UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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ELIAS TACHER, SAL TACHER, :
:
Petitioners-Appellees, :
:
MARC LUXENBERG, : Docket No.:00-7734
:
Petitioner-Appellee- :
Cross-Appellant, :
:
- against- :
:
GREGORY S. PARSONS, Individually, :
and as Trustee for the CENTRAL :
CAROLINA ENT CENTER PA PROFIT :
SHARING PLANS and the CENTRAL :
CAROLINA EAR, NOSE, THROAT and :
AUDIOLOGY CENTER, :
:
Respondent-Appellants- :
Cross-Appellees. :

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AMICUS BRIEF OF THE
PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

PIABA's STANDING

The Public Investors Arbitration Bar Association ("PIABA"), is a not-for-profit corporation, with in excess of three hundred members from forty-one states, districts and territories, who represent public investors throughout the United States. PIABA is recognized by the SEC and the self-regulatory organizations ("SROs"), such as the National Association of Securities Dealers ("NASD"), as speaking on behalf of public investors concerning issues affecting compulsory securities arbitration. PIABA has been permitted to appear before this Court as *Amicus Curiae* on two previous occasions: *PaineWebber v. Bybyk*, 81 F.3d 1193 (2nd Cir., 1996); and *Barbier v. Shearson Lehman Hutton*, 948 F.2d 117 (2nd Cir., 1991).

AMICUS BRIEF's COVERAGE

In this amicus brief, PIABA will focus upon the anti-waiver statutory provisions of state securities consumer protection laws, often called "Blue-Sky Laws."

PIABA will also discus the SEC and NASD positions that hold that any contractual provision in a customer agreement that attempts to deprive a public investor of a state statutory right is against the force of federal law.

STATE ANTI-WAIVER STATUTORY PROVISIONS

Thirty-nine states, the District of Columbia, and Guam and Puerto Rico, have adopted forty-five "Blue-Sky Laws" regulating the sale of securities in their jurisdictions, as well as the rendering of investment advise, all of which contain anti-waiver provisions. While the grammar is often different, all these provisions are based upon the anti-waiver provision of the Uniform Securities Act, and all contain the six emphasized words set forth below:

> Any **condition**, **stipulation**, or **provision** binding any person acquiring any security to **waive compliance** with any provision of this act or any rule or order hereunder is **void**.
>
> [Uniform Securities Act, §410(g),
> BSLR CCH P 5550 (emphasis added)]

Appendix-A hereto is entitled "State Anti-Waiver Statutory Provisions," and sets forth and references all forty-five statutes along with an analysis as to how each provision is worded.

STATE ANTI-WAIVER STATUTES
v.
CONTRACTUAL CHOICE OF LAW PROVISIONS

When faced with a Broker-Dealer's or other securities issuer's defense that a Public Investor should be deprived of a statutory remedy from his or her state of residence because of an out-of-state choice-of-law contractual provision, courts uniformly focus upon their state's anti-waiver provisions and/or their states public policy of protecting purchasers of securities and regulating the sellers.

CALIFORNIA

Hall v. Superior Court, 197 Cal.Rptr. 757 (Cal.App. 4 Dist.,1983, Crosby, J.) involved a Nevada choice of law provision in a limited partnership agreement: "This Agreement shall be deemed to have been made in and shall be governed by and enforced in accordance with the laws of the State of Nevada, and any litigation regarding the Agreement may only be brought in the State of Nevada." The contract also contained a self-serving provision that: "Purchasers represent that no offer to sell the securities of Issuer was made in any state other than Nevada and that no substantial or serious negotiations regarding this investment were conducted other than in Nevada and this investment was made, contracted for, and delivered in Nevada." But the facts were that the purchasers were California residents, some of the negotiations took place in California, and telephone and mail communications were directed to the purchasers in California, but the seller was arguably a Nevada entity. In finding the Nevada choice-of-law invalid, the California Court emphasized the California Blue-Sky Law's anti-waiver provision:

