitrators may still perhaps apply the equitable doctrine of laches. For further discussion of the applicability or non-applicability of statutes of limitations in arbitration, *see* J. Smith, *Statute of Limitations as Bar to Arbitration Under Agreement*, 94 A.L.R.3d 533; J. Long, *Re-Thinking the Application of Statutes of Limitations in Arbitration*, PIABA Bar Journal (Summer 2007); and S. Edwards, *From the Lone Star State: Overcoming Statute of Limitation Defenses in Securities Arbitration*, PIABA Law Journal (Summer 2005).

date that such fraud or misrepresentation occurred. C.G.S.A. § 36b-29; West's F.S.A. § 95.11. However, the statute of limitations under Pennsylvania's Blue Sky law is more restrictive, providing only one year after the date that the claimant knew or should have known of the violation, with a maximum of five years after the transaction at issue. 70 P.S. § 1-504.

Moreover, although most Blue Sky law statutes of limitation specifically incorporate the discovery rule, others do not do so, at least on their face.[22]

Under the fact pattern, and assuming statutes of limitations can be applied in her arbitration, the claimant would be barred from bringing her claim under Pennsylvania's Blue Sky law because it is been more than a year since the date that she discovered, or should have discovered, the fraudulent misrepresentations and omissions. However, the claimant would still be within the statute of limitations periods in Florida and Connecticut.

Therefore, it is very important to be cognizant of whether the statutes of limitations of relevant states applies in arbitrations and, if so, to determine whether the Blue Sky law claim at issue is barred by any of those relevant statutes of limitations.

The Practical Perspective and Conclusion

From a practical perspective, under the above fact pattern, the Connecticut statute is the best choice because it mandates an award of reasonable attorneys' fees to the claimant if he or she prevails.[23] Even if a claim under Pennsylvania's Blue Sky law were not barred by its statute of limitations, it adds nothing to assert such a claim due to the unavailability of

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22. Those states and territories that do not specifically incorporate the discovery rule into their Blue Sky law statute of limitations are Arkansas, Delaware, Guam, Louisiana, Nebraska, New Hampshire, Puerto Rico, Virginia, West Virginia, and Wyoming. However, this does not necessarily mean that the statute of limitations cannot be tolled by the discovery rule or fraudulent concealment; it just may require additional legal research by counsel.

23. Pursuant to *Cotton v. Slone*, 4 F.3d 176, 181 (2d. Cir. 1993), the Connecticut Blue Sky law "mandates the award of attorney's fees to a prevailing plaintiff 'in order to encourage the enforcement of [the Connecticut Uniform Securities Act] by victims of improper securities transactions who might not otherwise be able to afford to do so.'" (*Quoting, Russell v. Dean Witter Reynolds, Inc*., 200 Conn. 172, 196, 510 A.2d 972, 985 (1986)). Therefore, according to the Second Circuit, "The only issue within the court's discretion on a request for attorney's fees under [Connecticut's Blue Sky law] is the reasonableness of the amount requested."

attorneys' fees or any remedies not otherwise available under Connecticut's Blue Sky law. Moreover, although Florida's Blue Sky law provides attorneys' fees to the prevailing party, asserting a claim thereunder would open the door to the unfortunate possibility of the assessment of attorneys' fees against the claimant in a proper case while providing no remedies that are not otherwise available under Connecticut's Blue Sky law. Nonetheless, where there is no discernible difference between several applicable Blue Sky laws, it makes practical sense to assert claims under each such law, thereby giving the court or arbitrators the option to choose.[24]

24. *See*, Lloyd Paul Stryker, *The Art of Advocacy: A Plea for the Renaissance of the Trial Lawyer* (Simon & Schuster 1954) ('No point is ever better made when not directly made at all, but is so presented that the jury itself makes it. Men pride themselves on their own discoveries, and so a point which the jury are allowed to think their own ingenuity has discovered can put the advocate in a position where the jury begin to regard him not only as their spokesman, but their colleague.")

RECENT ARBITRATION AWARDS

John S. Burke

Callas Foundation, Inc. v. Morgan Keegan & Company, Inc.
FINRA Case No. 10-00606

Claimant, a charitable foundation administered by Maria Callas, asserted the following causes of actions: 1) misrepresentation and failure to disclose material facts; 2) violation of NASD and NYSE rules; 3) omissions; 4) breach of fiduciary duty; 4) constructive fraud; 5) breach of contract; 6) common law fraud; 7) negligence; 8) breach of duty to supervise; 9) negligent supervision; 10) violations of federal securities laws; and 11) violations of Georgia law including the Georgia Securities Act. The claims related to Claimant's purchase of shares of RMK Advantage Income Fund and RMK Multi-Sector High Income Fund in Claimant's account. Claimant requested compensatory damages in excess of $343,221.27, well-managed damages if Claimant's account had been properly invested, pre- and post-judgment interest at the legal rate, statutory damages pursuant to the Georgia Securities Act, costs of arbitration including filing fees and expert witness fees, attorneys' fees, punitive damages, and such other and further relief provided by law and equity. Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

Award: The Panel found that Respondent was liable and ordered it to pay to Claimant compensatory damages in the sum of $ 231,336.76 plus interest at the rate of 7% accruing from November 15, 2009, until the date of payment of the Award. The accrued interest totaled an additional $31,000.00 making the total paid by Morgan Keegan $267,450.00.

The Panel explained that when Claimant opened its account with Respondent, the account was invested in cash and certificates of deposits. Claimant's primary investment objective was growth. Claimant's experience was limited to two years in stocks and mutual funds without any experience in bonds of any type. Claimant told the registered representative assigned to the account that it did not want to lose money. The registered representative recommended investments in RMK Advantage Fund and RMK Multi-Sector High Income Fund, resulting in Claimant being transformed from 60% in cash and charitable trusts to 60% in speculative bond funds. When Claimant inquired about the decrease in the funds' value and the appointment of a new fund manager, she was told to ride out the downturn.

The Panel noted in the award that although Claimant's administrator had some experience, she was not advised or admonished by Respondent that a

majority of the high yield bond funds' investments were in below investment grade or junk bonds and could be highly volatile. Respondent did not communicate any recommendation as to the proper concentration of high yield bond funds in a charitable foundation, which, as a result of its acquisition of the two funds, now had a majority of its holdings in high yield, high risk speculative bond funds.

Ms. Callas was given written materials (brochure and prospectus) but the panel found that there was no evidence that she understood the risks of these investments, nor was she presented with a recommended diversified portfolio across various asset classes appropriate for Claimant's objectives of growth, income, and preservation of capital.

There was no evidence presented that this account was adequately supervised since it was over-weighted with high risk investments, and inappropriate for the objectives of Claimant. Although this was an account owned by a charitable foundation, no exception report was generated and the account just sat with recommendations to ride out the downturn.

The Panel concluded that the investment recommendation for Claimant was unsuitable and allowing a charitable trust to have a majority concentration in speculative bonds funds while it had a known primary objective of growth was improper. The Panel found, however, that Claimant bears some responsibility for the losses by not liquidating earlier. As a result, the Panel declined to award attorneys' fees and expert witness fees, and concluded that the parties should each be responsible for half of the FINRA fees and costs incurred in this arbitration, which were substantial after seventeen sessions, five prehearing evidentiary motions, two motions for sanctions and a motion to strike.

Claimants' Counsel: James A. Dunlap, Jr., Esq., James A. Dunlap Jr. & Associates LLC, Atlanta, GA.

Respondent's Counsel: David King, Esq. and M. Jason Hale, Esq., Bass, Berry & Sims PLC, Nashville, TN.

Claimant's Expert: Dr. Eddie S. O'Neal of Securities Litigation and Consulting Group, Inc.

Respondent's Expert: John West of West Consulting Group and Christopher Laursen of NERA Economic Consulting.

Arbitrators: Michael M. Hachigian (Public Chairperson); Henry L. Dahl, Jr. (Public); Charles W. Herf (Non-Public)

This case is significant because unlike most FINRA arbitration awards, the Panel provided a reasoned award detailing the basis for finding liability against Respondent for the unsuitable concentration of high yield bond funds in the account of a charitable trust, and the failure of Respondent to supervise the account properly that was over weighted in high risk investments

inconsistent with the account investment objectives. In addition to paying the full account losses suffered by Claimant, the panel also included accrued interest, amounting to $31,000.00, to the damage award. On the other hand, the Panel's decision lacked the same detail in finding that Claimant was responsible for not liquidating earlier, which was the reason it gave for not awarding attorney fees and assessing half of the arbitration costs to Claimant.

Robert Trumper, Karen Trumper v. CapWest Securities, Inc., Ronald Lee Ellis, Dale Keith Hall, Kathleen Louise Heshelow, Timothy James Kenkel, Lawrence William Lambert, Edward Lowry Price, Jeffrey Jon Pridey, Kent Waldene Pridey

FINRA Case No. : 10-02249

Claimants asserted the following causes of action: 1) violation of Colorado Securities Act; 2) violation of the Colorado Consumer Protection Act; 3) common law fraud and misrepresentation; 4) violations of Section 2110 Conduct Rules of the NASD; 5) violation of Section 2120 Conduct Rules of the NASD; 6) violation of Section 2310 Conduct Rules of the NASD; 7) violation of Section 3010 Conduct Rules of the NASD; 8) breach of fiduciary duty; 9) negligence and negligent supervision; and 10) respondeat superior. The causes of action relate to Claimants' purchase of Striker Petroleum and Medical Capital Corporation ("Med Cap"), including Med Cap IV and Med Cap V. Claimants sought rescissory and compensatory damages of a minimum of $606,400.00 in principal, plus accrued interest and well-managed portfolio profits, punitive or exemplary damages, pre- and post-award interest; costs and attorneys' fees.

