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ARBITRATORS MISCLASSIFIED:
LOOKING BACK TO MOVE FORWARD

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The Financial Industry Regulatory Authority (FINRA) regulates its member firms who compel their customers to arbitrate any future claim they may have against the firm.[1] Prior to 2008, in claims exceeding $100,000, an arbitration panel was composed of three arbitrators, two public and one industry (i.e., one with ties to the securities industry). After a decade of changes attempting to eliminate customers' perceptions that some industry arbitrators are biased, customers were given the option to choose an all public panel. However, despite ties to the financial industry, some arbitrators continue to be misclassified as part of the public pool. Therefore, a customer's choice to have an all public panel can be nullified by the improper classification of arbitrators. FINRA rules should be amended to resolve this problem.

Defining Public v. Non-Public Arbitrators

The FINRA Code of Arbitration Procedure (Code) sets forth the definition of public and non-public arbitrators. A non-public arbitrator, also known as an industry arbitrator, is deemed non-public due to his or her ties to the securities industry.[2] The public arbitrators must be qualified to serve as

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1. FINRA Code of Arbitration Procedure § 12200.

2. FINRA Code of Arbitration Procedure § 12100(p) defines a non-public arbitrator as one who is qualified and:

> (1) is, or within the past five years, was:
>
> > (A) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or municipal securities dealer);
> >
> > (B) registered under the Commodity Exchange Act;

arbitrators and must not be personally engaged in certain activities that would make them non-public, or have the immediate family member of a person engaged in such activities.[3]

(C) a member of a commodities exchange or a registered futures association; or

(D) associated with a person or firm registered under the Commodity Exchange Act;

(2) is retired from, or spent a substantial part of a career engaging in, any of the business activities listed in paragraph (p)(1);

(3) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in paragraph (p)(1); or

(4) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities future or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities.

For purposes of this rule, the term "professional work" shall not include mediation services performed by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.

3. FINRA Code of Arbitration Procedure § 12100(u) defines a public arbitrator as one who is qualified and:

(1) is not engaged in the conduct or activities described in paragraphs (p)(1)-(4);

(2) was not engaged in the conduct or activities described in paragraphs (p)(1)-(4) for a total of 20 years or more;

(3) is not an investment advisor;

(4) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past two years from any persons or entitled listed in paragraphs (p)(1)-(4);

(5) is not an attorney, accountant, or other professional whose firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1) relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees, and consulting fees;

(6) is not a director or officer of, and is not the spouse or an immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business;

These distinctions were created to preserve the perception of fairness. Over the last decade, amendments to the definitions of public and non-public arbitrators, as well as to the composition of the arbitration panel have been made, but as a result of significant pressure from the industry, these amendments have fallen short of the mark.

2004 Amendment to the Definitions of Public and Non-Public Arbitrator

In 2003, changes to rules 10308 and 10312 were made to modify the definitions of public and non-public arbitrators, which required potential arbitrators to disclose any relationships or financial interests they may have that are likely to affect impartiality or that might reasonably create an appearance of partiality or bias.

These amendments followed the 2002 Perino Report assessing the adequacy of the National Association of Securities Dealers' (NASD now FINRA) arbitrator disclosure requirements.[4] The Perino Report made several recommendations which were incorporated into the 2003 revisions to the classification rules. The purpose of the Perino Report recommendations was to reduce the appearance of partiality customers' may have of public arbitrators.

The 2002 Perino Report proposed:

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(7) is not a director or officer of, and is not the spouse or immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business; and

(8) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)-(4). For purposes of this rule, the term immediate family member means:

(A) a person's parent, stepparent, child, or stepchild;
(B) a member of a person's household;
(C) an individual whom a person provides financial support of more than 50 percent of his or her annual income; or
(D) a person who is claimed as a dependent for federal income tax purposes.

For purposes of this rule, the term "revenue" shall not include mediation fees received by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.

4. The Perino Report, November 4, 2002, available at http://www.sec.gov/pdf/arbconflict.pdf.

- An increase from three years to five years the period for transitioning from a non-public to public arbitrator after leaving the securities industry.
- Clarified that the term "retired" from the industry includes anyone who spent a substantial[5] part of his or her career in the industry.
- Prohibited anyone who has been associated with the industry for at least 20 years from ever becoming a public arbitrator, regardless of how long ago the association ended.
- Excluded from the public arbitrator roster attorneys, accountants, or other professionals whose firms have derived 10 percent or more of their annual revenue in the previous two years from clients involved in securities-related activities.

In response to industry objections to the proposed changes being overly restrictive, NASD took the position that it preferred the definition of public arbitrator to be more restrictive rather than overly permissive in order to protect investors' confidence in the integrity of the forum.[6]

Public Investors Arbitration Bar Association's (PIABA) September 11, 2003 comment letter supported these amendments to the definition of public arbitrator, but argued that the NASD and Securities and Exchange Commission (SEC) should eliminate all banking and insurance personnel from the public arbitration pool, as well as all partners of those that are deemed non-public, regardless of the 10% threshold. [7]

The 2003 recommendations were adopted by the NASD and approved by the SEC in April of 2004.[8]

2006 Amendment to the Definition of Public Arbitrator

On July 22, 2005 the NASD proposed further amendments relating to the classification of arbitrators to prevent individuals with certain indirect ties to the securities industry from serving as public arbitrators. The NASD

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5. The term "substantial" appears to be undefined.

6. NASD Comment Letter to the SEC, February 2, 2004. http://www.sec.gov/rules/sro/nasd/nasd200395/srnasd200395-10.pdf.

7. PIABA Comment Letter to the SEC, September 11, 2003. http://www.sec.gov/rules/sro/nasd/nasd200395/srnasd200395-5.pdf.

8. Federal Register Vol. 69, No. 78, April 16, 2004. Release No. 34-49573. http://edocket.access.gpo.gov/2004/pdf/04-9163.pdf.

proposed to amend the definition of public arbitrator to exclude individuals who work for, or are officers or directors of an entity that controls, is controlled by, or is under common control with, a broker-dealer or who have a spouse or immediate family member who works for, or is an officer or director of, an entity that is in such a control relationship with a broker-dealer. The NASD also proposed an amendment to clarify that individuals registered through broker-dealers may not be public arbitrators, even if they are also employed by a non-broker-dealer.

PIABA's September 9, 2005 comment letter stressed the importance of excluding industry professionals from classification as public arbitrators in order to limit industry influence on the panel. PIABA argued that this potential for two or even three arbitrators with industry connections on the panel "presents an unacceptable appearance of pro-industry partiality or bias."[9]

Despite industry comments that the proposed amendments were not necessary, NASD supported the rule change, stating the change was important to promote the appearance of impartiality. The SEC approved the amendments on October 16, 2006 and they became effective January 15, 2007.

2008 Amendment to the Definition of Public Arbitrator

Concurrent with the 2004 amendment, NASD also had a proposal pending with the SEC to amend the Code to reorganize the rules into a Customer Code, Industry Code and a separate mediation code. These changes were approved on January 24, 2007 and became effective April 16, 2007. Due to continuing concerns, FINRA proposed a 2008 amendment to the definition of public arbitrator. Many commentators sought to eliminate all professionals who received any compensation from the industry from the definition, whereas the industry opposed this. The result of this debate was a compromise which set limits of compensation at $50,000 in annual revenue in the past two years that an attorney, accountant or other professional firm could receive from the securities industry.

The North American Securities Administrators Association's (NASAA) August 2, 2007 comment letter approved the proposal, yet believed it did not go far enough. NASAA criticized the piecemeal changes to the definition of public arbitrator and noted that "[i]f the NASD is willing to acknowledge

9. PIABA Comment Letter to the SEC, September 5, 2005.
http://www.sec.gov/rules/sro/nasd/nasd2005094/rjshockman090905a.pdf.

that the receipt of this type of revenue creates conflicts or an appearance of bias, then logic dictates that the receipt of any form of revenue from the brokerage industry would be equally problematic."[10]

PIABA's July 23, 2007 comment letter supported the proposed amendment, although it also voiced concerns that the amendment did not go far enough, noting that the type of services rendered should be irrelevant because it is the receipt of funds that creates the perception of bias that the arbitrator is beholden to the industry.[11] FINRA's response letter dated January 17, 2008, found that forty-one out of sixty-four comment letters contended that the proposal did not go far enough.[12] The proposal was adopted in March of 2008.

FINRA's 2008 Pilot Program

Originally, the FINRA rules provided for the "Majority Public Panel" method for choosing an arbitration panel.[13] A panel was composed of two public (two arbitrators out of three) and one industry arbitrator.

The Pilot Program was a proposed solution to long-standing complaints about the unfairness of requiring an industry arbitrator to sit on a panel deciding the merits of a customer complaint against a brokerage firm. The Pilot Program allowed investors with claims against a limited number of participating firms to select an all public panel. FINRA collected data on the Pilot Program to help better understand the role of the industry arbitrator and parties' perceptions.

The results of the Pilot Program demonstrated that 29% of participating customers accepted the presence of an industry arbitrator and 96% of brokerage firms accepted an industry arbitrator. (See charts below).[14]

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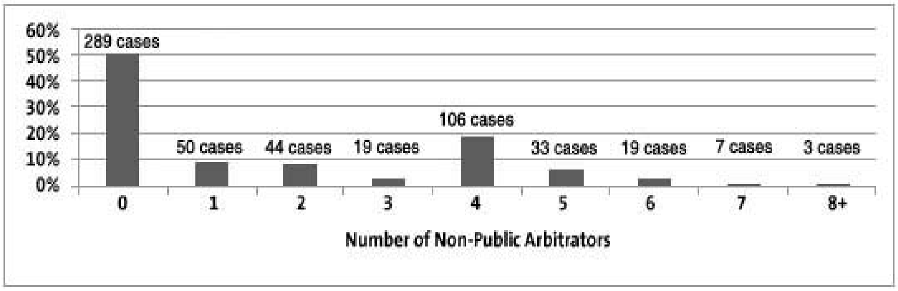
10. NASAA Comment Letter to the SEC, August 2, 2007. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-20.pdf.

11. PIABA Comment Letter to the SEC, July 23, 2007. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-3.pdf.

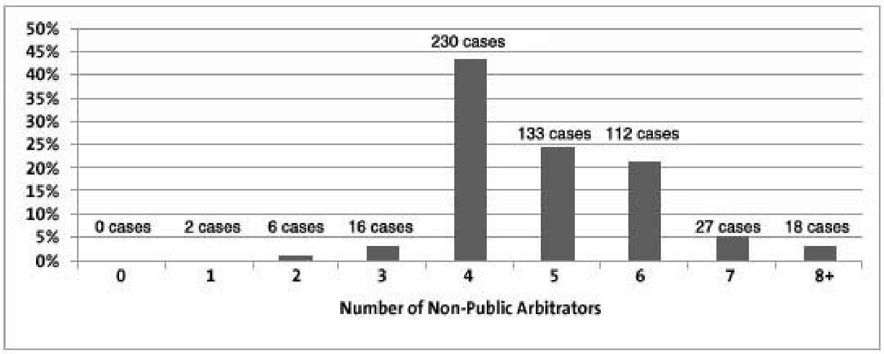
12 FINRA Comment Letter to the SEC, January 17, 2008. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-65.pdf.