> California's policy is to protect the public from fraud and deception in securities transactions. The Corporate Securities Law of 1968 was enacted to effectuate this policy by regulating securities transactions in California and providing **statutory remedies** for violations of the Corporations Code, in addition to those available under common law. The cornerstone of the law is section 25701, which provides, "Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law ... is void." Section 25701 applies where there is an offer to sell or buy securities in California. The facts before us (i.e., the negotiations in Laguna Hills and the interstate telephone call to California) support the notion that an offer to sell or buy a security was made in this state . . . , and the parties may not waive or evade the application of California law to the transaction by private agreement.
>
> . . . . .

> Similarly, we believe the right of a buyer of securities in California to have California law and its concomitant nuances apply to any future dispute arising out of the transaction is a "provision" within the meaning of section 25701 which cannot be waived or evaded by stipulation of the parties to a securities transaction. Consequently, we hold the choice of Nevada law provision in this agreement **violates** section 25701 and the **public policy** of this state . . . and for that reason deny enforcement of the forum selection clause as unreasonable.
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> [Id at 761-3 (emphasis added)]

West v. Lloyd's [of London], 1997 WL 1114662 (Cal.App. 2 Dist.,1997, Lillie, P.J., not officially published) involved California investors in securities issued by Lloyd's of London pursuant to contracts containing English choice-of-law and a London choice-of-forum provisions. Citing Hall as controlling authority, this California Appellate Court reemphasized the overwhelming importance of that state's Blue-Sky Law's anti-waiver provision: .

> Drawing an analogy with forum selection agreements in cases arising under federal law thus fails to support the enforcement of the choice of law in the Lloyd's undertaking. In any event, appellants' cause of action is brought under California securities law, not federal law. **In California, a choice of law clause will not be given effect where to do so would be contrary to a fundamental policy of a state**, and where California has a materially greater interest than the chosen state in the determination of the particular issue. [citation omitted] The **protection of its investors is a fundamental policy** of this state, and by making the choice of foreign law void, the Legislature has deemed that California has a materially greater interest than other forums in the determination of issues involving the violation of its laws designed to protect its investors. [citing *Hall*] Respondents suggest that the promotion of international commerce is a more important public policy than the protection of this state's investors, and that "[t]he expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we insist on a parochial concept that all disputes must be resolved under our laws and in our courts ...." [citation omitted] The general purpose of the Corporate Securities Act is to protect the public

against fraudulent or unlawful stock and investment schemes and enterprises. [citation omitted] It is a "a bulwark against fraudulent practices of those who seek to gain from the ruin or expense of others," and must be enforceable against all businesses to be effective in its purpose.

[Id at pg-8 (emphasis added)]

WASHINGTON

Ito Intern. Corp. v. Prescott, Inc., 921 P.2d 566 (Wash.App. Div. 1, 1996, Coleman, J.) involved a Japanese Kumiai, the equivalent of a general partnership, which owned and operated a building in Seattle, and sold interests to Washington business entitles and Japanese individuals. Some marketing activity occurred in Seattle. The Certificate of Partnership Interest stated that the partnership was "formed pursuant to Japanese law," and that the partnership's regulations must be interpreted in accordance with Japanese law. This agreement even went so far as to explicitly exclude the applicability of several enumerated provisions of Washington's Blue-Sky Law such as a right to an accounting.

The WSSA states that any provision binding a person acquiring a security to waive compliance with the statute is void. [citation omitted] Washington courts will not implement a choice of law provision if it conflicts with a **fundamental state policy** or if the state has a materially greater interest than the other jurisdiction in the resolution of the issue. [citation omitted] Here, the State has a strong interest in applying its securities act to a partnership involving several Washington defendants, Washington plaintiffs, and property located in Washington. Because the WSSA expressly invalidates provisions waiving compliance with the statute, we do not rely on the choice of law provision and instead conduct a choice of law analysis.