All Respondents denied the allegations in the Statement of Claim, and Respondents Ellis, Heshelow, Kenkel, Lambert, Jeffrey Pridey, and Kent Pridey raised various affirmative defenses.

Award: The Panel found for Claimants as follows: 1) for their investment in Striker Petroleum, Claimants were awarded a total of $200,000.00 in compensatory damages, with Respondent CapWest being solely liable to Claimants for half and Respondents CapWest and Kent Pridey being jointly and severally liable for the remaining $100,000.00; 2) for their investment in Med Cap IV, Claimants were awarded $250,000.00 in compensatory damages, with Respondents CapWest, Hall, Lambert, and Heshelow being jointly and severally liable for half; and Respondents CapWest, Kent Pridey, Hall, Lambert, and Heshelow being jointly and severally liable for the remaining $125,000.00; 3) for their investment in Med Cap V, Claimants were awarded a total of $ 100,000.00 in compensatory damages, with Respondents CapWest, Kent Pridey, Hall,

Lambert, Heshelow, and Jeffrey Pridey jointly and severally liable for $50,000.00 in compensatory damages, and Respondents CapWest, Hall, Lambert, Heshelow, and Jeffrey Pridey jointly and severally liable for $50,000.00; and 4) Respondents CapWest, Kent Pridey, Hall, Lambert, Heshelow, and Jeffrey Pridey were jointly and severally liable for Claimants $7,500.00 in interest, attorneys' fees and direct costs pursuant to the Colorado Securities Act CRS 11-51-604.

In total, claimants were awarded $557,500.00 in compensatory damages, interest, attorney fees, and costs. In addition, the Panel assessed the total of $7,200.00 in hearing session fees jointly and severally to Respondents CapWest, Kent Pridey, Hall, Lambert, Heshelow, and Jeffrey Pridey.

Claimants' Counsel: Dave Neuman, Esq., of Stoltmann Law Offices, P.C., Chicago, IL.

Respondent's Counsel: H Thomas Fehn, Esq., Fields, Fehn & Sherwin, Los Angeles, CA

Claimant's Expert: None

Respondent's Expert: None

Arbitrators: Donald N. Tolin (Public Chairperson); Bruce J. Pederson (Public); Helen P. Love (Non-Public)

This case is significant because the Panel found that the control persons were liable. CapWest's compliance manual maintained that the board of directors were responsible for performing due diligence on any products sold by the firm. The directors who were found liable were on the board of directors during the time that the investments in Medical Capital were sold to the Claimants. Based on the Colorado Securities Act, control persons are liable "unless the controlling person sustains the burden of proof that such person did not know, and in the exercise of reasonable care could not have known, of the existence of facts by reason of which the liability is alleged to exist." See C.R.S. 11-51-604(5)(a). Apparently, the Panel found that the control persons did not sustain their burden that they exercised any reasonable care in performing due diligence on the products at issue.

The Panel awarded the Claimants interest, attorney fees, and costs of $7,500.00, against all respondents, including the control persons. The Panel specifically cited to the Colorado Securities Act, C.R.S. 11-51-604(5), as authority for awarding interest, attorney fees, and costs against all respondents in the award, indicating that the panel indeed found control person liability under the Colorado Securities Act.

Douglas A. Mirabelli and Kristin L. Mirabelli v. Merrill Lynch, Pierce, Fenner & Smith, Inc.

FINRA Case No. 10-03400

Claimants asserted the following causes of action: 1) violations of Michigan Securities Act; 2) violations of Washington Securities Acts; 3) misrepresentation and omission; 4) negligence; 5) breach of contract; and 6) breach of fiduciary duty. The causes of action related to Claimants' allegation that Respondent's employee, Phil Scott, provided inappropriate investment advice, including the recommendation and purchase of various securities, including Alliance Resource Partners LP, Apollo Investment Corp., and Copano Energy LLC., while Claimants' account was pledged as collateral for an interest-only mortgage on their home issued by a subsidiary of Respondent Merrill Lynch.

In the Statement of Claim, Claimants requested rescission of the purchase of the securities; restitution of the amounts paid for the securities; compensatory damages according to proof but at a minimum, $606,400.00 in principal, plus accrued interest and well-managed portfolio profits that would have been earned had the investments been properly managed; punitive or exemplary damages; pre- and post-award interest; costs including attorneys' fees; treble damages; and other and further relief as the Panel may deem just and proper.

Respondent denied the allegations in the Statement of Claim and asserted affirmative defenses.

Award: The Panel found that Respondent was liable and ordered the Respondent to pay Claimants as follows: 1) $800,219.00 in compensatory damages: 2) interest on the above-stated sum at the rate of 6% per annum from and including July 26, 2010, through and including the date this Award is paid in full; 3) $47,339.91 in costs; and 4) $391,474.00 in attorneys' fees pursuant to MCL § 451.810.

Claimants' Counsel: John J. Miller, Esq., Swanson Midgley LLC, Kansas City, Missouri, and Barry R. Lax, Esq., Lax & Neville, LLP, New York, New York.

Respondent's Counsel: Nathan T. Alexander, Esq., Dorsey & Whitney LLP, Seattle, Washington, and J. David Jackson, Esq., Dorsey & Whitney LLP, Minneapolis, Minnesota

Claimant's Expert: Robert Lowry of RL Consulting Services, Leesburg, VA

Respondent's Expert: Michael Weiner of Bates Group LLC, Lake Oswego, OR

Arbitrators: Jacqueline R. Fox (Public Chairperson); John F. Burns (Public); Larry C. Kreu (Public)

This case finds a two time Boston Red Sox knuckleball catcher, Doug Mirabelli, being paired with a Yankee fan, Barry Lax, and this time, Merrill Lynch paid the price. This case is significant because of the substantial award involving a home mortgage and margined account. The Claimants' accounts at Merrill Lynch were pledged as collateral for interest-only mortgages on their homes issued by a subsidiary of Merrill Lynch. When the market collapsed in late 2008, the Claimants' account values fell below the minimum collateral requirements, resulting in large sellouts and $800,000.00 in losses. Claimant alleged that Respondents advisor represented that the all-equity portfolio was suitable, but it was not given the Claimant's retirement from baseball and the pledges of the accounts. Claimants were awarded full-statutory damages under Michigan law, including all interest, attorneys' fees, and expenses.

Jane Ellison Usher, both individually and as trustee for the Jane Ellison Usher Trust of October 20, 2000, and as custodian for Samuel T. Usher and Jackson A. Usher under the Uniform Gifts to Minors Act, and Samuel T. Usher v. Todd A. Brooks, Scott S. Brooks, Bambi I. Holzer, Wedbush Securities Inc.

FINRA Case No. 10-00603

Claimants asserted the following causes of action: 1) fraudulent misrepresentation and omissions; 2) intentional and negligent breach of fiduciary duty; 3) securities fraud; 4) negligence; and 5) failure to supervise Holzer. The causes of action relate to Claimants' investments in various securities, including but not limited to: Commonwealth Income & Growth II and III; Behringer-Harvard REIT I; Behringer-Harvard Strategic Opportunity Fund; Highland Floating Rate Advisors Fund; and Provident Shale Royalties 8. In the Statement of Claim, Claimants requested compensatory damages in excess of $2,000,000.00, and punitive damages. At the close of the hearing, Claimants requested damages of $ 1,657,996.00, plus interest.

Respondents denied the allegations in the Statement of Claim.

Prior to hearing, Claimant dismissed respondent Scott Brooks. During the hearing, Claimant dismissed Respondent Todd Brooks.

Award: The Panel awarded Claimants a total of $1,405,393.00 in compensatory damages, with Respondent Holzer being solely liable for $1,119,780.00 in compensatory damages, and Respondents Holzer and Wedbush being jointly and severally liable for $285,613.00 in compensatory damages. In return for payment of the awarded damages, Claimants were to assign and transfer to Respondent Holzer all rights, title and interest in Commonwealth Fund II, Commonwealth Fund III, Behringer-Harvard REIT

I, and Behringer-Harvard Strategic Opportunity, without warranty. Claimants were also to assign and transfer to Respondent Holzer and Respondent Wedbush, jointly and severally, all rights, title and interest in and to Provident Shale Royalties, without warranty.

The Panel also provided an alternative in the award for the parties to negotiate the value of the aforementioned securities that Claimants choose to retain if any, which amount, if agreed, shall reduce, dollar for dollar the amount of the respective Award to Claimants (from Holzer or Holzer and Wedbush).

Finally, the Panel assessed $5,250.00 of the hearing session fees jointly and severally to Claimants and $4,800.00 of the hearing session fees jointly and severally to Respondents Holzer and Wedbush.

Claimants' Counsel: Mark T. Drooks, Esq., Bird Marella Boxer Wolpert Nessim Drooks, Los Angeles, CA.

Respondent's Counsel: H Thomas Fehn, Esq., Fields, Fehn & Sherwin, Los Angeles, CA. for Bambi I. Holzer.

Charles LaChaussee, Esq., and John L. Erikson, Jr., Esq., Wedbush Morgan Securities Inc., Los Angeles, CA. for Wedbush Securities, Inc.