13. FINRA Code of Arbitration Procedure § 12403(c), which provides for a panel of one chair-qualified public arbitrator, one public arbitrator and one non-public arbitrator in every customer case.

Investors' rankings:



Firms' rankings:



This stark difference demonstrates that aggrieved investors prefer public arbitrators to industry arbitrators. Contrariwise, brokerage firms overwhelmingly prefer an industry arbitrator likely because they believe that the presence of an industry arbitrator favors the firm in customer disputes.

The 2008 Securities Industry Conference on Arbitration (SICA) survey revealed that investors viewed the FINRA arbitration process as biased and unfair. One of the reasons for this is that almost half of the investors who participated in the survey believed that their arbitration panel was biased against their position. The survey questions that generated the highest

14. Public Arbitrator Pilot Program Summary Sheet With Interim Results http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P122535.

negative customer responses concerned perceptions of arbitrator impartiality.[15]

FINRA proposed the amendment to allow for an optional all public panel. The amendment was approved by the SEC and adopted in January 2011.[16] Despite this amendment, however, customers still face arbitrators with industry backgrounds or ties on their panels due to a lax definition of the public arbitrator under FINRA Code §12100(u) and equally problematic definitions under section 12100(p).

For example, a Texas arbitrator with a CRD number listed on his disclosure form who describes himself as having retired from the investment management industry after thirty one years of managing institutional equity portfolios for publically traded mutual funds and private pensions funds is nonetheless classified as a public arbitrator. This arbitrator appears to have been classified as public because only 12 of his 31 years of work experience in the industry were at a licensed broker dealer. Clearly, the "substantial part" clause in Rule 12100 (p)(2) did not account for the 18 years that this arbitrator worked managing portfolios. The arbitrator's classification as "public" presents questions about the integrity of the process.

Moving Forward

Despite numerous attempts to tailor the definition of public arbitrator to improve the appearance of impartiality, the incremental changes of the last decade have been inadequate and the problem remains unsolved.[17] The present classification allows arbitrators with significant ties to the industry to remain in the public pool.

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15. 36.5% of customers perceived that the industry arbitrator favored at least one securities party. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration* (2008) 2008 J. Disp. Resol. 349, 385.

16. FINRA Code of Arbitration Procedure § 12403(d), which provides for an all-public arbitration panel or majority public panel depending on how the parties exercise their strikes. The rule allows each separately represented party to strike up to all ten arbitrators on the non-public list. If all are stricken, FINRA will appoint the next highest ranked public arbitrator.

17. NASAA Comment Letter to the SEC regarding proposed 2008 Amendment to the definition of public arbitrator, August 2, 2007. http://www.sec.gov/comments/sr-nasd-2007-021/nasd2007021-20.pdf.

Under the current Code section 12100(u), an arbitrator can be classified as public immediately after leaving a law, accounting, or other professional firm that has received revenue from the securities industry.[18] This means that a person who would be classified as non-public one day, can terminate their employment and the very next day be re-classified as public. Despite terminating the employment relationship, customers still perceive bias because of the relationships that the now public arbitrator may still have to other industry members and firms. Thus, partners and associates of large defense firms who for years have represented the industry can become public arbitrators the day after they leave their firm. FINRA's classification system also fails to alert parties if an industry arbitrator is later reclassified as public.

New revisions must close this loophole. Some might propose a "cooling off" period, a time out, or a look back, for an attorney, accountant or other professional formerly employed by a firm with a significant securities practice following his/her termination of employment is a start similar to that in section 12100(p), but is not sufficient to solve the problem. Some may argue that firms employed by the industry are not part of the industry and therefore do not carry the same perceptions. However, when a firm derives ten percent or more of its annual revenue from the industry, it is impossible to remove the association between the firm and the industry. A bright line rule disqualifying anybody who has worked in the industry or on behalf of the industry must be implemented. No formal audit process to determine the scope of the work performed or relationship with the industry exists. Instead FINRA relies on the individual applicant and their good faith determination of revenues in determining whether a candidate will be classified as industry or public.

Lawyers and other professionals who have worked for firms providing services to the securities industry are apparently able to qualify for the public pool the day after they terminate their employment irrespective of how long they were at the firm. For example, a New York arbitrator was employed for 33 years at a law firm that derived significant revenues representing Wall Street. He retired as a partner and continues to receive benefits from this firm but is classified as public. Similarly, a Midwest based arbitrator was for more

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18. Under the Code § 12100(u)(4), arbitrators are excluded from serving as public arbitrators if they are professionals whose *current* firm derived ten percent or more of its annual revenue in the past two years from any persons or entities listed in paragraphs (p)(1)-(4). Section 12100(5) excludes individuals from serving as public arbitrators if their *current* firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed in paragraph (p)(1).

than 10 years the General Counsel of one of the world's largest exchanges. No "cooling off" period could possibly cleanse the perception of bias of these two arbitrators.

Other members of the industry, including persons employed by or associated with registered investment advisors, mutual funds, and hedge funds fall through loopholes and are classified as public arbitrators. The five year time out provision of section 12100(p) is also problematic. Suggesting that working for less than twenty years in the industry and having been out for five years somehow eliminates the perception of bias is illogical. Changes that remove potential bias and perceived unfairness are essential.

If a claimant has a hearing in a mandatory arbitration with an arbitrator who has been misclassified as public, the claimant has little chance of being able to overturn the result. This is because courts are hesitant to vacate an arbitration award and give arbitrators great deference. Courts have interpreted the grounds for reversal of an arbitration award narrowly and the misclassification of an arbitrator does not fit into any of the statutory grounds enumerated in Section 10 of the FAA. In fact, in Bulko v. Morgan Stanley DW, Inc., the 5th Circuit held that the arbitrator's misclassification was a "trivial departure not warranting vacatur."[19]

Conclusion

Despite the long history of concern and amendments over the definition of public arbitrator and the perception of partiality, the time has come to solve the problem. The current definition must be amended to eliminate the loopholes through which professionals in the industry or those who worked on behalf of the industry are classified as public arbitrators. Public should mean public.

19. *Bulko v. Morgan Stanley DW, Inc.*, No. 05-10242, 2006 U.S.App. LEXIS 13322 (5th Cir. May 30, 2006).

THE SHIFTING TIDE OF ESI DISCOVERY COST ALLOCATION

Edward Pekarek[1]

"*Too often, discovery is not just about uncovering the truth, but also about how much of the truth the parties can afford to disinter*."[2]

Introduction

An estimated 60 billion email messages are transmitted each day.[3] Recent advertising from networking hardware manufacturing giant, Cisco Systems, projects that by 2013, some 50 billion networked devices will roam the planet, translating into no less than seven such devices for every person alive, and by 2015, there will be the equivalent of one mobile-connected device for each of earth's inhabitants.[4] The Cisco commercial spot continues by noting the speed at which networked data travels has increased over the last decade and a half, by a factor of 18 million times, and that, in 2009 alone, more digital data was created by humans than in all prior years—*combined*. As reported recently by *Law Technology News*, the technology consulting firm, Gartner, determined that Electronically Stored Information

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2. Rowe Entm't, Inc. v. William Morris Agency, Inc., 205 F.R.D. 421, 423 (S.D.N.Y. 2002) (Francis, Mag. J.).

3. Daniel E. Harmon, *The New Data Wrangler—Their Motto: "Always Ready" for Electronic Discovery*, LAWYER'S PC, 25 No. 16 LAWPC 1 (May 15, 2008).

4. Cisco Systems, Advertisement: *Big Things Are Happening . . . learn who is at the heart of the digital revolution* (2011), http://www.youtube.com/watch?v=Ct0KTSHhhg8.

(ESI) discovery has become an "industry" unto itself, one which will realize roughly $1.5B in annual revenues by 2013.[5]

Regardless of the means by which data travels, or the media on which it is stored, it is now, without question, "black letter law that computerized data is discoverable if relevant."[6] New York law, however, is anything but well settled with regard to ESI discovery cost allocation. Neither the New York Court of Appeals, nor the state's Civil Practice Law and Rules (CPLR), have yet to address the issue of ESI discovery costs, while a fissure between the approaches employed by judges in the New York state court system continues to grow. Federal district courts routinely resolve ESI discovery cost allocation issues equitably, and while minor differences exist in a handful of judicial districts, the Federal Rules of Civil Procedure were amended in 2006 to adopt the essence of the analytical framework established by somewhat celebrated Southern District of New York jurists.[7]

The recent trend in New York state courts reveals a decisive move away from the supposed "general rule," conjured mainly from one deeply flawed trial court decision, toward harmonization with the vastly more elegant federal jurisprudence of permissive cost-shifting for inaccessible ESI. This trend has been ratified locally by amended rules within the Supreme Court Commercial Division,[8] and by a comprehensive manual prepared and proposed by the New York City Bar Association.[9] On a national level, there

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5. Evan Koblentz, *E-Discovery Market Predicted to Reach $1.5B in 2013*, LAW TECHNOLOGY NEWS (May 23, 2011), http://www.law.com/jsp/lawtechnologynews/PubArticleLTN.jsp?id=1202494788349&EDiscovery_Market_Predicted_to_Reach_15B_in_2013.

6. Anti-Monopoly, Inc. v. Hasbro, Inc., No. 94 Civ. 2120, 1995 U.S. Dist. LEXIS 16355 (S.D.N.Y. Nov. 3, 1995).

7. *See*, *e.g.*, Jeff Brown, *And the E-Discovery Oscar Goes To. . .* , LAW PRACTICE TODAY (March 2005), http://apps.americanbar.org/lpm/lpt/articles/tch3051.html; Frost, Brown & Todd, *Electronic Document Discovery Issues in a Post Zubulake World* (Feb. 2006), http://www.frostbrowntodd.com/resources-390.html; MICHELE C.S. LANGE, KRISTIN M. NIMSGER, ELECTRONIC EVIDENCE AND DISCOVERY: WHAT EVERY LAWYER SHOULD KNOW *NOW* (Foreward by Hon. Shira A. Scheindlin) (2d ed. 2009); and Douglas J. Good, *A Modest Proposal to Resolve the E-Discovery Crisis*, NY LAW J. (May 16, 2011), *available at* http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=1202493759317 ("The *Zubulake* pentalogy is perhaps the Bible of e-discovery production obligations").

8. N.Y. COMP. CODES R. & REGS. tit. 22, § 202.70(g)(8)(b).

9. Joint E-Discovery Subcommittee of the Association of the Bar of the City of New York, *Manual for State Courts Regarding Electronic Discovery Cost Allocation*

has been a wave of amendments, including key changes in 2006 to the Federal Rules of Civil Procedure;[10] proposals offered by the Federal Judicial Center,[11] a consortium of state court Chief Justices,[12] and by the American Bar Association.[13] In addition, uniform ESI discovery rules have recently been developed by the same organization that created the Uniform Commercial Code;[14] as well as principles and best practices advanced by The Sedona Conference. [15] The Sedona Conference participants estimated that in 2004, over 90 percent of all information created was first generated in digital format, that up to 70 percent of corporate records were stored in electronic

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(Spring 2009), http://www2.nycbar.org/Publications/pdf/Manual_State_Trial_Courts_Condensed.pdf

10. Carl G. Roberts, *The 2006 Discovery Amendments to the Federal Rules of Civil Procedure*, LAW PRACTICE TODAY, Aug. 2006 (reciting the 2006 FED. R. CIV. P. amendments), http://apps.americanbar.org/lpm/lpt/articles/tch08061.shtml.