In determining choice of law, Washington applies the most significant relationship test under which each State's interest must be analyzed in relation to the specific issue.

[Id at 288 (emphasis added)]

IOWA

Getter v. R. G. Dickinson & Co., 366 F.Supp. 559 (S.D. Iowa, 1973) involved a New York choice-of-law provision in a purchase agreement for securities: "This agreement is being executed and delivered and the shares and the options are being delivered in the State of New York, and this agreement shall be construed in accordance with, and governed by the laws of such State." But the Court found significant contacts with the state of Iowa:

> There were, however, significant contacts with Iowa relating to this sale of securities, which were unregistered in Iowa. All of the plaintiff-investors were Iowa residents. One of the defendants was an Iowa brokerage house. All of the plaintiff-investors were solicited in Iowa by the defendant-brokers. A purchase agreement was tendered by the defendants and signed by the plaintiffs in Iowa. The plaintiffs received their stock certificates in Iowa. Subsequently, the plaintiffs elected to rescind in Iowa.
>
> [Id at 573 (emphasis added)]

With such significant contacts in Iowa, this Federal Court had little trouble finding that a New York choice-of-law contractual provision cannot negate the Iowa Blue-Sky Law's anti-waiver statutory provision:

> The question is whether this portion of the purchase agreement is a valid waiver of any rights or remedies the plaintiffs have under the Iowa Securities Act. Ordinarily, choice of laws provisions in contracts are valid except where they are contrary to State public policy. In the present case, we have a **protective statute for purchasers of securities in the State of Iowa**. This Court concludes as a matter of law that under the circumstances of this cause of action that the plaintiffs did not waive the protections of the Iowa Securities Act.
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> [Id at 575 (underscoring and emphasis added)]

SOUTH DAKOTA

Boehnen v. Walston & Co., Inc., 358 F.Supp. 537 (D.C.S.D., 1973, Nichol, C.J.) involved a New York choice of law provision in a Broker-Dealer's customer agreement: "The provisions of this agreement shall in all respects be construed according to, and the rights and liabilities of the parties hereto shall in all respects be governed by, the laws of the State of New York." The Broker-Dealer sold securities from its New York office by telephoning the customer in South Dakota. When a dispute arose, the Broker-Dealer took the position that its New York choice-of-law provision made the South Dakota Blue-Sky Law inapplicable. This Federal Court disagreed:

> It is the defendants' first contention that the South Dakota Blue Sky Laws do not apply because the parties have expressed their intentions that the laws of New York should govern. Paragraph 18 of the Customer's Agreement provides the basis upon which the defendants make this assertion. A close reading of that paragraph discloses that it is the construction of the provisions of that agreement upon the rights and liabilities of the parties thereto which will be governed by New York law. The plaintiff does not quarrel with the provisions of the Customer's Agreement, therefore a construction of its provisions is unnecessary. However, the plaintiff is alleging acts of the defendants, in selling or offering for sale securities, which fall within the clear language of the South Dakota Blue Sky Laws. **The agreement's choice of law provision, selecting New York law as governing, simply does not apply to the alleged actions of the defendants in alleged violations of the South Dakota Blue Sky Laws**.
>
> . . . . .
>
> The purpose of the South Dakota Blue Sky Laws is to protect the public. [citation omitted] To permit the choice of law stipulation in question to control the determination of whether or not South Dakota law will apply, would be to provide an effective means of circumventing legislation designed to protect the citizens of South Dakota. This would clearly be **against public policy**.

[Id at 540-1 (emphasis added)]

CONTRACTUAL LIMITATIONS TO ARBITRATION

Aside and apart from anti-waiver statutory provisions in state Blue-Sky Laws, federal law explicitly prohibits Broker-Dealers from putting any contractual provision in their customer agreements that would interfere with a customer's right of access to the statutory remedies contained in that customer's state Blue-Sky Law. This federal law, as it is embodied in the NASD Rules of Fair Practice, rules that must be specifically approved by the SEC pursuant to federal statute, states as follows:

> No agreement [between a Broker-Dealer and a Public Investor] shall include any condition which . . . limits the ability of a party to **file any claim in arbitration** or limits the ability of the **arbitrators to make any award**.