Claimant's Expert: Lorena J. Kern of Kern Consulting LLC, Glen Rock, NJ

Respondent's Expert: none

Arbitrators: Kirtley M. Thiesmeyer (Public Chairperson); Holly Banafsheh (Public); Anna Marie Turco (Non-Public)

This case involved sale of non-traded REITS, equipment trusts and leveraged funds recommended to a Trust and to minors. While the award was significant in size, the majority of the award was against the broker, Bambi Holzer, in the form of rescission. The employing broker dealer, Respondent Wedbush Securities, was responsible for only about 20% of the total award. This apportionment of responsibility is interesting in light of the fact that a review of the FINRA BrokerCheck for Ms. Bambi Holzer reveals that at the time she joined the broker dealer her license had been revoked in the State of Illinois and FINRA had fined her $100,000 and given her a twenty-one day suspension. FINRA BrokerCheck also records that 60 customer disputes going back to at least 1998 have been recorded against Ms. Holzer.

Frank M. Taylor and Taylor Affiliates, LLC v. Securian Financial Services, Inc. and Salvatore Joseph Durso

FINRA Case No. 10-03642

Claimants asserted the following causes of action: 1) misrepresentations; 2) failure to supervise; 3) respondeat superior; 4) unauthorized transactions; and 5) suitability. Claimants alleged that Respondents made unsuitable recommendations regarding promissory notes related to certain real estate transactions and those Respondents misrepresented the investments as being safe and consistent with their investment objectives. Claimants sought compensatory damages for the $4,200,000 invested in the promissory notes plus interest, less the interest received.

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

Award: The Panel found that Respondent Securian Financial Services, Inc. was liable and ordered Respondent to pay Claimants: 1) $ 2,375,000.00 in compensatory damages; and 2) post-award interest on the above-stated sum in accordance with rates set forth under MCLA 600.6013.

Claimants' Counsel: Adam J. Brody, Esq., Varnum, LLP, Grand Rapids, MI

Respondent's Counsel: Larry King, Esq. of Larson King LLP, Saint Paul, MN. Represented Securian Financial Services, Inc.

Brian J. Masternak, Esq. of Warner Norcross & Judd LLP, Grand Rapids, MI. represented Respondent Salvatore Joseph Durso

Claimant's Expert: None

Respondent's Expert: None

Arbitrators: Jeffry M. Bauer (Public Chairperson); Michael J. Meeusen (Public); Dana Ray Darnell (Non-Public)

This case is significant because Respondent moved for leave to take the deposition of the individual Claimant and a non-party to the arbitration, or in the alternative to preclude the use of depositions of Securian Employees. The panel denied both the Respondent's motion to depose and the alternative motion to preclude the Claimant from using the depositions of Respondent's employees. Respondent Securian asked for the depositions because it claimed not to have even basic information regarding the nature of Claimants' claim. Claimants' counsel, on the other hand, had taken the depositions of eight of Respondent Securian's compliance department employees in a state court case involving a different client related to the same real estate venture. Respondent argued that Claimant had an unfair advantageous position over them. Claimants responded that Securian had more information than a typical Respondent because it had already taken the depositions of Claimant and many other witnesses in the related state court

case and there was a significant overlap of pertinent fact between the court case and the arbitration claim brought by Claimant. Respondent replied that it did not know Claimant would be asserting a claim when they first deposed him. Respondent further argued that it would be unfair to allow the use of the Respondent's employees' depositions if they were not allowed to depose Claimant again. The Panel apparently agreed with Claimant and denied Respondent's motion without explanation.

Leave is rarely granted to take depositions in arbitration. In this case, a related state court proceeding provided the Panel with relevant deposition testimony of Respondent's compliance department employees. The result was a substantial award in favor of Claimant and an assessment of all FINRA forum fees against Respondent.

PCF LLC and TGV LLC, v. William James Kring and Triad Advisors, Inc.
FINRA Case No. 11-00106

Claimants asserted the following causes of action: 1) breach of contract; 2) fraud; 3) negligence; 4) misrepresentation; and 5) breach of fiduciary duty. The causes of action relate to Claimants' investments in two real estate projects: Le*Nature, a beverage bottling plant in Phoenix, Arizona, and US Medical Towers, a medical office building in Houston.

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

Respondents filed a Motion to Dismiss and for an Award of Attorneys' Fees in which they asserted that the Panel should dismiss Claimants' claims pursuant to Rule 12504 of the Code of Arbitration Procedure because: 1) in connection with their investment in Le*Nature, Claimants knowingly transferred their right to bring this action to a third party by signing a settlement agreement and receiving compensation pursuant thereto; and 2) Claimant PCF's claims in connection with its investment in US Medical Towers are based upon a decision made by a third party three years after the time of the investment, rendering Respondents disassociated with the conduct at issue. In response, Claimants asserted that: 1) with respect to the Le*Nature investment, Claimants did not enter into a settlement agreement; and 2) with respect to the US Medical Towers investment, Respondents were associated with the conduct at issue because Respondents were negligent in their investigation of the offering materials.

Award: The Panel granted Respondents' Motion to Dismiss as to the Phoenix Interests pursuant to Rule 12504 (a)(6)(A) and as to the Houston Interest pursuant to Rule 12504 (a)(6)(B). The Panel granted Respondent's Motion for Attorneys' Fees as it related to the Phoenix Interests, finding that

the claims asserted by Claimants in connection with their purchase of interests in the Phoenix property were without substantial justification due to their prior assignment of those claims, and that Respondents are entitled to an award of attorneys' fees pursuant to O.C.G.A. § 51-7-81 or Florida Statute § 57.105 in an amount to be determined by a court of competent jurisdiction.

Claimants' Counsel: Shana M. Rugani, Esq., Novato, California, and Richard Sacks, Investors Recovery Service, Novato, California

Respondent's Counsel: J. Steven Parker, Esq. and Robert Perry, Esq., Page Perry, LLC, Atlanta, Georgia.

Arbitrators: William H. Fleece (Public Chairperson); John T. Luce (Public); Arthur DeStefano (Non-Public)

This case is significant because the Panel granted Respondent's motion to dismiss pursuant to Rule 12504(a)(6) of the FINRA Code of Arbitration Procedure for Customer Disputes following a telephonic Pre-hearing Conference. The decision is a very well-reasoned award. The Panel's award discusses in detail how Claimants gave up their rights to bring claims concerning the Le*Nature, Inc. real estate project as a result of a settlement agreement that they previously entered into. Likewise, the award discusses in detail that Claimant's claims concerning the US Medical Towers real estate project did not involve the Respondent. In applying Rule 12504(a)(6) the Panel recognizes the purpose of the Rule as discussed in SEC Exchange Release No. 57497, March 14, 2008. The Panel determines that the case before it is precisely the situation envisioned in Rule 12504(a)(6)(A) that would be unfair to require a party to proceed to hearing.

Having determined that dismissal of Claimants statement of claim was appropriate under Rule 12504, the Panel went on to determine Claimants' claims were frivolous and groundless in fact or in law. The Panel applied both Georgia law and Florida law to determine the award of Respondents' attorney's fees. The Panel concluded by determining that the Respondents were entitled to attorney's fees and costs for defending both claims, but left it to a court of competent jurisdiction to apportion the fees.

CASES & MATERIALS

Birgitta Siegel

SUPREME COURT DEVELOPMENTS

CompuCredit Corp. et. al. v. Greenwood, et.al.
565 U.S. __, 132 S. Ct. 665 (Jan. 10, 2012)

By an 8-1 vote, the Supreme Court held that claims for violations of the Credit Repair Organizations Act ("CROA"), 15 U.S.C. §§ 1679 *et. seq*., must be arbitrated according to the terms of a valid arbitration agreement. At issue in the case was whether Respondents, Plaintiffs below, had satisfied their burden of showing Congressional intent to ban compulsory arbitration of CROA claims. The five justice majority concluded that the CROA was silent on this issue, thus requiring enforcement of the arbitration clauses. Justices Sotomayor and Kagan found that the evidence of intent was too inconclusive to override enforcement of the Federal Arbitration Act (the "FAA").

Background

Petitioner CompuCredit marketed Visa cards via mass direct mail solicitations to individuals with marginal credit scores and who sought to rebuild their credit. Respondents applied for and received the credit cards. However, the promise of $300 of available credit was illusory because of hidden fees that were assessed against the credit once the cards were activated. Thus, the available credit was in fact only $43.00, and the hidden fees incurred interest if not fully paid each month. In 2008, Respondents filed a putative class action alleging that CompuCredit misrepresented the fees, the card's ability to help rebuild credit, and the effective credit limits on the accounts.

The credit applications incorporated pre-dispute arbitration clauses by reference to an "insert," which further prohibited class action litigation. In accordance with the mandate of CROA Section 1679c(a), however, and prior to execution of any contract, CompuCredit provided an initial disclosure that stated "You have a right to sue a credit repair organization that violates the Credit Repair Organization Act." The CROA's substantive provisions

further contain a non-waiver clause that states "[a]ny waiver by any consumer of any protection provided by or any right of the consumer under this subchapter" (1) shall be treated as void; and (2) may not be enforced by and Federal or State court or any other person." 15 U.S.C. §1679f(a). *See* 132 S.Ct. at 669. Petitioner CompuCredit moved to compel arbitration under the Federal Arbitration Act, 9 U.S.C. §§ 1 *et. seq*. (the "FAA"). Respondents argued that the CROA's disclosure and non-waiver provisions evidenced Congressional intent to preclude enforcement of pre-dispute arbitration agreements in lawsuits alleging CROA violations.

The District Court for the Northern District of California denied CompuCredit's motion to compel arbitration. The Ninth Circuit Court of Appeals affirmed, holding that CROA's disclosure and non-waiver provisions, taken together, manifested Congressional intent to bar mandatory arbitration of such claims.