11. BARBARA J. ROTHSTEIN, RONALD J. HEDGES AND ELIZABETH C. WIGGINS, FED. JUDICIAL CTR., MANAGING DISCOVERY OF ELECTRONIC INFORMATION: A POCKET GUIDE FOR JUDGES (2007), *available at* http://www.fjc.gov/public/pdf.nsf/lookup/eldscpkt.pdf/$file/eldscpkt.pdf.

12. CONFERENCE OF CHIEF JUSTICES, GUIDELINES FOR STATE TRIAL COURTS REGARDING DISCOVERY OF ELECTRONICALLY-STORED INFORMATION 7 (Aug. 2006), *available at* http://www.ncsconline.org/images/EDiscCCJGuidelinesFinal.pdf. (“This Guideline reflects the analysis conducted in *Zubulake v. UBS Warburg LLC*, 216 F.R.D. 280 (S.D.N.Y. July 24, 2003) (Scheindlin, J.) [ ], the leading federal case on the issue.”).

13. *See* Gregory P. Joseph and Barry F. McNeil, Co-Chairs, ABA Task Force on Electronic Discovery, Litigation Section, *Letter to Members of the Bench, Bar and Academia, RE: Electronic Discovery Standards Draft —Amendments to ABA Civil Discovery Standards*, Nov. 17, 2003, *available at* http://www.fjc.gov/public/pdf.nsf/lookup/ElecDi12.pdf/$file/ElecDi12.pdf; *see also* ABA Civil Discovery Standards (1999) (Containing a “red-lined” draft identifying the 2003 ABA amendments, i.e., section 29(b)(iii)), *available at* http://www.utcourts.gov/committees/civproc/materials/ABA%20Civil%20Discovery%20Standards.pdf.

14. UNIFORM RULES RELATING TO THE DISCOVERY OF ELECTRONICALLY STORED INFORMATION (Nat’l Conf. Comm’r Unif. State Laws, Oct. 10, 2007), *available at* http://www.law.upenn.edu/bll/archives/ulc/udoera/2007am_final.pdf.

15. *See* SEDONA CONFERENCE PUBLICATIONS, ELECTRONIC DOCUMENT RETENTION AND PRODUCTION, http://www.thesedonaconference.org/publications_html?grp=wgs110.

format, and 30 percent of all electronic information was never even reduced to paper form.[16]

Recent guidance by the Financial Industry Regulatory Authority (FINRA) has also embraced the ESI discovery logic utilized in the Southern District of New York, recognizing the leading case in this line of jurisprudence as "a standard of necessary steps that must be taken to preserve and produce electronic data."[17] While some states continue to employ the antiquated and inequitable "requester pays" approach, there can be little debate that the increasingly rapid pace of technological advancement demands regular refinement of e-discovery law. Permissive case-by-case cost-shifting of inaccessible ESI, through a multi-factor analysis, is the appropriate standard for resolving discovery production cost disputes. This is especially true in securities arbitration, where economic disparities and informational asymmetries between disputants are often substantial, sometimes to the point of debilitating a genuine search for the truth, and at times, a disputant's life savings may hang in the balance. As Judge Scheindlin rightly recognized in *Zubulake*, "discovery that would be too expensive for one [party] to bear would be a drop in the bucket for another."[18]

This article evaluates and traces the lineage of New York's "requester pays" approach, maintaining it is inequitable and grounded in faulty analysis.

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16. Frost, Brown & Todd, *Electronic Document Discovery Issues in a Post Zubulake World*, *supra* note 7, *citing* THE SEDONA PRINCIPLES: BEST PRACTICES, RECOMMENDATIONS & PRINCIPLES FOR ADDRESSING ELECTRONIC DOCUMENT PRODUCTION 3 (Jan. 2004), *available at* http://www.thesedonaconference.org/dltForm?did=SedonaPrinciples200401.pdf (log in required).

17. Irene C. Warshauer, *Electronic Discovery*, THE NEUTRAL CORNER, Vol. 2 (2011), *available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p123535.pdf. The relevant factors analyzed by the *Zubulake* court are as follows: (1) the "extent to which the request is specifically tailored to discover relevant information"; (2) the "availability of such information from other sources"; (3) the "total cost of production, compared to the amount in controversy"; (4) the "total cost of production, compared to the resources available to each party"; (5) the "relative ability of each party to control costs and its incentive to do so"; (6) the "importance of the issues at stake in the litigation"; and (7) the "relative benefits to the parties of obtaining the information." Zubulake v UBS Warburg*, LLC*, 217 F.R.D. 309, 322-23 (S.D.N.Y. 2003)(opining that the first two factors offer the greatest analytical heft). *Cf.* Rowe Entm't, Inc. v. William Morris Agency, Inc., 205 F.R.D. 421 (S.D.N.Y. 2002).

18. *Zubulake*, 217 F.R.D. at 321.

It evaluates and criticizes *Lipco Elec. Corp. v. ASG Consult. Corp.*,[19] the misguided trial court opinion, which established the supposed "rule" from whole cloth, and compares it with case opinions such as *MBIA v. Countrywide*,[20] which convincingly deconstruct the flawed predecessor. It reviews various *Lipco* successors in the New York state court system and identifies a host of key distinctions. This article then contemplates Article 31 of the New York Civil Practice and Litigation Rules (CPLR), which provides a more flexible, equitable and logical framework than *Lipco* envisioned. It also discusses objections, protective orders, litigation holds and applications for attorney fees in the ESI discovery context, primarily under New York law. Discussion of the local rule adopted recently by one New York trial court division is also featured.

The key concept of accessibility, relative to discoverable ESI and the relevant cost burdens associated with production is addressed in this article. It also evaluates various Securities and Exchange Commission (SEC) and Self-Regulatory Organization (SRO) record retention rules for Broker-Dealers, including the rule change that is slated to take effect in December 2011. The author advocates for an enlargement of the time required to retain all required records in an "easily accessible" place.

This article continues with a discussion of the recent policy shift at FINRA and explains how the FINRA dispute resolution process emphasizes equity, a principle in stark conflict with "requester pays," particularly in light of the informational asymmetry among securities arbitration disputants, and the deleterious effect it has when parties of disparate economic means seek to resolve disputes through arbitration. It concludes that corporate parties benefit the most from "requester pays," offending the concept of equity, likely precluding valid claims from resolution on the merits in an affront to public policy; harming disputants of modest means and likely eroding investor confidence, all of which ultimately questions the meaning of justice and threatens the long-term vitality of the domestic capital markets.

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19. 2004 WL 1949062 (Sup. Ct. Nassau Co. Aug. 18, 2004) .

20. MBIA Insur. Corp. v. Countrywide Home Loans, Inc., et al., 895 N.Y.S.2d 643 (N.Y. Sup. Ct. 2010).

You may ask yourself, well, how did we get here?[21]

New York policy toward ESI discovery cost allocation can be traced back to a tersely-worded opinion of the Supreme Court Appellate Division, Second Department, in the matter of *Schroeder v. Centro Pariso Tropical*, which stated that a third-party defendant was not entitled to assistance from a defendant to "defray the costs of its own discovery."[22] The two cases on which the state appellate court relied for this ruling contemplated paper documents only and considered costs relating to redaction and reproduction in the former, and foreign language translation in the latter. In the matter of *Rubin v. Alamo Rent-A-Car*, the court cited two early 1980s Second Department cases for the principle that "each party should shoulder the initial burden of financing his own suit, and based upon such a principle, it is the party seeking discovery of documents who should pay the cost of their [reproduction]."[23]

While the *Rubin* court ordered the "requester" to bear the costs of document reproduction *and* redaction for privileged content, it also allowed for the prospect of an application to tax those discovery costs if the requester was ultimately the prevailing party.[24] *Rubin* was pruned subsequently by a federal tribunal applying New York law, in *Fletcher v. Atex*, *Inc*., solely to reproduction costs, with the recognition that creating such a sweeping rule "would result in requiring the discovering party in virtually all cases to compensate its adversary for all costs of document production, such as the hourly fee paid to paralegals to locate documents."[25] The *Fletcher* court

21. TALKING HEADS, *Once in a Lifetime*, *on* REMAIN IN LIGHT (Warner / Chappell Music 1984).

22. Schroeder v. Centro Pariso Tropical, 649 N.Y.S.2d 821 (N.Y. App. Div. 1996), *citing* Rubin v. Alamo Rent-A-Car, 593 N.Y.S.2d 284 (N.Y. App. Div. 1993); Rosado v. Mercedes-Benz of North Am., 480 N.Y.S.2d 124 (N.Y. App. Div. 1984).

23. *Rubin*, 593 N.Y.S.2d at 286 (brackets in original), *citing Rosado*, 480 N.Y.S.2d 124; Wiseman v. American Motors Sales Corp., 479 N.Y.S.2d 528 (1984) (ordering each party to bear its own respective costs related to the deposition of a non-party witness located in another state, with related costs to be taxed subsequently by the prevailing party).

24. *Rubin*, 593 N.Y.S.2d at 285.

25. Fletcher v. Atex, Inc., 156 F.R.D. 45, 50 (S.D.N.Y 1994) (applying New York law), *citing* Hinton v. Geary, 1984 WL 759, at *5 (S.D.N.Y. 1984); First Nat'l City Bank v. State of New York, 421 N.Y.S.2d 381, 382-83 (N.Y. App. Div. 1979) (additional citations omitted).

dispensed with the overly blunt approach, and stated flatly, "[t]his is plainly not the law either in federal or in state court," and ordered production "without costs or disbursements."[26]

The second opinion cited by *Schroeder* for its cost allocation ruling was *Rosado v. Mercedes-Benz of North America*,[27] wrongful death litigation in which the plaintiff sought translation of a German language Mercedes Benz brochure published by a non-party and produced during discovery by the defendant automobile manufacturer.[28] The brochure was relevant as it pertained to the vehicle's cruise control mechanism, which the plaintiff maintained malfunctioned and caused the collision that took the life of her husband.[29] The *Rosado* court sought guidance from the United States Court of Appeals for the First Circuit, citing *In Re Puerto Rico Electric Power Authority*.[30] Relying on the 1982 federal appellate opinion, the *Rosado* court determined that ". . . each party should shoulder the burden of financing his [*sic*] own suit, and based on such a principle, it is the party seeking discovery of documents who should pay the cost of their translation."[31]

The *Rosado* court, in a footnote, likened CPLR 3120[32] with Rule 34 of the Federal Rules of Civil Procedure,[33] the discovery rule which the cited federal circuit court had considered.[34] Professor Connors observed keenly, "[o]n closer inspection, it does not appear that *In Re Puerto Rico Electric Power Authority* actually supports the proposition that *Rosado* cites to it for

26. *Fletcher*, 156 F.R.D. at 50.

27. 480 N.Y.S.2d 124 (N.Y. App. Div. 1984).

28. *Id*.

29. *Id*.

30. 687 F.2d 501, 507-09 (1st Cir. 1982).

31. *Rosado*, 480 N.Y.S.2d at 124.