[NASD Fair Practice Rule 3110(f)(4), formerly numbered Rule 21(f)(4) (emphasis added)]

A full appreciation of the scope of this consumer protection quasi-statutory provision will be aided by an examination of the history leading up to its enactment.

In the 1989 case of *Roney & Co. v. Goren*[1], 875 F.2d 1218 (6th Cir, 1989, Kennedy, J.), the issue was the Broker-Dealer's ability to enforce two contractual provisions in their standard customer agreement: a)-limiting the arbitration forum to the NYSE, whereas the customer had filed at the NASD; and b)-imposing a one-year limitation period in which to commence arbitration. The SEC filed and argued as *amicus curiae*, and took the position that the brokerage's contractual limitations regarding arbitration were "inconsistent with the regulatory scheme set up by the Exchange Act." [Id at 1221] Responding to this position, the Sixth Circuit reminded the SEC that the SEC had the power to enact new SRO rules to cure any defect in Broker-Dealer customer agreements:

[1] The author of this PIABA *Amicus* Brief was the attorney of record for the public investor Jene Goren in all phases of the *Roney* litigation.

> Last, as the Supreme Court did in *McMahon*, **we emphasize the SEC's "expansive power" to regulate the arbitral procedures of the various SROs**. McMahon, 482 U.S. at 233_34, 107 S.Ct. at 2341_42. Although the SEC, which appeared as *amicus*, asserts that enforcement of the forum selection clause in this instance "would be inconsistent with the regulatory scheme set up by the Exchange Act," **the SEC retains the ability "to regulate the rules adopted by SROs including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights**." McMahon, 482 U.S. at 234, 107 S.Ct. at 2341. If, in its judgment, the NYSE Arbitration Code is inadequate to further the objectives of the Exchange Act, **the Commission may, on its own initiative, "abrogate, add to, and delete from" the NYSE Code as the Commission deems necessary. See 15 U.S.C. § 78s(c) (1982)**.
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> [Id at 1221 (emphasis added)]

Based upon the explicit and somewhat taunting suggestion of the Sixth Circuit, the SEC immediately went about compelling the SROs to adopt new rules to protect public investors from Broker-Dealer's contractual limitations to arbitration. One result was NASD Fair Practice Rule 21(f)(4) [currently renumbered as Rule 3110(f)(4)] herein requited: "No agreement [between a Broker-Dealer and a Public Investor] shall include any condition which . . . limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award."

In the NASD's Notice to Members 95-16 ("NTM 95-16", 1995), that SRO used strong language to remind its member firms concerning the unlawfulness of contractual limitations to arbitration:

> Specifically, Section 21(f)(4) of the NASD Rules of Fair Practice, as amended, prohibits the use in any customer agreement of any language that (a) limits or contradicts the rules of the NASD or any other self-regulatory organization: (b) limits the ability of a party to file a claim in arbitration; or (c) **limits the ability of the arbitrators to make an award under** the arbitration rules of a self-regulatory organization and **applicable law.**

[NASD NTM 95-16, pg-1 (underscoring added)]

NASD's NTM 95-16 went on to specifically deal with the situation wherein a Broker-Dealer attempts to use a New York choice of law provision to violate Section 21(f)(4)'s anti-limitation purpose:

> Some customer agreements attempt to directly limit the ability of a customer to file a claim or to limit the authority of the arbitrators to make an award, including an award of punitive damages. Others attempt to do so indirectly by the use of so-called **"governing law clause."** For example, certain customer agreements simply state that New York law will govern any dispute in arbitration, but do not disclose that New York law prohibits an award of punitive damages in arbitration. **Where the governing law clause is used to limit an award, it violates Section 21(f)(4) of the NASD Rules of Fair Practice**. Indeed, in 1989 the SEC said that:
>
> > "customer agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages or attorney's fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them." (See Securities Exchange Act Release No. 26805.)
>
> [NASD NTM 95-16, pg-2 (emphasis added)]