The Supreme Court

On January 10, 2012, the U. S. Supreme Court reversed and remanded. Writing for the majority, Justice Scalia reviewed the mandate of Section 2 of the FAA, which establishes generally that arbitration clauses shall be enforced upon their terms. Justice Scalia emphasized that the FAA embodies a strong federal policy favoring arbitration, and the Court has an obligation to enforce such agreements, "even when the claims at issue are federal statutory claims, unless the FAA's mandate has been 'overridden by a contrary congressional command.'" 132 S. Ct. at 669 (quoting *Shearson/American Express Inc. v. McMahon,* 482 U.S. 220, 226, 107 S.Ct. 2332,(1987), wherein the Court enforced agreements to arbitrate federal RICO and securities claims).

The opinion then turned to the explicit language of the CROA. The Court observed that the disclosure statement and the "right to sue" language are not part of the statute's liability provisions. According to the Court, the "right to sue" language does not, therefore, confer any rights other than the right to receive the disclosure statement. The disclosure statement merely alerts consumers that their rights are provided elsewhere in the statute. Justice Scalia stated that the phrase "right to sue" is just a "colloquial method of communicating to consumers that they have the legal right, enforceable in court, to recover damages" from offending credit repair organizations; the phrase may be "imprecise," but does not mislead consumers with false notions that they may not be bound by contract initially to arbitrate a dispute. *See id*. at 672. As to the CROA's use of terms such as "action" and "court"

within its liability sections, the Court relied largely on precedent (*e.g. Gilmer v. Interstate/Johnson Lane Corp*, 500 U.S. 20, 28 (1991)), to find that such terms do not evince Congressional command to override the FAA. In sum, "contractually required arbitration of claims satisfies a statutory prescription of civil liability in court." *Id.* at 671.

The Court held that had Congress intended to prohibit arbitration of the CROA claims, it would have done so "with a clarity that far exceeds the claimed indications" in the statute. Citing other statutes that do effectively prohibit arbitration, such as the Commodity Exchange Act (7 U. S. C. §26(n)(2) (2006 ed., Supp.IV) ("No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section"), and the Automobile Dealer's Day in Court Act (15 U. S. C. §1226(a) (2) (prohibits arbitration unless all parties consent after the dispute arises) (2006 ed.) the Court held it "unlikely" that Congress intended a similar prohibition within the CROA statutory scheme. 132 S. Ct. at 672-673. Indeed, the majority ultimately states that the CROA is "silent" on the questions presented, thereby requiring enforcement of the arbitration clause in accordance with the FAA.

Emphasizing further that it is not for the Court, but for legislators and regulators, to bar or limit arbitration as appropriate, the Court notes that the newly created Consumer Financial Protection Bureau ("CFPB"), is empowered to regulate or even prohibit arbitration of certain consumer claims. *Id*. at 672. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U. S. C. §5518(b)), Congress authorizes the CFPB to:

> [P]rohibit or impose conditions or limitations on the use of an agreement between [a person engaged in providing a consumer financial product or service] and a consumer for a consumer financial product or service providing for arbitration of any future dispute between the parties, if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers.

Though the Court does not discuss the CFPB at length, the conspicuous mention of it may serve as a means available to prohibit arbitration of certain claims. Specifically, the CFPB is charged by Congress to study the use of pre-dispute arbitration clauses in consumer financial services contracts, to report results of the study to Congress, and to prohibit or regulate these arbitration provisions if such action is in the public interest and would protect consumers. Thus, if Congress agrees with the CFPB's conclusions and recommendations, the CFPB can prohibit arbitration of consumer claims, regardless of judicial precedent to the contrary.

Concurring and Dissenting Opinions

Writing for the concurrence, Justice Sotomayor explained that the case presented a much "closer call" than suggested by the majority opinion. She also mentioned that she does not understand why the majority requires stark evidence of Congressional intent as is seen in some statutes cited by the majority, such as the Commodities Exchange Act. Nevertheless, the concurring opinion found that the CROA language did not adequately indicate its intent. Nor did Respondents identify anything "in the legislative history or purpose of the Act that would tip the balance of the scale in favor of their interpretation." *Id*. at 675. Respondents failed to meet their burden.

The lone dissent was penned by Justice Ginsburg. The opinion illuminates historical facts, examines the statutory scheme in depth, and concludes that the Court's decision was not compelled by relevant precedents. Unlike either the majority or concurring opinions, the dissent also concluded that Congressional intent to bar mandatory arbitration was evidenced by the CROA's express consumer protection goals, among other factors. *Id*. at 678.

KPMG LLP v. Robert Cocchi et al, _U.S._ ,
132 S. Ct. 23 (Nov. 7, 2011)
(state court must assess the arbitrability of each claim and enforce the FAA where applicable, even if the result is piecemeal litigation of nonarbitrable and arbitrable claims)

Investors lost millions in three limited partnerships (the "Rye Funds") which had been invested with Ponzi schemer Bernie Madoff. The Rye funds were managed by Tremont Group Holding, Inc. and Tremont Partners, Inc. ("Tremont"). KPMG audited all the funds. The investors sued KPMG, Tremont, and the Rye Funds in Florida state court. As to KPMG, Respondents' theory was that the firm failed to use proper auditing standards that could have detected the fraud. They alleged: negligent misrepresentation; violations of the *Florida Deceptive and Unfair Trade Practices Act* (FDUTPA); professional malpractice; and aiding and abetting a breach of fiduciary duty.

KPMG moved to compel arbitration of the investors' claims, relying on the arbitration clause in its audit services agreement with the Tremont fund managers. The Florida Fourth District Court of Appeal affirmed the trial court's denial of the motion, holding that because the investors were not parties to the audit services agreement that contained the arbitration clause, and because the claims for negligent misrepresentation and violation of

FDUTPA were direct claims against KPMG, rather than derivative to KPMG's audit services agreement with Tremont, the investors could not be compelled to arbitrate those two claims. The Court of Appeal made no findings as to whether the remaining claims for professional malpractice or breach of fiduciary duty were arbitrable.

The U.S. Supreme Court granted KPMG's petition for certiorari. In its *per curium* decision, the Court first emphasized that arbitration agreements within the scope of the Federal Arbitration Act ("FAA") "must be enforced in state and federal courts," and that state courts "have a prominent role to play as enforcers of agreements to arbitrate." 132 S. Ct. at 25. The question presented had been previously addressed in *Dean Witter Reynolds Inc. v. Byrd,* 470 U.S. 213, 217, 105 S.Ct. 1238, 84 L.Ed.2d 158 (1985), which held that the FAA requires courts to "compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums." *Id.* at 217, 105 S.Ct. 1238. Because the Florida Court of Appeals did not address whether the plaintiffs' claims for professional malpractice and breach of fiduciary duty were arbitrable, the Supreme Court vacated the judgment and remanded with instruction that the court below determine whether those claims were arbitrable.

LOWER COURTS

COMMENCING ARBITRATION

Khan v. Dell Inc., __F.3d___, 2012 WL 163899 (3d Cir. Jan 20, 2012) (Section 5 of the FAA compels appointment of a substitute arbitration forum when designated arbitration forum is defunct and no alternative forum is specified.)

Background

When Appellees, Plaintiffs below, bought a Dell computer on-line, they were required to check a box agreeing to the terms of sale. Those terms included an arbitration clause that designated the National Arbitration Forum ("NAF") as the exclusive dispute resolution forum. Khan ultimately sued Dell in a putative class action alleging, among other things, the defective design of certain Dell Inspiron computers.

Dell moved to compel arbitration, relying on its customer purchase agreement, which stated that all disputes "**SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION ADMINISTERED BY THE NATIONAL ARBITRATION FORUM (NAF)** under its Code of Procedure then in effect." 2012 WL 163899 at *1. By the time Khan filed his lawsuit, however, the NAF had been barred from sponsoring consumer arbitrations by a Consent Judgment which settled charges brought by Minnesota's Attorney General. Khan opposed a motion to compel arbitration, arguing in part that the arbitration clause was unenforceable due to the unavailability of the NAF as a forum. The District Court agreed with Khan, denied Dell's motion, and held that the arbitration clause demonstrated "the parties' intent to arbitrate exclusively before a particular arbitrator, not simply an intent to arbitrate generally." The court explained that the parties' designation of NAF as the forum was "integral" to the agreement to arbitration, and that appointment of a substitute arbitrator would force the parties to "submit to an arbitration proceeding to which they have not agreed."

Third Circuit Decision

In a 2-1 vote, the Third Circuit Court of Appeals reversed. Noting that the issue presented was one of first impression in its jurisdiction, the Court discussed conflicting decisions from other district and circuit courts. The analysis begins first with the general mechanism provided by Section 5 of the FAA, which states in pertinent part:

> If in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators or an umpire, such method shall be followed; but if no method be provided therein, or if a method be provided and any party thereto shall fail to avail himself of such method, or if for any other reason there shall be a lapse in the naming of an arbitrator, or arbitrators or umpire, or in filling a vacancy, then upon the application of either party to the controversy the court shall designate and appoint an arbitrator… who shall act under the said agreement with the same force and effect as if he or they had been specifically named therein. 9 U.S.C. § 5.

As the NAF was undisputedly unavailable and the contract contained no provision for a replacement arbitrator, the Court analyzed whether the parties' choice of forum was "integral" to their agreement. *See, e.g., Brown v. ITT Consumer Fin. Corp.,* 211 F.3d 1217, 1222 (11th Cir. 2000)*; Reddam*

v. KPMG LLP, 457 F.3d 1054, 1061 (9th Cir.2006), *abrogated on other grounds by Atlantic Nat'l Trust LLC v. Mt. Hawley Ins. Co.,* 621 F.3d 931 (9th Cir.2010).