32. N.Y. C.P.L.R. 2101(b) (McKinney 1997). Although the plaintiff based her application on CPLR 2101, the *Rosado* court found the CPLR section's meaning of "papers" to exclude the brochure at issue, and expanded its analysis, *sua sponte*, to consider whether CPLR 3120 (and CPLR 3114) would support her request.

33. FED. R. CIV. P. 34.

34. *In Re* Puerto Rico Elec. Power Auth., 687 F.2d 501, 507 (1st Cir. 1982), *citing* FED. R. CIV. P. 34(a).

authority."[35] In fact, the circuit court specifically tempered any notion of a bright-line rule flowing from its decision, by highlighting the equitable powers available to courts to prevent the imposition of "undue burden or expense."[36] As a result of the distinctions discussed above in the authorities on which *Schroeder*, *Rosado* and *Rubin* based the respective holdings, the New York "requester pays" rule rightly appears to be but a sandcastle slipping into the sea.

Lipco Pretzel Logic – Occam's Razor Run Amok[37]

The Honorable Leonard B. Austin, New York Supreme Court Justice for Nassau County, was tasked with resolution of competing discovery motions in litigation between a consultant, ASG Consulting Corp. (ASG), and two electrical contractors, Action Electrical Contracting Co., Inc. and Lipco Electrical Corp. (Action and Lipco, respectively).[38] The litigation related to the soured business relationships between the consultant and the electrical

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35. Patrick M. Connors, *Which Party Pays the Costs of Document Disclosure?*, 29 PACE L. REV. 441 *n*.32 (2009), *citing Rosado*, 480 N.Y.S.2d at 126 and *In Re Puerto Rico Elec. Power Auth.*, 687 F.2d at 507.

36. Professor Connors noted that the federal appellate court actually stated:

> To be sure, the respondent is expected to accept the initial expense of producing its own documents, . . . *But if the discovery requests threaten to impose 'undue burden or expense' upon a [party], the district courts are specifically empowered to enter protective orders conditioning the request or requiring the requesting party to pay the expenses of production.*

Connors, *Which Party Pays?*, at *n*.32, *supra* note 35, *quoting In Re Puerto Rico Elec. Power Auth.*, 687 F.2d at 507, *citing* FED. R. CIV. P. 26(c).

37. Professor Massimo Pigliucci, Philosophy Dept. Chair, CUNY-Lehman College, and *Philosophy & Theory in Biology* Editor-in-Chief, deems the Middle Ages law of succinctness (*lex parsimoniae*) as an "epistemological principle formulated in a number of ways by the English Franciscan friar and scholastic philosopher William of Ockham (1288-1348). *Frustra fit per plura quod potest fieri per pauciora*. ('It is futile to do with more things that which can be done with fewer.')" Prof. Pigliucci's blog recently featured a multi-disciplinary debate of the ancient theory. *Available at* http://rationallyspeaking.blogspot.com/2011/05/razoring-ockhams-razor.html.

38. Lipco Elec. Corp. v ASG Consulting, 798 N.Y.S.2d 345 (N.Y. Sup. 2004)(table), 2004 WL 1949062.

contractors, which dated back to the early 1990s, and interpretation of consulting agreements between the parties pertaining to various public works projects on which the contractors bid and the assistance ASG was retained to provide in connection with the bidding on those projects.[39] The parties later modified the consulting agreements and created a joint venture which apportioned potential profits and losses equally between the parties in thirds.[40] Litigation ensued in both New York[41] and Nassau Counties, regarding performance of the agreements, with over-billing allegations averred by the contractors.[42]

Lipco ESI Discovery Dispute

The discovery dispute before the court related, primarily, to data created with a vertical market software application. The application, known as "Emque," was described as "customized, non-commercial billing software."[43] The ESI at issue was data created by Emque users at ASG from 1993 through 1997,[44] located on the hard drives of computers owned by ASG, and backup tapes its personnel had used for archiving purposes.[45]

Justice Austin first acknowledged that CPLR 3101(a) calls for disclosure of all items that are "material and necessary in the prosecution of the action . . . regardless of the burden of proof."[46] He proceeded to determine that the question of what is "material and necessary" is resolved by a test of "usefulness and reason,"[47] and recognized that discovery sought need not be admissible, but only that it "should lead to the disclosure of admissible

39. *Id.* at *1-2.

40. *Id.* at *2.

41. *Id.* ("The New York County litigation was discontinued.").

42. *Id.* at *3.

43. *Id.* at *7.

44. *Id.*

45. *Lipco*, 2004 WL 1949062, at *5. (The *Lipco* court conducted no meaningful accessibility analysis of the distinction between data located on a hard drive and data archived on backup tape).

46. *Id.* at *3.

47. *Id.*, *citing* Allen v. Crowell-Collier Publ. Co., 21 N.Y.2d 403, 406 (1968).

evidence."[48] However, as the *Lipco* court noted, one need not comply with a "palpably improper" discovery demand, such as those which seek irrelevant or confidential information.[49]

The court turned to ESI discovery, which constituted four of the seven demands at issue.[50] The items sought were various categories of ASG business records, such as bookkeeping, payroll, payment receipts, income and expenses, contract cash disbursements, and the like.[51] Some of what was sought by the electrical contractors was located on ASG computer hard drives, while others were apparently housed on backup tape or other archive media.[52] ASG voluntarily produced paper copies for three of the four demanded ESI records categories, but Action and Lipco demanded electronic versions of the records, maintaining it was "the only [to] confirm [ ] the hard copy data is true and accurate is by obtaining the raw data in computerized form."[53]

Justice Austin observed, correctly, that "[e]lectronic discovery raises a series of issues that were never envisioned by the drafters of the CPLR."[54] He also noted that the court and the parties were unsuccessful in a search for "cases decided by New York [s]tate [c]ourts dealing with the issue of electronic discovery. Instead of relying on the analysis of *Zubulake* and its progeny, he instead likened the ESI discovery demands to "traditional paper discovery," but recognized that "[w]ith electronic discovery, totally different issues arise," and identified a handful of the novel issues ESI creates.[55]

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48. *Lipco*, 2004 WL 1949062, at *3, *citing* Southampton Taxpayers Against Reassessment v. Assessor of the Vill. of Southampton, 176 A.D.2d 795 (N.Y. A. D. 1991); Fell v. Presbyterian Hosp. in the City of New York, 469 N.Y.S.2d 375 (N.Y. A.D. 1983).

49. *Lipco*, 2004 WL 1949062, at *3, *citing* Saratoga Harness Racing, Inc. v. Roemer, 711 N.Y.S.2d 603 (3rd Dep't 2000); Titleserv, Inc. v. Zenobio, 619 N.Y.S.2d 769 (N.Y. A.D. 2000); Grossman v. Lacoff, 562 N.Y.S.2d 724 (N.Y. A.D. 1990); and Spancrete Northeast, Inc. v. Elite Assocs., Inc., 539 N.Y.S.2d 441 (N.Y. A.D. 1989).

50. *Lipco*, 2004 WL 1949062, at *5-6.

51. *Id*.

52. *Id*.

53. *Lipco*, 2004 WL 1949062, at *6.

54. *Id*.

55. *Id*.

Regarding the business records created by Emque, he noted that ASG "claimed" to have inquired with the software application's designer who, according to ASG, informed the consultant that the data is not maintained as "electronic files."[56] Instead, the court stated, "[t]he raw data is *allegedly* not stored in an easily extractable manner."[57] According to ASG, a separate program and relational database would have to be created to extract the data, and another program "devised to transfer the data on to a disc or hard drive," and a compatible version of Emque would have to be obtained to interpret the extracted records, followed by a privilege screening before production.[58] ASG contended all of the steps in such an undertaking would require "hundreds of man [*sic*] hours to perform."[59]

The court observed that ASG offered "*nothing more than a hearsay statement* outlining the procedures involved in extracting and collating this data while suggesting that the cost of accomplishing that will be substantial."[60] Lipco and Action maintained that a "family relationship" existed between the principals of ASG and Emque, and ASG's claims of substantial cost and effort to produce the demanded records was nothing more than a "smoke screen," the true reason for which was that the discovery sought "support[ed] its claim that [the contractors were] overcharged for labor, equipment and material."[61]

Lipco ESI Cost Allocation Analysis

Justice Austin identified the protective order measure available in CLPR 3103(a), noting it was "designed to prevent unreasonable annoyance, expense, embarrassment, disadvantage or other prejudice to any person or the court."[62] Ostensibly due to the lack of an ESI provision in the CPLR, and the absence of any New York state court decisions resolving ESI discovery issues, the court commenced with a discussion of a number of federal

56. *Id*. at 7.

57. *Id*. (emphasis added).

58. *Id*.

59. *Id*.

60. *Lipco*, 2004 WL 1949062, at *9.

61. *Id*. at 7.

62. *Id*. at 7, *citing* N.Y. C.P.L.R. (McKinney 2004).

authorities that had previously resolved issues of this nature. In fact, the first question the court posed was whether "[r]aw computer data or electronic documents are discoverable," and to resolve that threshold issue, it cited *Zubulake*, among others.[63] The court also turned to federal jurisprudence for guidance regarding whether deleted files were discoverable, and observed that "computer experts can allegedly determine if data has been altered and reconstruct the originally entered data."[64]

Inexplicably, with a well-developed universe of federal authority available from which to craft his analysis, Justice Austin instead returned to his comparison of ESI with paper for the purposes of production cost allocation.[65] In recognition of disaster recovery as one of the key purposes of ESI, and aware of its nominal archiving costs,[66] the court observed that such data storage methods typically do not enable one to "retrieve an individual document," and opined that the retrieval of "computer based records or data is not the equivalent of getting the file from a file cabinet or archives."[67] However, one could certainly envision a scenario where a file cabinet or other paper archive was not labeled, or was labeled improperly, or the records were retained in some arcane system or even haphazardly, such that one searching for paper records first would have to remove all of the papers and organize them in order to conduct a search for discrete items. The court did not recognize this seemingly obvious extension of its ESI versus paper comparative analysis and develop a "simple" solution to resolve the parties' discovery dispute.[68]

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63. *Lipco*, 2004 WL 1949062, at *7, *citing* Zubulake*,* 217 F.R.D. 309 (S.D.N.Y. 2003); Playboy Ents., Inc. v. Welles, 60 F.Supp.2d 1050 (S.D. Cal. 1999); and Anti-Monopoly, Inc. v. Hasbro, Inc., 1995 WL 649934 (S.D.N.Y. Nov. 3, 1995).

64. *Lipco*, 2004 WL 1949062, at *8, *citing* Antioch Co. v. Scrapbook Borders, Inc., 210 F.R.D. 645 (D. Minn. 2002); Simon Properties Grp., L.P. v. mySIMON, Inc., 194 F.R.D. 639 (S.D. Ind. 2000); and *Welles*, 60 F.Supp.2d 1050.

65. *Lipco*, 2004 WL 1949062, at *7.

66. *Id*. at *8, *citing Rowe*, 205 F.R.D. 421; McPeek v. Ashcroft, 202 F.R.D. 31 (D.D.C. 2001).

67. *Lipco*, 2004 WL 1949062, at *8.