Finally, NASD's NTM 95-16 discussed the SEC's position that NASD Fair Practice Rule 21(f)(4) has the "force of federal law":

> "**NASD Rule 21(f)(4)** forbids the inclusion in broker-client arbitration agreements of provisions limiting the ability of arbitrators to award relief that would be available in a judicial forum. The Rule has an effective date of September 7, 1989; with respect to agreements executed after that date, the Rule has the **force of federal law** and precludes the enforcement of contractual previsions that are inconsistent with its terms."
>
> [NASD NTM 95-16, pg-2, quoting the U.S. Solicitor General and the SEC in the Supreme Court case of *Mastrobuono v. Shearson Lehman Hutton* (under-scoring and emphasis added)]

In 1976 the New York Court of Appeals unequivocally pronounced that punitive damages could only be awarded by a judicial tribunal and not by arbitrators. *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976). This was one of the reasons that Broker-Dealers were so anxious to put New York choice-of-law clauses in their customer agreements alongside provisions requiring compulsory arbitration. How would the conflict be resolved when *Garrity's* 1976 prohibition against arbitral punitive damages, came up against NASD Rule of Fair Practice 21(f)(4)'s 1989 prohibition against contractual limitations of arbitrators' powers? The answer came in a 1998 decision by the United States District Court for the Eastern District of New York.

Sanders v. Gardner, 7 F.Supp.2d 151 (E.D.N.Y.,1998, Seybert, J.) involved an NASD arbitration against what this Federal Court referred to as a "classic 'boiler room' operation"—the Broker-Dealer Stratton Oakmont and its "supervisory personnel," which the Court further characterized as "principals without principles" engaged in "nefarious endeavors" and "storied infamy." The arbitration award included punitive damages in the amount of $10 million. The customer was a California physician. The Broker-Dealer's customer agreement contained a New York choice-of-law provision: "this Customer Agreement shall be governed by and construed, and the substantive rights and liabilities of the parties determined, in accordance with the laws of the State of New York." In turning down respondent's argument that under New York law punitive damages cannot be dispensed by arbitrators, this Federal Court stated:

> The [Supreme Court in *Mastrobuono*] also referenced Rule 21(f)(4) of the NASD rules of Fair Practice which applies to agreements signed after September 7, 1989, inapplicable therein but relevant in the instant case, which reads: "No agreement [between a member and a customer] shall include any condition which ... limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award."

The [NASD] clarifying Notice [95-86] also referenced SEC Release No. 34-26805 (May 10, 1989); 54 F.R. 21144, which provides:

> "This provision makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution. **Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum**. If punitive damages or attorneys fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators rights to award them. The agreements may not be used to shorten applicable statutes of limitation, restrict the situs of an arbitration hearing contrary to SRO rules, nor limit SRO forums available to parties."
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> [Id at 172 (emphasis added)]

NEW YORK CHOICE-OF-LAW PROVISIONS IN OUT-OF-STATE CUSTOMER AGREEMENTS

When a customer: a)-resides in State-A; b)-receives his or her monthly brokerage statements, trade confirmations and other correspondence in State-A; and c)-is telephoned in or telephones from State-A; it constitutes a blatent violation of federal law—specifically NASD Rule of Fair Practice 3110(f)(4) [formerly numbered Rule 21(f)(4)]—for the Broker-Dealer to attempt to disenfranchise the customer from access to State-A's Blue-Sky Law in an NASD arbitration. The customer is entitled to State-A's Blue-Sky Law for both statutorily defined violations, as well as civil remedies with their attendant calculation of damages.

Respectfully submitted,
PIABA by its General Counsel

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