The two judge panel in *Khan v. Dell* determined that the arbitration clause at issue was "at best ambiguous as to whether the parties intended to have their disputes arbitrated in the event that NAF was unavailable for any reason." In other words, the Court found it unclear as to whether the designation of the NAF was integral to the parties' agreement, or just a "logistical ancillary concern." Among the ambiguities found by the Court, was the use and placement of the term "exclusively" within the parties' arbitration agreement. According to the majority, the term "exclusively" could reasonably be meant to modify only the phrase "binding arbitration." rather than the phrase "National Arbitration Forum." In addition, it appears the Court adopted a higher standard than applied in previous decisions addressing application of Section 5 of the FAA. The Court stated that, "the parties must have unambiguously expressed their intent not to arbitrate their disputes in the event that the designated arbitral forum is unavailable." The language also appears potentially at odds with the general rule that the party opposing arbitration is to be afforded the "benefit of all reasonable doubts and inferences that may arise." *See* 2012 WL 163899 at*3 (quoting *Kaneff v. Delaware Title Loans, Inc*., 587 F.3d 616,620 (3d Cir. 2009). In light of perceived ambiguities, and the strong federal policy favoring arbitration, the Court resolved the matter in favor of arbitration.

As a shot across the bow, the dissent found that the majority had paid "mere lip service" to the fundamental principle that arbitration is a creature of contract. The judge furthermore found the arbitration clause unambiguous in its designation of the NAF forum as the exclusive forum, and that the designation was integral to the agreement.

(Note: This issue has arisen in the context of securities arbitrations, when a party seeks to enforce or avoid language that designates a currently unavailable forum, such as the NYSE.)

UBS Financial Services, Inc., UBS Securities, LLC v. West Virginia University Hospitals, Inc., West Virginia University 23 Hospitals-East, Inc., United Hospital Center, Inc., City Hospital 24 Foundation, Inc., West Virginia United Health System, Inc.,
660 F.3d 643 (2d Cir. Sept 22, 2011) (advisory client is "customer" of broker/dealer and is entitled to FINRA arbitration of claims; venue clause in parties' contract is an issue for arbitrators, not court).

Background

UBS[1] served as both the lead underwriter and primary broker/dealer for West Virginia University Hospitals ("WVUH"), which issued $329 million of bonds. At the suggestion of UBS, a significant portion of the bonds were structured as Auction Rate Securities ("ARS") so as to refinance WVUH's existing debt and finance capital improvements. Also at the suggestion of UBS, the parties executed interest rate swap agreements intended to limit some of WVUH's exposure in high interest rate environments by fixing a low interest rate on certain principal sums. WVUH issued the bonds via three offerings in 2003, 2005, and 2006.

For each offering, the parties executed two contracts including: 1) a broker-dealer agreement outlining UBS's duties as a broker-dealer; and 2) a purchase contract governing the underwriter/issuer relationship whereby UBS bought the ARS at a discount for re-sale to other dealers and to retail investors. The broker-dealer agreements also specified fees that WVUH paid to UBS for the latter's "services" in facilitating auctions. None of the agreements mentioned arbitration in any forum, though the 2006 broker-dealer agreement stated that any "action or proceeding shall" be brought in New York County.

The ARS market collapsed in February 2008. WVUH filed a FINRA arbitration against UBS alleging violations of the Securities Exchange Act of 1934 and the Uniform Securities Act. The claims arose from UBS's conduct both as underwriter and as provider of auction services it sold to WVUH. According to WVUH, UBS concealed material facts concerning the ARS market, and the firm's crucial role in supporting that market, when it suggested that WVUH issue the bonds, and when UBS induced WVUH to purchase auction services from UBS.

Because the there was no arbitration agreement between the parties, WVUH asserted FINRA jurisdiction under Rule 12200 of the Code of Arbitration Procedure ("CAP"). Under the relevant parts of Rule 12200, member firms must submit to FINRA arbitration if: (1) "requested by the customer"; (2) the "dispute is between a customer and a member"; and (3) the "dispute arises in connection with the business activities of the member

1. Appellants-Plaintiffs are collectively referred to as "UBS." Appellees-Defendants are collectively referred to as "WVUH." The Court of Appeals noted that the corporate distinctions had no affect on its reasoning or decision.

or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company."[2]

WVUH alleged it was UBS's customer and that the dispute arose from UBS's business activities, including underwriting, and "broker-dealing." UBS filed an action in the Southern District of New York, seeking declaratory relief and a preliminary injunction to bar arbitration on the ground that WVUH was not its "customer" as that term is intended by FINRA Rule 12200. Alternatively, UBS sought to halt the pending arbitration from proceeding outside of New York County under the forum/venue selection clause in the 2006 agreement.

The District Court held that UBS failed to make a prima facie case sufficient to obtain a preliminary injunction enjoining the arbitration; to obtain an injunction, UBS had to prove: (1) irreparable harm; and (2) either (a) the "likelihood of success on the merits" (the merits being UBS's ultimate goal of permanently enjoining the arbitration), or (b) "serious questions" concerning WVUH's customer status so as to tip the balance in favor of UBS at the preliminary stage. In reaching its holding, the District Court relied on *Patten Securities Corp. v. Diamond Greyhound & Genetics, Inc*., 819 F.2d 400 (3d Cir. 1987), and *J.P. Morgan Securities Inc. v. Louisiana Citizens Property Insurance Corp*., 712 F. Supp. 2d 70 (S.D.N.Y. 2010), to find that FINRA intends issuers to be customers of their underwriters for purposes of FINRA Rule 12200. Thus, UBS failed to show any likelihood of success on that question.

In addition, the Court held that questions concerning the venue selection clause (sometimes referred to in the opinion as a 'forum' selection clause) should be decided by the Director of FINRA Dispute Resolution. Accordingly, the Court denied both motions. UBS withdrew its attendant declaratory action, and requested entry of judgment, presumably to clear the way for its appeal.

The Second Circuit

The Second Circuit affirmed the denial of UBS's motion to enjoin the arbitration, however it did so on independent grounds. Rather than deciding whether an issuer is the underwriter's customer as a matter of law, the Court concluded that as an advisory client of UBS, WVUH was its customer as a

2. FINRA Rule 12200 sets forth additional grounds for compulsory arbitration, which are not relevant here.

matter of law.[3] As to UBS's motion to enforce the "forum" selection clause, the Court vacated the judgment and remanded with instructions to dismiss for lack of subject matter jurisdiction.

Applying *de novo* review to the district court's legal holdings, the Court examined UBS's request for a preliminary injunction. By the time the appeal was briefed, the parties agreed that UBS would suffer irreparable harm if wrongfully forced to arbitrate the claims. Therefore, the court focused primarily on the "likelihood of success" that UBS would be able to show that WVUH was not its "customer," and that UBS would ultimately be entitled to a permanent injunction.

Scrutinizing FINRA rules, the FINRA glossary, common dictionaries, and the agreements between the parties, the Second Circuit concluded that WVUH became UBS's customer when the former agreed to pay UBS for its auction services. The FINRA Glossary defines "customer" broadly as "[a] person or entity (not acting in the capacity of an associated person or member) that transacts business with any member firm and/or associated person." FINRA's Code of Arbitration Procedure says only that "[a] customer shall not include a broker or dealer." FINRA Code, Rule 12100(i). Common definitions provide that a customer is one who pays for services or goods. Because WVUH paid fees to UBS in connection with the re-sale of its ARS and the setting of interest rates, WVUH was a customer.

UBS raised the surprising argument that customer relationships contemplated by Rule 12200 require a fiduciary relationship (an argument UBS might disavow in retail arbitrations), and that such a relationship was lacking between it and WVUH. *See id.* at 652. In addition, UBS asserted that FINRA simply does not contemplate arbitrations with sophisticated parties such as WVUH. The Court rejected both arguments as unsupported and fundamentally flawed. In addition, the Court expressly rejected "UBS's contention that FINRA has a narrow 'investor-protection mandate,' such that 'customers' should include only those receiving 'investment or brokerage services.'" *Id*. Accordingly, the Court concluded that WVUH was clearly UBS's customer.

Next, the Court examined whether the dispute arose "in connection with the business activities of" the member firm, as required under the last prong of Rule 12200. UBS argued that the gravamen of the arbitration claims

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3. Although the Court "declined to address whether every issuer is a customer of its underwriter," as concluded by the trial court, the Court flatly rejected the dissent's assertion that issuers can never be customers of underwriters.

involved only the bond issuance - and not the auction rate services and transactions - rendering the dispute beyond the business activities of UBS as a broker/dealer. In rejecting these arguments, the Court relied on the parties' agreements, which provided that the auction rate issuances, the auction services, and the swap transactions would constitute an integrated whole. And, the Statement of Claim filed by WVUH alleged wrongdoing as to all aspects of this integrated whole. Thus, the Court concluded that WVUH's dispute arose in connection with the business activities of UBS.

Finally, the Court addressed UBS's alternative argument to compel arbitration in New York County. Relying on *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002), and *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), the Court explained that the [venue] "forum selection clause arises only after the question of the arbitrability… has been resolved in favor of arbitration," at which time the question is one for the arbitrators, not the Court.