68. *See*, *e.g.*, Hon. James C. Francis (S.D.N.Y.) and Hon. Sidney I. Schenkier (N.D. Ill.), *Surviving E-Discovery – New York Workshop – 07/27/06* (downloadable powerpoint presentation) (2006), *citing* Crown Life Ins. Co. v. Craig, 995 F.2d 1376 (7th Cir. 1993); *In Re* Brand Name Prescription Drugs Antitrust Litig., 1995 WL 360526 (N.D. Ill. June 15, 1995). ("YOU CHOSE HOW TO KEEP YOUR DOCUMENTS, SO IF IT IS COSTLY TO FIND AND PRODUCE RESPONSIVE

The court cited *only* federal opinions in making its threshold determination that the ESI sought by Action and Lipco was discoverable.[69] When the court turned to the issue of cost allocation, it again cited federal authority in recognition of the federal framework for resolving ESI discovery cost allocation issues, including the "seven point analysis" of *Zubulake*.[70] The court acknowledged the United States Supreme Court stated in *Oppenheimer Fund, Inc. v. Sanders* that "the party responding to the discovery demand bears the cost of complying with discovery demands,"[71] then retreated from the available federal framework and cited two Second Department opinions, and stated, "cost shifting of electronic discovery is not an issue in New York since the courts have held that, under the CPLR, the party seeking discovery should incur the costs incurred in the production of discovery material."[72]

As discussed *infra*, the opinions on which the *Lipco* court relied for its declaration of a new bright-line do not support that new "rule." Inexplicably, after recognizing that the CPLR 3103(a) protective order is "designed to prevent unreasonable annoyance, expense, embarrassment, disadvantage or

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ONES, TOO BAD.") (capitalization in original), http://www.fjc.gov/public/pdf.nsf/lookup/MagJ0608.ppt/%24file/MagJ0608.ppt. Incidentally, the author is not suggesting the *Lipco* court should have used the above approach, but rather that it was readily available if the court was seeking a "simple" solution. *See Lipco*, 2004 WL 1949062, at *9 ("Therefore, the analysis of whether electronic discovery should be permitted in New York is much simpler than it is in the federal courts. The court need only determine whether the material is discoverable and whether the party seeking the discovery is willing to bear the cost of production of the electronic material.").

69. *Lipco*, 2004 WL 1949062, at *8 ("Having concluded that the material is discoverable, the [c]ourt must now determine the procedure for its production and who will bear the cost. . . .").

70. *Id*. at *8, *citing Zubulake*, 217 F.R.D. 309; *Rowe*, 205 F.R.D. 421; and *Welles*, 60 F.Supp.2d 1050 ("The party from who[m] electronic discovery is sought should be required to produce material stored on a computer so long as the party being asked to produce the material is protected from undue burden and expense and privileged material is protected.").

71. Oppenheimer Fund, Inc. v. Sanders, 437 U.S. 340 (1978). *But see*, *id*. at 361, *citing* Sanders v. Levy, 558 F.2d 636, 654 (2d Cir. 1976) ("We do not think a defendant should be penalized for not maintaining his records in the form most convenient to some potential future litigants whose identity and perceived needs could not have been anticipated.").

72. *Lipco*, 2004 WL 1949062, at *9.

other prejudice to any person or the court," it granted the request for just such an order, despite the fact that "the parties [ ] failed to establish the costs to be incurred in the production of this material."[73] Adding to the curious nature of the court's determination, it denied the Action/Lipco joint motion to compel, with leave to renew. In so doing, the court shifted the burden to establish ESI production costs to the parties seeking the discovery, without citing any authority to do so, instead of requiring the party who sought protection from production, based on CPLR 3103(a), to actually demonstrate the existence of *unreasonable* expense.[74]

"Precarious Footing"

The matter of *MBIA Insur. Corp. v. Countrywide Home Loans*, *Inc.*, *et al.*,[75] involves protracted litigation between a monoline insurer and a residential mortgage lender, located squarely in the center of the mortgage securitization maelstrom. It also provided a New York Supreme Court Justice an opportunity for to resolve a CPLR 3103(a) motion, while revealing that the ESI cost allocation emperor's wardrobe was indeed lacking, by stating "Countrywide fail[ed] to show that it is settled law that the party requesting discovery must bear the cost of its production."[76] The *MBIA* court's rejection of *Lipco* leaves little doubt that the supposed "general rule" that a requester must finance an adversary's ESI production is hardly axiomatic.[77] The court observed that the notion a party seeking discovery must bear the cost of ESI production cost "stands on more precarious footing than . . . *Lipco* and Countrywide suggest."[78]

MBIA undercut *Lipco* drastically, and with it, the scope of *Rosado*,[79] which *MBIA* observed correctly, "supports a much narrower holding than the

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73. *Id.* ("At the present time, *the Court has before it nothing more than a hearsay statement* outlining the procedures involved in extracting and collating this data while suggesting that the cost of accomplishing that will be substantial.").

74. *Id.*, at *10 ("[D]enied with leave to renew upon presentation of information regarding the actual cost for extracting this information . . .").

75. 895 N.Y.S.2d 643 (Sup. Ct. N.Y. Co. Jan. 14, 2010).

76. *Id*. at 654.

77. *See id.*; *Lipco*, 2004 WL 1949062.

78. *MBIA*, 895 N.Y.S.2d at 653.

79. 480 N.Y.S.2d 124 (N.Y. A. D. 1984).

cited cases imply."[80] The only discovery cost allocation issue resolved by the *Rosado* court involved translation expenses for a German language brochure, not data extraction from an "obsolete system" requiring a "computer archeologist to dig it out," as was partially the case in *Lipco*, although some of the demanded Emque data apparently resided on one or more ASG hard drives.[81] The *MBIA* court drew a sharp contrast between a party's discovery quest for accessible (versus deleted) data, noting that New York "courts have shown a greater willingness to allocate the cost of discovery when the request involves the recovery of *deleted* or *archived* electronic-data, especially when allocation is consented to by the producing party."[82] The state of New York e-discovery law at present is that *MBIA* established that accessible data should be produced without cost-shifting, and inaccessible ESI production costs should be analyzed using the multi-factor balancing tests developed by Southern District of New York judges, it also expertly exposed the flawed *Lipco* logic, along with much of its progeny.

Related New York Jurisprudence

In the matter of *T.A. Ahern Contractors Corp. v. Dormitory Auth. of the State of N.Y.*,[83] the defendant agreed conditionally to produce requested email messages, provided the plaintiff assumed the cost of an ESI expert to search for responsive emails. The plaintiff refused to bear the costs and sought to

80. *MBIA*, 895 N.Y.S.2d at 654.

81. *Id.*; Michael Bobelian, *Judge Charts a Course On Electronic Discovery*, N.Y. LAW J. (Aug. 23, 2004), *available at* http://www.law.com/jsp/nylj/PubArticleFriendlyNY.jsp?id=900005413545.

82. *MBIA*, 895 N.Y.S.2d at 654, *citing* Samide v. Roman Catholic Diocese of Brooklyn, 773 N.Y.S.2d 116 (N.Y. A. D. 2004) ("In accordance with the consent of the plaintiff's attorney at oral argument of this appeal, all costs related to the *recovery* of the hard drive data shall be borne solely by the plaintiff") (emphasis in original); Delta Fin. Corp. v. Morrison, 819 N.Y.S.2d 908 (N.Y. Sup. Ct. 2006) (Warshawsky, J.) (requesting party held responsible for 100% of the costs and expenses of searching through *restored* backup tapes) (emphasis in original); and Etzion v. Etzion, 796 N.Y.S.2d 844 (N.Y. Sup. Ct. 2005) (party requesting discovery directed to bear the cost of cloning or copying the hard drives of computers containing *deleted* business records) (emphasis added).

83. 875 N.Y.S.2d 862 (slip op.) (N.Y. Sup. Ct. 2009).

compel production, relying on *Zubulake*.[84] The *T.A. Ahern* court refused to apply the balancing test created by Judge Scheindlin.[85] In the court's view, *Zubulake* concerned itself only with federal discovery, where a presumption exists that a "responding party must bear the expense of complying with discovery requests," and that, absent cost-shifting, "the potential would exist for litigants to formulate overly broad discovery requests which have the effect – whether intended or otherwise – of placing unnecessary and oppressive (even prohibitive) costs upon an opponent."[86]

According to the *T.A. Ahern* court, the "requester-pays" standard actually reduces the potential for abuse in discovery requests.[87] As a result, the court elected to follow the illogical *Lipco*, choosing not to upset "the well-settled rule in New York State that the party seeking discovery bear the cost incurred in this production"[88] and refused to compel production "until such time as [the plaintiff] communicates that it is willing to bear the costs incurred for their production, subject to any possible reallocation of costs at trial."[89]

Around the time the ESI discovery issues in *Waltzer* were resolved, two unpublished opinions in *EBC I*, *Inc. v. Goldman*, *Sachs & Co.*, were issued by a New York County Commercial Division Judicial Hearing Officer ("JHO"), who roundly rejected the *Lipco* "general rule" and characterized the overly simplistic bright-line test rather dimly, appropriate only for paper discovery.[90] The JHO eschewed "requester pays" and instead applied the

84. *Id*. at 868. ("While it is true that New York courts have received guidance from the federal courts on the issue of electronic discovery (*see Delta Fin. Corp.*, 819 N.Y.S.2d 908) (citing cases), the courts have noted that a clear distinction exists between the CPLR and the Federal Rules of Civil Procedure with respect to the cost of producing disclosure," *citing Lipco*, at *8).

85. *Id*. at 869.

86. *Id*. at 868.

87. *Id*.

88. *Id*. at 869, *citing* Waltzer v. Tradescape & Co., 819 N.Y.S.2d 38 (N.Y.A.D 2006).

89. *T.A. Ahern*, 875 N.Y.S.2d at 869. ("discovery cost allocation determinations [allowed] when the discovery costs at issue concern [ESI] that is not readily available"); *see* Silverman v. Shaoul, Index No. 603231/08, 2010 N.Y. Misc. LEXIS 6003, at *4 (Sup. Ct. New York Co. Nov. 3, 2010) (Bransten, J.).

90. *See* EBC I, Inc. v. Goldman Sachs, & Co., No. 601805-2002, at *4-6 (slip. op.) (Sup. Ct. N.Y. Co. June 19, 2006) (Bradley, JHO); EBC I, Inc. v. Goldman Sachs, & Co., No. 601805-2002, at *3 (slip. op.) (Sup. Ct. N.Y. Co. Feb. 15, 2007).

Zubulake balancing factors to determine whether it was proper for the requesting party to bear production costs related to the restoration and production of relevant, but inaccessible, data stored on backup tape.[91] The JHO also applied *Zubulake* to determine whether the parties should divide the producing party's legal fees related to review of the ESI at issue before producing it to the requesting party.[92]

The New York Supreme Court Appellate Division, First Department, required the parties in *Waltzer v. Tradescape & Co.*[93] to seek judicial intervention at the onset of a dispute pertaining to who should bear ESI discovery costs. The *MBIA* court noted that *Waltzer* accepted "the principle that 'under the CPLR, the party seeking discovery should bear the cost incurred in the production of discovery material,'" as stated by *Lipco* and its progeny, yet the Appellate Division rejected the principle and, instead, elected to "distinguish[ ] its facts on the basis that (1) it did not deal with deleted electronically stored material [ ] and (2) the information sought was readily available."[94] Similarly, in *Vinings Spinal Diagnostic v. Progressive Casualty Insurance Co.*, the court noted its broad discretion to develop the terms and conditions of ESI discovery, pursuant to CPLR 3103(a), while ultimately determining the plaintiff should bear the production costs.[95]

The trend away from the *Lipco* legacy, and its supposed "general rule," is indeed manifest. So much so, in fact, that in an otherwise detailed February 2010 report to the Chief Judge and Chief Administrative Judge of the New York State Unified Court System,[96] the report conspicuously indicates that it:

Unreported New York opinions are available at http://iapps.courts.state.ny.us/iscroll/.