Wachovia Bank, N.A., v. VCG Special Opportunities Master Fund, Ltd., 661 F.3d 164
(2d Cir. Oct. 28, 2011) (Hedge fund was not a "customer" within meaning of FINRA's arbitration rules)

On the heels of deciding *UBS Financial Services, Inc. v. West Virginia University Hospitals, Inc.,*660 F.3d 643 (2d Cir. Sept.22, 2011), the Second Circuit once again addressed the question of "who is a customer" under FINRA Rule 12200. The Court distinguished the facts of the UBS case and held that, based on extensive adduced evidence, the hedge fund was not a "customer" entitled to compel arbitration.

The Appellee hedge fund, VCG, had entered an arm's length credit default swap agreement with Wachovia Bank ("Bank"). When VCG was allegedly required to post more collateral with the Bank under the terms of the parties' swap agreement, VCG commenced action in New York Supreme Court. The case was then removed to federal court, where the judge ultimately resolved all claims in favor of Wachovia Bank. Thereafter, VCG filed a FINRA arbitration against the Bank's broker-dealer affiliate, Wachovia Capital Management, LLC ("WCM"), alleging primarily the same conduct at issue in the court proceedings, and further alleging that certain WCM employees wrongfully induced VCG to enter the swap agreement with Wachovia Bank. VCG had not maintained accounts with WCM, and had no arbitration agreement with WCM. Nor was WCM a party to the credit default swap agreements. Both WCM and the Bank sought to enjoin the FINRA arbitration and filed for summary judgment. The District Court

denied the motions, holding that VCG was a customer under FINRA's broad definition of the term. The court noted that the merits of VCG's claim concerning WCM's culpability, however dubious that claim might be, would properly be decided by the arbitrators.

On appeal, the Second Circuit reversed and remanded, instructing the District Court to enjoin VCG's arbitration. In its review of the extensive factual record, the appellate court highlighted the testimony of VCG's agent and which confirmed that VCG had not relied upon the Bank or WCM when deciding to enter the swap agreement. The testimony further differentiated the present case from parallel litigation brought by VCG against Citibank and its broker-dealer affiliate. 661 F.3d at 173-174. In addition, the Second Circuit admonished VCG for raising legal arguments previously considered and rejected by the Second Circuit in the parallel litigation between VCG and Citigroup. Finally, the Court gave weight to language in the agreement between the Bank and VCG wherein VCG acknowledged that it had not relied on the Bank or its affiliates for any agency, brokerage or fiduciary services; however, the Court's discussion of the extensive factual record provides the basis for most of the Court's analysis and conclusions.

Although the Court reaches a different conclusion than it did in the *UBS* case, *supra*, the opinion reflects that VCG's connection to WCM was too attenuated. To be a 'customer' of a broker-dealer, one must show some advisory, brokerage, fiduciary or investment services relationship with the firm.

Twenty–First Securities Corp. v. Crawford,
2011 WL 6326128 (S.D.N.Y. Dec. 15, 2011)
(investor who received advice was "customer" entitled to bring FINRA arbitration)

Plaintiff, Twenty-First Securities Corp., moved in federal court to enjoin the FINRA arbitration filed by an investor, Defendant Crawford. Defendant did not maintain an account with the Plaintiff firm, nor was there any arbitration agreement in effect between the parties. Plaintiff argued that Defendant Gordon was not its "customer" as that term is intended by FINRA Rule 12200. Defendant argued that it was the firm's "customer" by virtue of advice given by Plaintiff's president, Mr. Robert Gordon ("Gordon").

Declarations submitted by the parties reflected that Gordon, in his capacity as president of Twenty-First Securities Corp., did provide investment materials or advice to Defendant from time to time. When Defendant Crawford spoke directly to Gordon in 2007, seeking an income investment, Gordon gave Defendant some materials concerning the 1861

Capital Discovery Domestic Fund, LP ("Fund"). Defendant invested about 6 million dollars in the Fund through a Swiss investment firm. Twenty-First Securities, however, received a solicitation fee directly from the Fund; this fact was disclosed in the Fund's disclosure statement.

Judge Pauley of the Southern District Court of New York recognized that there must be some nexus between an investor and a broker-dealer in order to find a "customer" relationship.

> Although courts in this jurisdiction have construed the term "customer" broadly, they have found that "there must be some nexus between the investor and the member or associated person in order for a party to take advantage of the [FINRA] arbitration provision." *Malak v. Bear Stearns & Co,* 2004 WL 213014, at *4 (S.D.N.Y. Feb. 4, 2004).

See 2011 WL 6326128, at * 2.

However, Judge Pauley concluded that the evidence amply supported a finding of Defendant's customer status. Plaintiff directly spoke to the Defendant about investment matters, arguably solicited Defendant's purchase of the Fund, and was in fact paid a "solicitation fee" for referring Defendant to the Fund. Finally, the District Court found that *UBS Financial Services v.West Virginia Univ. Hospitals,*. 660 F.3d 643 (2d Cir.2011) controlled the legal issues (clarifying that advisory relationships can satisfy the concept of "customer" as intended by FINRA Rule 12200).

POST- ARBITRATION: CONFIRMATION OR VACATUR PROCEEDINGS

Hosier v. Citigroup Global Markets, Inc.,
__F.Supp__; 2011 WL 6413812 (D. Colo. Dec.21, 2011)(Court confirms $54 Million arbitration award; Petitioner given leave to request attorneys fees incurred in opposing Citigroup Global Markets, Inc.'s ("CGMI's") motion to vacate.)

On December 21, 2011, the federal District Court granted investors' Petition to Confirm the FINRA arbitration award of $54.1 million in connection with their losses in a leveraged municipal bond arbitrage fund marketed by Citigroup between 2007 and 2008. The award included approximately $34 million in compensatory damages, $17 million in punitive damages, $3 million in attorneys' fees, expert witness fees and other costs. CGMI had opposed the petition and also moved to vacate the award. In denying CGMI's motion, the Court further granted Petitioners leave to seek attorneys' fees expended in opposing Citigroup's vacatur efforts.

Legal Standards

The Court initially reviewed relevant legal standards regarding confirmation proceedings under 9 U. S. C. § 9, and grounds for vacatur under 9 U.S.C. §10. As to confirmation, the FAA states that a district court **"must** grant…an order [confirming the award] unless the award is vacated, modified or corrected." 2011 WL 6313812 *5 (quoting 9 U.S.C. § 9, emphasis added). Thus, arbitration awards are given maximum deference, and cannot be overturned even in the event of factual errors or misunderstandings of the law. The award is to be confirmed, unless the opposing party – CGMI in the case at issue – shows grounds under the narrow prescriptions of the FAA.[4]

In addition, some Circuit Courts recognize the judicially created doctrine of "manifest disregard of the law," as grounds for vacatur, supplementing those set forth in the FAA. The District Court noted the split among the Circuits as to whether the theory presents a valid basis to overturn an arbitration award. Indeed, the Supreme Court has declined to answer whether "manifest disregard of the law" survived its decision in *Hall Street Associates, L.L.C. v. Mattel, Inc*., 552 U. S. 576 (2008). Likewise, the Tenth Circuit, which includes the District Court of Colorado, has declined to answer the question. *See Abbott v. Law Office of Patrick J. Mulligan*, 2011 WL 4375087, at *6, (10th Cir. Sept. 21, 2011).

CGMI argued that the Panel's award showed "manifest disregard" concerning law pertaining to the "prospectus bespeaks caution" defenses. Stating that she would consider CGMI's theory only for the sake of the Order in the *Hosier* case, and noting the theory was ultimately inconsequential to the case outcome, the District Court Judge assumed that the "manifest disregard" theory was valid and considered CGMI's arguments. CGMI also argued that the Panel exceed its authority by awarding punitive damages and attorneys' fees. The Court rejected all of CGMI's arguments as discussed below.

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4. Section 10 of the FAA provides for vacatur only if : 1) the award was procured by corruption, fraud, or undue means; (2) there was evident partiality or corruption in the arbitrators, or either of them; (3) the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made. *See* 9.U.S.C. §10.

No Manifest Disregard of the Law

CGMI's "manifest disregard" argument centered on the supposed strength of risk disclosures in the subscription documents. According to CGMI, the disclosures were more than adequate, and that, as a matter of law, (*see Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983)), the Hosier investors could not reasonably have relied on any representations to the contrary. The District Court Judge disagreed and found that: CGMI "vastly overstates" the holding of *Zobrist*, *supra*; *Zobrist*, however, addresses federal 10b-5 claims, which the *Hosier* petitioners never alleged in the first instance; possible similarities between Colorado state decisions and *Zobrist* were never presented to the arbitrators, and they therefore could not have manifestly disregarded the argument; and, issues regarding reasonable reliance are fact specific, and not ones to be decided as a matter of law under Colorado decisions, or even under *Zobrist*. Thus, CGMI failed to demonstrate any basis for vacatur under this theory.

Panel Did Not Exceed Its Authority By Awarding Punitive Damages or Attorneys' Fees

CGMI also contended the arbitration panel had no authority to award punitive damages. Petitioners had alleged punitive damages as allowed under Colorado statutes. However, CGMI alleged that the panel's failure to state its basis for awarding punitive damages violated FINRA's Arbitrator's Reference Guide, which suggests that arbitrators should include the basis for such an award. The District Court Judge rejected this argument, noting that the Guide placed no obligation on the panel to state the basis for its punitive damages award.

CGMI also contended the award of attorneys' fees was beyond the scope of the panel's authority because the fee statute relied upon by Petitioners provided for recovery of attorneys' fees only for claims under the state's securities act. Petitioners had not alleged Colorado securities violations in their Statement of Claim. The District Court found this argument unavailing. The opinion discusses the strong deference to be given arbitration awards, with doubts being resolved in favor of the arbitrators' decisions. Furthermore, the Court found ample evidence that CGMI understood the state securities statute to be at issue when CGMI's counsel relied on the statute, as well as cases interpreting the statute, in his presentations to the

panel. Any panel could conclude the statutory and common law claims were sufficiently intertwined so as to find a basis for an award of attorneys' fees. Moreover, Petitioners requested attorneys' fees in their papers; CGMI never objected. Finally, "by signing the Submission Agreements, the parties submitted the issue of attorneys' fees to the Panel." 2011 WL 6413842 *8, citing *Hollern v. Wachovia Sec. Inc.* ,458 F.3d 1169, 1174 (10th Cir. 2006) ("By incorporating their pleadings, including their parallel requests for attorneys' fees, into the Uniform Submission Agreement, the parties expressly empowered the arbitrators to award attorneys' fees.").

The District Court granted Petitioners' motion to confirm the award, and denied CGMI's motion to vacate. In addition, the Court granted leave to Petitioners so they might submit a motion for attorneys' fees incurred in connection with CGMI's motion to vacate.

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 Ryan Bakhtiari at rbakhtiari@aol.com, Scott Ilgenfrtiz at scotti@jpfirm.com or Robin S. Ringo, rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *Release No. 34-65585/File No. SR-FINRA-2011-057; Proposed Rule Change to Adopt New FINRA Rule 5123 (Private Placements of Securities)* was submitted to the Securities and Exchange Commission by Ryan K. Bakhtiari on November 14, 2011.

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

Re: SR-FINRA-2011-057, Proposed Rule Change To Adopt New
FINRA Rule 5123 (Private Placements of Securities)

Dear Ms. Murphy:

Thank you for the opportunity to comment on the above-referenced proposal to adopt new FINRA Rule 5123 regarding disclosures with respect to private placements. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is cautiously supportive of the new rule, recognizing that it is important that regulators remain vigilant.

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

We are pleased that FINRA has recognized the need for a rule that would set forth the disclosures a firm must make when offering or selling a private placement to its customers. The rule will require fums to describe the anticipated use of offering proceeds, and the amount and type of offering expenses and offering compensation. It is understandable that brokerage firms may have no control over the documents prepared by the issuer of the private placement, and therefore it would not be feasible for the firm to ensure that disclosures are made in those documents. However, it should not be a burden on the firms to disclose this information, as it should be in possession ofthis information in connection with its own due diligence on the offering. Therefore, the firms are capable of providing their own independent disclosure.

We are also pleased that FINRA will require that the firms file these disclosure documents. The proposed rule requires the initial disclosure

document be filed within 15 days of the date of [lrst sale. Any amendments to the disclosure documents must be provided to FINRA within 15 days after being provided to any investor or prospecti ve investor. We believe that this is inconsistent. The two provisions should be consistent, and firms should be required to flIe the initial disclosure documents within 15 days of being provided to an investor or prospective investor.

In addition, we believe FINRA should remain vigilant in ensuring that brokers are following the sales practice rules. It should be clear that simply providing a disclosure document will not correct an oral misstatement or omission made by the broker. Most investors rely on the oral presentation made by their brokers, as opposed to numerous documents they receive prior to and shortly after investing, which may contain pages of small print that is often difficult to understand.

There have been a recent string of private placements that have turned out to be Ponzi schemes. Some that come to mind are Medical Capital, Provident/Shale Royalties, and DBSL More than ever, FINRA needs to help protect investors and make sure that brokers provide balanced, accurate information regarding these private placements. When a broker tells a customer that an investment is appropriate, that customer should be able to trust that their broker is giving them valid advice, and if the advice is inappropriate, the customer should be able to hold that broker accountable. The broker should not be able to hide behind the paperwork that accompanied or followed the investment decision.

Therefore, PIABA is supportive of the new rule, but requests that it be clear that the rule will not create a safe harbor for broke. Once more, we appreciate the opportunity to comment on the proposed rule.

Very truly yours,
Ryan K. Bakhtiari
President

The following PIABA Comment Letter regarding *Regulatory Notice 11-44; Proposed Amendments to NASD Rule 2340* was submitted to the Financial Industry Regulatory Authority (FINRA) by Ryan K. Bakhtiari on November 11, 2011.

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 "K" Street, N.W.
Washington, DC 20006-1506

Re: Regulatory Notice 11-44 – Proposed Amendments to NASD Rule 2340

Dear Ms. Asquith:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"),[1] I thank FINRA for the opportunity to comment on the proposed amendments to NASD Rule 2340. We believe some provisions of the proposed amendments may benefit investors by causing general securities members to provide investors with more accurate valuation information concerning unlisted direct participation program ("DPP") and unlisted REIT shares on account statements. We also write to point out that the provisions of the amended rule allowing general securities members to not provide valuation information to investors if the most recent annual report of a DPP or REIT does not contain per share estimated value in compliance with the amended rule is a step backwards.

Rule 2340 was previously amended in late 2000. The amended rule required general securities members to make certain disclosures about DPP and REIT securities and to require the inclusion on account statements of a per share estimated value for DPP or REIT securities if

1. PIABA is a national, not-for-profit bar association comprised of attorneys, including law professors and regulators, both former and current, who devote a significant portion of their practice to representation of public investors in securities arbitrations.

the annual report filed by a DPP or REIT sponsor with the Securities and Exchange Commission ("SEC") included a per share estimated value. Coincident with the amendment of NASD Conduct Rule 2340, the SEC approved amendments to NASD Conduct Rules 2710 and 2810 with respect to REIT and DPP securities.

Background Concerning Amendments to NASD Conduct Rules 2340, 2710, and 2810

On November 29, 2000, the SEC issued Release No. 34-34601, announcing amendments to NASD Conduct Rules 2340, 2710 and 2810 (the "SEC Release"). The SEC Release makes clear that the genesis of the amendments to the above-referenced rules was a March 9, 1994, letter from Representative Edward J. Markey, Chairman, and Representative Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, to Joseph R. Hardiman, then President and Chief Executive Officer of the National Association of Securities Dealers, Inc. ("NASD") (hereinafter the "1994 Letter"). See SEC Release at p. 71169, FN 8. According to the SEC Release, Rep. Markey and Rep. Fields "expressed concern to the NASD regarding the sufficiency of information provided on customer account statements with respect to the current value of illiquid partnership securities. The House Subcommittee noted that investors in non-traded partnerships should be able to know how their investments are performing and expressed a belief that their [sic] might be shortcomings in current valuation reporting to that group of investors." *Id.*

The comments of Rep. Markey and Fields followed closely the limited partnership debacle of the late 1980's and early 1990's. For years, broker/dealers carried limited partnership units at cost basis on customers' monthly statements, or customers' monthly statements indicated that valuation of their limited partnership units was not available.

In response to the 1994 Letter, the NASD proposed and the SEC approved amendments to NASD Conduct Rules 2340, 2710, and 2810.

NASD Conduct Rule 2340 was amended to include subsection (b) (currently subsection (c)). Subsection (b)(1)(B) of the Rule required members, which carry customer accounts and hold customer funds or securities, to provide on customer statements a per share estimated value for any DPP or REIT security held in a customer's account, if the annual report for a DPP or REIT included a per share estimated value for a DPP or REIT security and if certain conditions were met. The estimated value stated in the annual report or derived from an independent valuation service or another source was required to be included on the first customer account statement issued after the annual report became available, provided the member met the conditions of subsections (b)(2) and (3). *See* SEC Release at p. 71170. Subsection (b)(2) dictated that a member could provide a per share estimated value for a DPP or REIT security on an account statement only if the estimated value had been developed from data that is of a date no more than eighteen months prior to the date of the statement. Subsection (b)(3) was added to require that any account statement providing an estimated value for a DPP or REIT security include a brief description of the estimated value, its source, and the method by which it was developed. Subsection (b)(3) also required that the account statement disclose that DPP or REIT securities are generally illiquid and the estimated value may not be the actual liquidation value of the security.

The SEC Release stated that during the course of the amendment process, NASD Regulation revised Rule 2340(b)(4) to prohibit a member from including estimated per share value for a DPP or REIT security on a customer account statement if the member was able to demonstrate that the value was inaccurate as of the date of valuation or later became inaccurate. The SEC Release further stated that NASD Regulation had noted that the revision of NASD Rule 2340(b)(4) did not relieve a member of its obligation to provide an alternative per share estimated value when the member's obligation was triggered by NASD Rule 2340(b)(1)(B). *See* SEC Release at p. 71171.

The SEC Release stated the rationale for the eighteen month time period for the use of the per share estimated value information provided in a sponsor's annual report. The SEC Release stated, in pertinent part:

> NASD Regulation believe that the 18-month standard provides sufficient time for the member and for an independent valuation source to develop an estimated value for DPP and REIT securities based on the audited financial statements contained in the Form 10-K of the DPP or REIT. For example, an estimated value based on December 31, 1999, financial statements could be used from January 1, 2000, through June 30, 2011, thereby allowing time between April and June, 2001, for a new estimated value to be developed based on the December 31, 2000, financial statements.
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> The Commission believes that NASD Rule 2340(b)(2) will help ensure the reliability of estimated valuations provided on customer account statements by requiring the valuations to be based on relatively recent data. In addition, as NASD Regulation noted in its proposal, the 18-month period should provide a member or an independent valuation source with sufficient time to develop a new valuation based on audited financial statements provided in a DPP or REIT's most recent Form 10-K.

See SEC Release at pp. 71170 and 71172 (emphasis supplied).