91. *Id.*

92. *Id.*

93. 819 N.Y.S.2d 38, 39-40 (N.Y. A. D. 2006).

94. *MBIA*, 895 N.Y.S.2d at 653, *citing Waltzer*, 819 N.Y.S.2d 38. *See* Silverman v. Shaoul, Index No. 603231/08, 2010 N.Y. Misc. LEXIS 6003, at *4 (Sup. Ct. New York Co. Nov. 3, 2010) (Bransten, J.).

95. Vinings Spinal Diagnostic v. Progressive Casualty Ins. Co., 829 N.Y.S.2d 871 (N.Y. Dist. Ct. 2006), *appeal dismissed*, 867 N.Y.S.2d 379 (N.Y. Sup. App. 2008) (Table) 2008 WL 2814831.

96. THE NEW YORK STATE UNIFIED COURT SYSTEM, ELECTRONIC DISCOVERY IN THE NEW YORK STATE COURTS (February 2010), http://www.nycourts.gov/courts/comdiv/PDFs/E-DiscoveryReport.pdf.

> does not address certain *unresolved legal and policy issues* particularly associated with e-discovery, *such as the allocation of e-discovery costs* between the parties. Such policy issues are beyond the scope of this report, *although it is important that they be addressed in the near future through clarifying amendments to the CPLR or the development of definitive case law*.[97]

One thing is abundantly clear about this collection of New York state cost allocation jurisprudence, particularly in light of the passage "certain unresolved legal and policy issues," from the above report, there is no such "general rule" that a requesting party must bear the cost of ESI discovery production, especially where the sought after ESI is relevant and accessible.

CPLR Article 31

CPLR Article 31 includes a "more flexible approach"[98] than the "rule" conjured by *Lipco*.[99] According to the Article, a party is entitled to full disclosure of any document that constitutes evidence "material and necessary in the prosecution or defense of an action."[100] It does not, however, expressly require a requesting party to bear production costs, although it empowers courts "at any time on its own initiative, or on motion, of any party or of any person from whom discovery is sought, [to] make a protective order *denying, limiting, conditioning or regulating* the use of any disclosure device."[101] The *Lipco* court ostensibly relied on CPLR 3013 when resolving ASG's motion favorably and shifting the ESI production cost burden to the "requesters," who opposed the CPLR 3013 application. It did so without the benefit of any non-hearsay evidence to establish the objectionable data recovery expenses at issue, and apparently ignored a New York intermediate appellate court opinion which had resolved that issue previously.[102]

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97. *Id*. at 2.

98. Connors, *Which Party Pays?*, *supra* note 35 at 442.

99. *Lipco*, 2004 WL 1949062, at *9.

100. N.Y. C.P.L.R. 3101(a) (McKinney 2004).

101. *Lipco*, 2004 WL 1949062, at *9, *citing* N.Y. C.P.L.R. 3103(a) (McKinney 2004) (emphasis added).

102. Justice Austin noted, curiously, that "[i]n this case, the cost factor for extracting the demanded information is unknown. . . . since the parties have failed to establish the costs. . . . [and a]t the present time the court has before it nothing more

It is unclear how the *Lipco* court justified the fashioning of such a remedy when the authority on which it was based is specifically "designed to prevent *unreasonable* annoyance, *expense*, embarrassment, disadvantage, or other prejudice," and the court expressly stated that its reasoning was premised on "a protective order to prevent a party from incurring unreasonable expenses in complying with discovery demands."[103] Instead, the trial court granted the application for a protective order and proclaimed, without binding authority or supportive evidence, that "under New York law the party seeking discovery must bear the cost of production of the items for which discovery is sought."[104] Adding to the flaws of *Lipco*, as discussed further *supra*, the court denied the cross-motion to compel production of the ESI at issue, "with leave to renew upon presentation of information regarding the *actual* cost for extracting this information,"[105] although there was no authority to shift the burden to establish production costs to the *opponent* of the CPLR 3103(a) protective order application.

Objections versus Protective Orders

A party who objects to ESI production costs, must, at a minimum, furnish the court with non-hearsay evidence to support an application seeking cost-shifting.[106] Oddly enough, the *Lipco* court hatched "requester pays" without a scintilla of admissible evidence about the disputed ESI discovery production costs.[107] Generally, New York courts are unlikely to preclude production based solely on a producing party "suggesting" substantial unspecified costs, where at least one has ordered production of "[a]ll

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than a hearsay statement . . . *suggesting* that the cost [ ] will be substantial." *Lipco*, 2004 WL 1949062, at *9 (emphasis added). *Cf.* Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn LLP, 743 N.Y.S.2d 72 (N.Y. A.D 2002).

103. N.Y. C.P.L.R. 3103(a); *Lipco*, 2004 WL 1949062, at *9, *citing* N.Y. C.P.L.R. 3103(a).

104. *Lipco*, 2004 WL 1949062, at *9.

105. *Id*. at 10. The court did allow for the prospect of "later apportionment," subject to a "proper application," presumably if the requesting parties were to prevail in the litigation.

106. *See* Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn LLP, 294 A.D.2d 190, 191 (1st Dep't 2002).

107. *Lipco*, 2004 WL 1949062, at *9.

databases, electronic material, tape media, electronic media, hard drives, computer disks and documents," despite a producing defendant's objections to the attendant costs.[108]

Underpinning the option of a CPLR 3103(a) protective order are equitable principles; a key purpose of the provision is to "balance the situation in which a disparity in the economic resources of the parties is disabling one from participating in the disclosure process or empowering another to take advantage of it."[109] Some espouse the notion that "requester pays" fosters responsible and economically efficient discovery,[110] and at least one commenter has proposed the abolition of virtually all ESI discovery.[111] Despite the doctrine's proponents, the use, and misuse, of "requester pays," can unquestionably result in abusive tactics by disputants who hold documents hostage with ransoms that an average brokerage customer cannot possibly afford.

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108. Weiler v. New York Life Ins. Co., 800 N.Y.S.2d 359, 2004 WL 3245345, at *7 (slip. op.) (Sup. Ct. N.Y. Co. 2005) (Cahn, J.). *See* Blue Tree Hotel Invs. (Canada) Ltd. v. Starwood Hotels & Resorts Worldwide, Inc., C 604295-00, at *6-7 (slip. op.) (Sup. Ct. N.Y. Co. July 29, 2003).

109. Connors, *Which Party Pays?*, *supra* note 35 at 443, *quoting* David D. Siegel, NEW YORK PRACTICE §353, at 578 (4th ed. 2005).

110. Daniel E. Troy, *Seize The Opportunity - Reduce The Costs And Burdens Of Our Current Justice System*, METROPOLITAN CORPORATE COUNSEL (July 5, 2010), http://www.metrocorpcounsel.com/current.php?artType=view&EntryNo=11174. Mr. Troy asserts the following *efficiency* argument in favor of using "requester pays" throughout the U.S. legal system:

> [U]nless the parties share discovery burdens (including costs), incentives to conduct targeted and efficient discovery are absent; the Rules provide none. The current Rules allow discovery to be used as a weapon in the requesting party's arsenal to impact the outcome of a case irrespective of the merits.
>
> A requester-pays rule will encourage parties to focus the scope of their discovery requests on evidence that is reasonably calculated to provide relevant information from the most cost-effective source.

Id.

111. Douglas J. Good, *A Modest Proposal to Resolve the E-Discovery Crisis*, NY LAW J. (May 16, 2011), *available at* http://www.law.com/jsp/nylj/PubArticle NY.jsp?id=1202493759317. ("Eliminate all discovery of electronic communications in the absence of a showing of extraordinary circumstances.")

Litigation Holds

Magistrate Judge Henry Pitman resolved issues pertaining to the duty to preserve ESI, in *Quinby v. West LB*, noting that "anyone who anticipates being a party or is a party to a lawsuit. . . is under a duty to preserve what it knows, or reasonably should know, is relevant in the action, is reasonably calculated to lead to the discovery of admissible evidence, is reasonably likely to be requested during discovery and/or is the subject of a pending discovery request."[112] According to Judge Pitman, citing *Zubulake*, the scope of the duty to preserve "extends to 'key players' in a litigation, i.e., 'individuals likely to have discoverable information that the disclosing party may use to support its claims or defenses.'"[113] Moreover, "in complying with a duty to preserve evidence, a party will be free to preserve electronic evidence in any format it chooses, including inaccessible formats."[114] Of course, one who preserves relevant ESI in an inaccessible format, after litigation became reasonably foreseeable, hinders the likelihood of shifting costs to a requesting party.

Magistrate Judge James Francis applied the *Zubulake* principles in *Richard Green (Fine Paintings) v. McClendon*,[115] to analyze "accessible" versus "inaccessible" ESI litigation records retention practices and stated that "[o]nce a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents."[116] This obligation does not, however, require the preservation of all potential evidence or "every single scrap of paper" in a business.[117] More than one court has commented that a party need not preserve all backup tapes in anticipation of litigation, but is

112. Quinby v. West LB, 245 F.R.D. 94 (S.D.N.Y. 2006).

113. *Id*. at 103, *citing Zubulake*, 220 F.R.D. at 218, *quoting* FED. R. CIV. P. 26(a)(1)(A).

114. *Quinby*, 245 F.R.D. at 104.

115. 262 F.R.D. 284, 289 (S.D.N.Y. 2009), *citing Zubulake*, 220 F.R.D. at 216, *accord* Fujitsu Ltd. v. Federal Express Corp., 247 F.3d 423, 436 (2d Cir. 2001).

116. *Richard Green (Fine Paintings),* 262 F.R.D. at 289.

117. Best Buy Stores, L.P. v. Developers Diversified Realty Corp., 247 F.R.D. 567, 570, *citing* Wiginton v. CB Richard Ellis, No. 02C6832, 2003 U.S. Dist. LEXIS 19128, at *12-13 (N.D. Ill. Oct. 24, 2003). N.B. The author is the former Marketing Manager of the defendant.

instead obligated to preserve evidence reasonably believed to be relevant.[118] In fact, a defendant's policy of automatically deleting emails eight days after transmission (or receipt) is not, by itself, sanctionable if the relevant emails were not in the party's system either at the time the litigation was commenced or when the discovery requests were served.[119] The *McPeek* court noted "there is certainly no controlling authority for the proposition that restoring all backup tapes is necessary in every case,"[120] but added "one judicial rationale that has emerged is that producing backup tapes is a cost of doing business in the computer age."[121] Judge Scheindlin noted that the law regarding preservation of backup tapes may previously have been a "grey area,"[122] but that "[l]itigants are now on notice, at least in this [c]ourt, that backup tapes that can be identified as storing information created by or for 'key players' must be preserved."[123]

Attorney Fees and Related Costs

Some New York courts may require a requesting party to bear a producing party's legal costs, sometimes including attorney fees for review of the requested ESI.[124] Other New York courts, however, have held that

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118. McPeek v. Ashcroft, 202 F.R.D. 31, 33 (D.C. 2001).

119. McKenna v. Nestle Purina PetCare Co., 2007 WL 433291 (S.D. Ohio Feb. 5, 2007) (shifting the cost of mirroring a computer network server as cost of implementing a litigation deemed unjustified).

120. *McPeek*, 202 F.R.D. at 33.

121. *Id*., *citing* In re Brand Name Prescription Drugs, 1995 WL 360526 at *3 (N.D.Ill., June 15, 1995).

122. *Zubulake*, 220 F.R.D. at 220.

123. *Zubulake*, 229 F.R.D. at 422. *But see* Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Secs., 685 F. Supp. 2d 456 (S.D.N.Y. 2010):

> I am not requiring that *all* backup tapes must be preserved. Rather, if such tapes are the *sole* source of relevant information (*e.g.*, the active files of key players are no longer available), then such backup tapes should be segregated and preserved.

Id.

124. *See Delta Fin. Corp.*, 819 N.Y.S.2d at 914 ("Although not binding precedent, the Court is in agreement with the logic in *Zubulake*. . . . Because the Court is not entirely convinced that relevant and responsive documents will be found, [the

privilege review costs, such as those referenced in *Delta Financial*,[125] are not to be borne by the requesting party when the documents sought are shown to be *relevant*.[126] That approach is consistent, generally, with federal jurisprudence,[127] but offers a key relevance distinction and asks whether the failure to disclose such documents was "willful and contumacious."[128]

Amended New York Commercial Division Rule 8(b)

Rule 8(b) of the New York State Supreme Court (Commercial Division) Rules of Practice, requires parties to address electronic discovery comprehensively and permits voluntary cost-sharing arrangements between parties.[129] The rule states, in pertinent part, that "counsel shall confer with regard to anticipated discovery issues," including "anticipated costs of data recovery and proposed initial allocation of such cost."[130] The rule's language provides substantially greater flexibility in dealing with ESI cost allocation, particularly in complex commercial cases. Effective in February 2009, the Nassau County Commercial Division addressed this need for added flexibility in its form Preliminary Conference Stipulation and Order. That requires, among other things, metadata preservation, directs parties to halt normal backup and deletion processes and mandates that "[i]ssues with regard to cost-shifting shall be brought to the attention of the Court as soon

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requester] will be initially responsible for one hundred percent of the costs and expenses of the search process, de-duplication process, as well as attorneys' fees and costs for the privilege review process.").

125. *Id*.

126. *See*, *e.g.*, *Waltzer*, 819 N.Y.S.2d at 40 ("A complete failure to disclose is not a prerequisite to the imposition of sanctions pursuant to CPLR 3126, the relevant factor being whether the failure to disclose relevant documents at issue was willful and contumacious.").

127. *See Zubulake*, 216 F.R.D. at 290 (stating "the responding party should *always* bear the costs of reviewing [for privilege] and producing electronic data once it has been converted to an accessible form.") (emphasis in original).

128. *Waltzer*, 819 N.Y.S.2d at 40.

129. N.Y. COMP. CODES R. & REGS. tit. 22, § 202.70(g)(8)(b).

130. *Id*.

as practicable."[131] On June 1, 2009, the Supreme Court, Nassau County, Commercial Division, published its own detailed local rules concerning ESI discovery.[132] In a dramatic departure from *Lipco*, which was also resolved in Nassau County, the court rules specify that ESI discovery costs are to be determined on a case-by case basis.

Accessibility

The distinction between accessible and inaccessible is "critical" in ESI discovery disputes.[133] A spectrum of accessibility exists; Judge Scheindlin identified a range of five categories, spanning the "easily" accessible to the inaccessible.[134] The level of accessibility is very much a function of the media on which the ESI is retained, as well as the database structure(s) and software used to retain it, with a correlation existing between the storage method and media selected, and the effort and cost of production.[135] Accessible ESI is data that is maintained in a usable format, such as on a hard drive, using "cloud" computing, flash memory and the like, and is retained in a manner that may be accessed relatively quickly. Alternatively, inaccessible data generally requires some sort of restoration or manipulation to render it usable, an undertaking which may require costly and time

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131. Nassau County Preliminary Conference Stipulation and Order (2009), *available at* http://www.nycourts.gov/courts/comdiv/PDFs/Nassau-PC-Order2-1-09.pdf.

132. Nassau County guidelines *available at* http://www.nycourts.gov/courts/comdiv/PDFs/Nassau-E-Filing_Guidelines.pdf.

133. Joint E-Discovery Subcommittee of The Association of the Bar of The City of New York, *Manual for State Trial Courts Regarding Electronic Discovery Cost Allocation* (Spring 2009), p. 4, *n*.6, http://www2.nycbar.org/Publications/pdf/Manual_State_Trial_Courts_Condensed.pdf.

134. *See Zubulake*, 217 F.R.D. at 318–19. (Judge Scheindlin identified an accessibility spectrum with five main categories: (1) active, online data; (2) near line data; (3) offline storage/archives; (4) backup tapes; and (5) erased, fragmented or damaged data); THE SEDONA CONFERENCE COMMENTARY ON: PRESERVATION, MANAGEMENT AND IDENTIFICATION OF SOURCES OF INFORMATION THAT ARE NOT REASONABLY ACCESSIBLE 10-11, n.42 (Thomas Y. Allman, et al. eds., July 2008)(*citing Zubulake*, 217 F.R.D. at 318–21), http://www.thesedonaconference.org. (click "Publications," log in required).

135. *Zubulake*, 217 F.R.D. at 318.

consuming processing.[136] Depending on the circumstances, tape backup or other similar disaster recovery media may host inaccessible data.[137] Previously deleted data is generally perceived as inaccessible.[138]

The 2006 amendment to the Federal Rules of Civil Procedure allows a party to avoid ESI production, through identification "by category or type, [of] the sources containing potentially responsive information that it is neither searching nor producing due to undue cost or burden."[139] The party who does opt to avoid production through this provision must demonstrate that the identified sources "are not reasonably accessible."[140]

The Uniform Rules of ESI discovery uses a balancing test for inaccessible ESI that echoes the principles of *Zubulake* and Fed. R. Civ. P. 26, to determine whether the "likely benefit of the proposed discovery outweighs the likely burden or expense, taking into account the amount in controversy, the resources of the parties, the importance of the issues, and the importance of the requested discovery in resolving the issues."[141] Even if there is a showing of reasonable inaccessibility by the party resisting production, it may nonetheless be compelled if an opponent can establish good cause for the materials it seeks.[142] However, even with good cause established, the costs of producing inaccessible ESI may be apportioned or

136. Robert Haig, *The Duty to Preserve Documents, Accessible and inaccessible electronic records*, 3 N.Y. PRAC., COM. LITIG. IN NEW YORK STATE COURTS § 25:28 (3d ed.), *citing* Allman, *The Sedona Conference Commentary*, *supra* note 134 (*citing Zubulake*, 217 F.R.D. at 318–21).

137. *Id*. ("Inaccessible data, on the other hand, is not readily usable. Backup tapes must be restored . . . fragmented data must be defragmented, and erased data must be reconstructed. That makes such data inaccessible.").

138. *Id*.

139. FED. R. CIV. P. 26(b)(2)(B) (Advisory Committee Notes – 2006). The permitted identification must be made with "enough detail to enable the requesting party to evaluate the burdens and costs of providing the discovery and the likelihood of finding responsive information on the identified sources." *Id*.

140. *Id*. *See* Peskoff v. Faber, 244 F.R.D. 54, 62 (D.C. 2007), *citing* FED. R. CIV. P. 26(b)(2)(B) (explaining that Rule 26(b)(2)(B) is "explicit" regarding the "obligation to search available electronic systems for the information demanded," which is excused only by establishing "undue burden or cost").

141. *See* Uniform ESI Discovery Rules, *supra* note 14, *Rule 8. Limitations on Discovery*.

142. FED. R. CIV. P. 26(b)(2)(B).

altogether allocated to the party seeking production, at the court's discretion.[143] Cost-shifting of this sort can bring discovery to a screeching halt, particularly when disputants are involved in arbitration with Broker-Dealers.

As financial services firms trend closer to paperless "cloud" computing, cost-shifting of the nature discussed in this article has the potential to eliminate ESI discovery in the securities arbitration context, as well as, for example, disputes involving "whistleblowing," and allegations of retaliation and discrimination, among various other civil rights and labor law claims where the relative means and power are lopsided. As one might imagine, the new identification rule is rife with potential for misuse because a party who elects to make inaccessibility designations in lieu of production is not required to first review the designated items, even those that are otherwise relevant and discoverable.[144]

Of course, such sharp practice tactics may cause a misguided advocate to run afoul of the good faith requirements in securities arbitration, especially if a party making such a designation cannot subsequently satisfy the burden to show an "undue burden or expense" as a result of feigned inaccessibility.[145] The burden or expense of discovery is deemed "undue," under the federal rules, if it "outweighs its likely benefit, considering the needs of the case, the amount in controversy, the parties' resources, the importance of the issues at stake in the litigation, and the importance of the discovery in resolving the issues."[146] *Zubulake* decisively led the way by eschewing cost allocation where the requested data is *accessible*, and the most widely employed multi-factor balancing test commences only upon a finding of inaccessibility.[147]

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143. Ervin A. Gonzalez and Patrick S. Montoya, *Ten Tips Leading to Efficient and Effective eDiscovery for the Small Law Firm*, TECHNOLOGY EREPORT, Vol. 6, No. 1 (April 2007), http://www.americanbar.org/content/newsletter/publications/technology_e_report_home/2007_apr_ediscovery.html.

144. *Id*.

145. FED. R. CIV. P. 26(b)(2)(B); FINRA Customer Code 12506(b)(2); NASD Notice to Members (NtM) 07-07 (Feb. 2007), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p018654.pdf.

146. FED. R. CIV. P. 26(b)(2)(B)(iii). *See generally*, *Peskoff v. Faber*, 244 F.R.D. at 62.

147. *Zubulake*, 217 F.R.D. at 318 ("[W]hether production of documents is unduly burdensome or expensive turns primarily on whether it is kept in an accessible or inaccessible format (a distinction that corresponds closely to the expense of production).").

Mindful of the omnipresent threat of abusive pre-hearing ESI discovery tactics, the most significant prophylactic measure one can take is perhaps to be well prepared to "win the battle of what is 'reasonably accessible.'"[148] Securities arbitration counsel would be well served to gain a sound understanding of an adversary's information technology early in the arbitration process and, if necessary, engage skilled experts who can convincingly contest speculative inaccessibility designations, especially when those tactical designations may later be revealed as disingenuous, and sanctions such as one or more adverse inferences, or perhaps worse, may be appropriate.[149] It is imperative for attorneys to obtain an independent understanding, as soon as possible, regarding any potential ESI issues that may arise within a dispute, including the methods and technology used by clients to store ESI, because courts expect that "counsel must become fully familiar with her client's document retention policies, as well as the client's data retention architecture," and must ensure that a client's compliance with proper discovery requests is timely.[150]

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148. Gonzalez, *et al*., *Ten Tips*, *supra* note 143.