The SEC Release also explained the rationale for the amendments to NASD Conduct Rules 2710 and 2810. The SEC Release stated, in pertinent part:

> NASD Regulation believe that the amendments to NASD Rule 2710, "Corporate Financing Rule – Underwriting Terms and Arrangements," and NASD Rule 2810, "Direct Participation Programs," will help ensure that DPP general partners or sponsors and REIT trustees provide estimated per share values in their

> annual reports. NASD Rule 2710(c)(6), as amended, states that, when proposed in connection with the distribution of a public offering of securities, it shall be unfair and unreasonable for a member or associated person to participate in a public offering of REIT securities unless the trustee will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Act a per share estimated value of the trust securities, the method by which it was developed, and the date of the data used to develop the estimated value.

See SEC Release at p. 71171 (emphasis supplied).

NASD Regulation announced the changes to Rules 2340, 2710, and 2810 in NASD Notice to Members 01-08. The amendments became effective on April 16, 2001. In announcing the changes to Rules 2710 and 2810, NASD Regulation incorporated the rationale set forth in the SEC Release. NASD NTM 01-08 stated, in pertinent part:

> **Rules 2710 And 2810** – NASD Regulation has also adopted amendments to Rule 2710, "Corporate Financing Rule – Underwriting Terms and Arrangements," and Rule 2810, "Direct Participation Programs," that are intended to help ensure that DPP general partners or sponsors and REIT trustees provide estimated per share values in their annual reports. Rule 2710(c)(6) and Rule 2810(b)(5), as amended, prohibit a member or associated person from participated in a public offering of DPP or REIT securities unless the general partner or trustee, as applicable, agrees to disclose in each annual report distributed to investors pursuant to Section 13(a) of the Securities Exchange Act of 1934 a per share estimated value of the securities, the method by which it was developed, and the date of the data used to develop the estimated value.

See NASD NTM 01-08 at p. 2.

Section 2710(a)(4) broadly defined "participation or participating in a public offering." Subsection (c)(6) of the July, 2001, Conduct Rules set forth a list of terms and arrangements which the NASD had determined were unfair or unreasonable with respect to publicly offered securities. Subsection (c)(6) also prohibited members or associated persons from participating in any way in the public offering of securities after any arrangement, term, or condition proposed in connection with the public offering had been determined to be unfair or unreasonable. Subsection (c)(6)(A) provided as follows:

> No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto, has been determined to be unfair or unreasonable pursuant to this Rule or inconsistent with any By-Law or any Rule or regulation of NASD.

Subsection (c)(6)(B) set forth the terms and arrangements proposed in connection with the distribution of a public offering of securities which NASD Regulation had determined to be unfair and unreasonable.

The amendment to Rule 2710 with respect to publicly offered, non-traded REIT securities announced in the SEC Release and NASD Regulation NTM 01-08 was set forth in subsection (xiv) of NASD Conduct Rule 2710(c)(6)(B). Subsection (c)(6)(B)(xiv) provided that it was an unfair or unreasonable term or arrangement of a public offering of non-traded REIT securities as follows:

> For a member or person associated with a member to participate in a public offering of real estate investment trust securities, as defined in Rule 2340(c)(4), unless the trustee will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Act a per share estimated value of the trust's securities, the method by which it was developed, and the date of

> the data used to develop the estimated value. (emphasis supplied)

This amendment to Rule 2710 remained in Rule 2710 until FINRA adopted Rule 5110. The amendment remains unchanged in Rule 5110(f)(2)(M) and is also set forth in FINRA Rule 2310(b)(5).

Comments on Proposed Amendments

The proposed replacement of subsection (c)(4) of Rule 2340 with subsection (c)(2)(A) is certainly an improvement of the rule for the benefit of investors. The proposed amendment changes the basis on which a member must refrain from including a per share estimated value for a DPP or REIT security on an account statement as follows: from the ability of the member to demonstrate that the value is inaccurate or later becomes inaccurate to a member knowing or having reason to know based on information from any source that the value provided by the sponsor in its annual report is unreliable. The broadening of the standard under which a member must refrain from providing an inaccurate per share estimated value on an account statement is certainly beneficial to investors.

However, the proposed amendment set forth in subsection (c)(2)(B) is troubling and is contrary to the interests of investors. Under current subsections (c)(1)(B) and subsection (c)(4), if a member can demonstrate that the value of a DPP or REIT security set forth in the annual report filed by the sponsor with the SEC is inaccurate or later becomes inaccurate, the member is still obligated to include an estimated value from an independent valuation service or another source.

Under the proposed amended subsection (c)(2)(B), a member may refrain from including a per share estimated value if the most recent annual report of a DPP or REIT does not contain a per share estimated value in compliance with the requirements of subsections (c)(1)(B) or (C). The proposed amendment in subsection (c)(2)(B) allows a member to refrain from providing a per share estimated value, so long as the member makes the disclosures set forth in subsection (c)(3).

Under the existing rule, a member still must provide an estimated value from a source other than the annual report for a DPP or REIT if the member can demonstrate the value set forth in the annual report is inaccurate or has become inaccurate as a result of material changes in the operations or assets of the program or trust. Relieving members of their obligation to provide per share estimated value of DPP or REIT securities if a member knows or has reason to know that the value stated in the annual report is inaccurate is a disservice to investors and is contrary to the intent of the previous changes to NASD Conduct Rules 2340, 2710, and 2810.

The proposed amendments to subsections (c)(1)(B) and (C) are both potentially beneficial to investors and detrimental to investors. In proposed subsection (c)(1)(B), FINRA gives its express approval of the use of offering price or cost basis, reduced by the amount of organization and offering expenses, as a permissible estimated value during the Initial Offering Period. Certainly, the requirement that organization and offering expenses be deducted from per share estimated value based upon the offering price of the securities, is beneficial to investors. However, allowing offering price or cost basis during the Initial Offering Period to be utilized as the basis for an estimated value is a disservice to investors and is contrary to the intent and express provisions of FINRA Rules 2310(b)(5) and 5110(f)(2)(M).

Subsection (b)(5) of Rule 2310 prohibits members from participating in a public offering of DPP or REIT securities unless the general partner or sponsor of the program or REIT will disclose in each annual report distributed to investors a per share estimated value of the securities, the method by which that value was developed, and the date of the data used to develop the estimated value. Subsection (f)(2)(M) of Rule 5120 contains the same prohibition with respect to REIT securities. The intent of the 2000 amendments to NASD Conduct Rules 2340, 2710, and 2810, as stated in the SEC Release, was to help ensure that general partners and sponsors of DPPs and REITs would provide per share valuation information based upon financial statements contained in annual reports. We submit that reporting offering price or cost basis as the estimated value of DPP or REIT securities is not a "method" by which a per share estimated value

is "developed" and is not based on anything in the financial statements set forth in an annual report.

In Regulatory Notice 09-09, FINRA provided guidance with respect to the use of "Par Value" as estimated value. The notice stated: "During the offering period, it **may** be reasonable to determine that the estimated value is the value at which the shares are being offered to the public." (emphasis supplied)

In proposed subsection (c)(1)(B), FINRA gives its express authorization to use offering price or cost basis, reduced by the amount of organization and offering expenses, as per share estimated value. Per share estimated value based upon offering price, reduced by organization and offering expenses, may well bear little, if any, relationship to an accurate estimated value of shares.

In FINRA's allegations in its May, 2011, enforcement complaint against David Lerner & Associates, FINRA documents that the Apple REIT sponsor paid distributions to shareholders during the offering period from borrowed funds and investors' capital. Information available from the financial statements of other REIT sponsors indicates that several other REIT sponsors have paid and are paying distributions with borrowed funds and investors' capital. The only manner in which a reasonably accurate estimated value may be obtained during the Initial Offering Period, and thereafter, is from an appraisal of the assets, liabilities, and operations of a REIT.

The requirement of proposed subsection (c)(1)(C) that per share estimated value be calculated based on appraisal of the assets, liabilities, and operations of a DPP or REIT after the Initial Offering Period is clearly beneficial to investors. However, such appraisals should be required as the basis for per share estimated values of DPP or REIT securities during the Initial Offering Period, as well.

Whatever beneficial effects the proposed amendments in subsections (c)(1)(B) and (C) may have for investors are vitiated by proposed subsection (c)(2)(B). Under that subsection, a member may refrain from providing a per share estimated value on investor account statements if the annual report of a DPP or REIT does not contain a per share estimated value that complies with the requirements of sections (1)(B) or (1)(C). All general partners or sponsors have to do to avoid a member reporting a per share estimated value on investor

account statements which is lower than offering price is to fail to provide per share estimated values in annual reports in compliance with subsections (c)(1)(B) or (C).

Per share estimated values should be required to be based upon appraisals of the assets, liabilities, and operations of a DPP or REIT beginning with the first annual report filed with the SEC. If general partners or sponsors fail to provide per share estimated values based upon such appraisals, members should be required to report per share estimated value based upon an analysis of the financial statements in an annual report by an independent valuation service or another source.

There is an alternative available to place the burden of providing per share estimated values on general partners or sponsors, rather than FINRA members. To ensure that general partners and sponsors provide per share estimated values based upon an analysis of the assets, liabilities, and operations of DPPs and REITs, FINRA could and should propose amendments to subsection (b)(5) of FINRA Rule 2310 and subsection (f)(2)(M) of Rule 5110. Those proposed amendments should provide that members are barred from participating in a public offering of DPP or REIT securities unless the general partner or sponsor of the program or REIT will disclose in each annual report a per share estimated value based upon an annual appraisal of the assets, liabilities, and operations of the program or REIT.

Respectfully submitted,
Ryan K. Bakhtiari
President