149 *See*, *e.g.*, Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc., 2005 WL 679071 (Fla. Cir. Ct., Mar. 1, 2005). *See also* Susanne Craig, *How Morgan Stanley Botched a Big Case by Fumbling Emails*, WALL ST. J. (May 15, 2005), 5/16/05 APDATASTREAM 12:50:35 (via Westlaw AllNewsPlus database) *available at* http://academic.udayton.edu/lawrenceulrich/MorganStanley EmailsWSJ051605.htm ("As a result of what she described as Morgan Stanley's 'bad faith' actions, Judge Elizabeth Maass made an extraordinary legal decision: [s]he told the jury it should simply assume the firm helped defraud [the plaintiff]. . . . The New York Stock Exchange is investigating Morgan Stanley's contention in arbitration cases that reams of documents were lost in the Sept. 11 [2001] terrorist attacks. Morgan Stanley told one Kansas City [, Mo.] investor her files were destroyed even though there were no trades in her account until October [2001]. The firm blamed a 'simple and honest mistake,' apologized and agreed to settle."); *see* Corporate Counsel Technology Institute of Widener Univ. School of Law powerpoint presentation regarding the "Brooklyn tapes" and *Coleman (Parent) Holdings*, *Inc. v. Morgan Stanley & Co.*, *Inc*. (powerpoint download), *available at* http://www.cctinstitute.com/%2Fdocs%2FOct-09%2F/Coleman%20v.%20 Morgan%20Stanley.ppt; and *Sec. Exch. Comm'n v. Morgan Stanley & Co.*, *Inc.*, Civ. No. 060882 (D.D.C., May 10, 2006), *available at* http://www.sec.gov/ litigation/complaints/2006/comp19693.pdf.

150. FED. R. CIV. P. 16(b), 26(f), *Zubulake*, 229 F.R.D. at 432. *See* Anne Shea Gaza and Jason J. Rawnsley, *Local Practices for Electronic Discovery*, FEDERAL LAWYER 32 (Feb. 2011), *available at* http://www.fedbar.org/Federal-Lawyer-Magazine/2011/February/Features/featurearticle1-feb11.aspx?FT=.pdf; *and* 22

Expand "Easily Accessible" Record Retention Rules

The SEC and FINRA both have implemented specific electronic record retention requirements that do not consider Broker-Dealer or third-party discovery production burdens. For example, Exchange Act Rule 17a-4 requires preservation of all records of correspondence of a Broker-Dealer "relating to his business as such," which necessarily includes email and a host of other forms of electronic communication media, the first two years of which must be located in an "easily accessible" place.[151] Recently approved FINRA rule changes,[152] scheduled to take effect near the end of 2011, are indeed encouraging, but it is the opinion of the author that an enlarged "easily accessible" records retention period would substantially advance the goals of protecting the public interest and improving market confidence.[153]

The pertinent rules do not excuse Broker-Dealers from their prescribed document retention duties, or production to a regulator, even if the required archiving functions are outsourced to a vendor. FINRA members would be unlikely to demand that Congress, or the DOJ, SEC, FINRA, NYSE, CTFC,

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NYCRR 202.70(g)(1) ("Counsel who appear in the [New York] Commercial Division must be fully familiar with the case in regard to which they appear. . . .").

151. 17 C.F.R. §240.17a-4; SECURITIES EXCHANGE ACT OF 1934 ("Exchange Act"), 15 U.S.C. § 78a, *et seq*.

152. *See* SEC Release No. 34-63784; File No. SR-FINRA-2010-052, *Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Adopting FINRA Rules Regarding Books and Records in the Consolidated FINRA Rulebook* (Jan. 27, 2011), *available at* http://www.sec.gov/rules/sro/finra/2011/34-63784.pdf; FINRA Regulatory Notice 11-19 ("Books and Records"), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123548.pdf.

153. The SEC approved the new FINRA "Books and Records" rules in early 2011, based principally on NASD Rule 3110, NYSE Rule 440 and NYSE Rule Interpretations 410/01 and 410/02, as well as FINRA Rules 2268, 4511, 4512, 4513, 4514, 4515, 5340 and 7440(a)(4). The subject rule changes take effect on Dec. 5, 2011. *See FINRA Reg. Notice 11-19*, *supra* note 152; Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc., Order Approving a Proposed Rule Change Adopting FINRA Rules Regarding Books and Records in the Consolidated FINRA Rulebook, Exchange Act Release No. 63784, 76 Fed. Reg. 5850 (Feb. 2, 2011) ("SEC Approving Release"), *available at* http://www.sec.gov/rules/sro/finra/2011/34-63784.pdf. *See also* FINRA Regulatory Notice 08-25 ("Books and Records"), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038507.pdf.

or others, "foot the bill" for required document production it imprudently elected to make inaccessible whether internally, by an outside vendor, or otherwise. Consequently, it defies logic that an arbitration disputant, proceeding in an "equitable forum," should have to bear discovery costs of inaccessible data, especially if those records were made inaccessible in violation of SEC and SRO rules, and further, because FINRA includes a discrete requirement for all pre-hearing discovery activities to be undertaken in good faith, militating that "a party must act in good faith when complying with . . . this rule,"[154] and that any "frivolous delays, unreasonable timeframes or bad-faith objections [will] be subject to sanctions under the Customer Code."[155]

According to NASD Rule 3110[156] and NYSE Rule 440,[157] members have been required, since May 2003, to preserve all electronic communications[158] between a member firm and its customers, and retain those records in strict compliance with Exchange Act Rules 17a-3 and 17a-4.[159] This records preservation requirements call for registered Broker-Dealers to retain electronic records and correspondence between the firm and customer, including email,[160] for varying periods,[161] in an indexed, accessible, non-

154. FINRA Customer Code 12506(b)(2).

155. NASD Notice to Members (NtM) 07-07 (Feb. 2007), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p018654.pdf.

156. NASD Rule 3110, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3734.

157. NYSE Rule 440, http://nyserules.nyse.com/nyse/rules/.

158. There is no definition of "communications" found in section 3 of the Exchange Act (15 U.S.C. § 78c), or the FINRA Customer Code 12100, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4099.

159. 17 C.F.R. §§ 240.17a-3 and 240.17a-4.

160. Exchange Act Rule 17a-4, NASD Rules 3010, 3110 and FINRA Rule 3130, in combination, require members to implement archiving and monitoring systems to archive and supervise all electronic communications, which necessarily includes data created by email, attachments, instant messaging (BBM, AOL, MSN, Yahoo!, etc.), chat rooms, blogs, bulletin boards, social media sites, website links, Bloomberg,® Thomson Reuters,® BlackBerry,® social media and more. *See FINRA Guide to the Internet for Registered Representatives*, (July 12, 2010), http://www.finra.org/industry/issues/advertising/p006118; *Division of Trading and Markets Broker-Dealer Net Capital and Books and Records Guidance*, http://www.sec.gov/divisions/marketreg/bdnetcapital.htm; *see*, *e.g.*, *The Message Archiver & Compliance Reviewer Broker Dealer, Compliance Solutions for email*

rewriteable and non-erasable format that preserves the original records.[162] NASD Rule 3010 also requires electronic communications supervision and review for non-compliant language and enforcement of internal email correspondence policies.[163]

There is no direct SEC authority pertaining to electronic communication supervision. The SEC apparently believes, or at least it *did* believe in 1996, when the Internet was still in its infancy, that "the rules concerning the supervisory requirements for electronic communications should be based on the content and audience of the message, and not merely the electronic form of the communication. . . . [suggesting] as a practical matter, [communications that] replace or substitute for telephone conversations, in many cases would not require advance authorization or prior supervisory review."[164]

It seems highly unlikely, especially subsequent to email intensive matters such as the recent Abacus CDO enforcement litigation,[165] and the now

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and instant message record management, http://www.globalrelay.com/files/Broker-Dealer-Compliance-Email-Archiving.pdf. Exchange Act Rule 17a-3 identifies approximately 22 specific types of records which must be retained by FINRA members.

161. Rule 17a-4 requires a Broker-Dealer to maintain all communications received and copies of all communications sent that relate to the Broker-Dealer's "business as such" for three years (the first two years of which such records must be kept in an "easily accessible place"), and certain other records must be retained for longer periods. *See* Exchange Act Section 17(a)(1) and Exchange Act Rules 17a-3 and 17a-4.

162. *See* SEC Release No. 34-38245; File No. S7-21-93, *Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934*, 17 CFR Part 240, *available at* http://www.sec.gov/rules/final/34-38245.txt; s*ee also* Leonor Ciarlone, *Eliminating the Fear Factor: Creating a Culture of Compliance* 7 (Nov. 2006), http://www.omtool.com/miDocs/White_Paper_Eliminating_the_Fear_Factor_Creating_a_Culture_of_Compliance.pdf.

163. *See FINRA Guide to the Internet*, *supra* note 160.

164. Use Of Electronic Media By Broker-Dealers, Transfer Agents, And Investment Advisers For Delivery Of Information; Additional Examples Under The Securities Act Of 1933, Securities Exchange Act Of 1934, And Investment Company Act Of 1940, Securities Exchange Act Release No. 7288, 61 SEC Docket 2167, 2168 and n.5 (May 9, 1996).

165. *See* Sec. Exch. Comm'n v. Goldman Sachs & Co., et al., S.D.N.Y. civil case no. 1:10-cv-03229 (Complaint), *available at* http://sec.gov/litigation/complaints/2010/comp21489.pdf.

infamous email exchange between former Goldman Sachs executive Thomas Montag[166] and co-worker Daniel Sparks, in which Montag exclaimed, "boy, that timeberwof [*sic*] was one shitty deal," about a product sold to its clients. Montag's remark was cited repeatedly by United States Senator Carl Levin, during an April 27, 2010 Senate Committee hearing,[167] that the SEC would continue to view electronic communications as some innocuous medium supplanting telephone chatter, unworthy of supervision or being subject to prudent record retention policies and regulatory access.[168] Interpretive letter guidance provided to a member, by FINRA (NASD) Associate General Counsel Eric Moss, indicates the SRO views these rules as permitting: "examining staff *immediate access* to required [electronic] books and records; . . . [and] to download and print hard copies of required books and records."[169]

One important yet relatively uncomplicated policy step, at least in the abstract, toward protecting the investing public, enhancing market integrity and improving securities regulation, would be to enlarge the records retention period, pursuant to section 17(a)(1) of the Exchange Act and Exchange Act Rules 17a-3 and 17a-4, beyond that of the imminent December 5, 2011 rule change, during which members and associate persons must maintain records in an "easily accessible" place, from the current 2-3 years to 6 years.[170]

166. Thomas K. Montag, Officer and President, Global Banking and Markets, Bank of America Corp.; Director, BlackRock, Inc. (current), http://people.forbes.com/profile/thomas-k-montag/52920.

167. *See* MATHEW TAIBBI, GRIFTOPIA: BUBBLE MACHINES, VAMPIRE SQUIDS, AND THE LONG CON THAT IS BREAKING AMERICA 236 (2010) ("'You knew it was a shitty deal and that's what your emails show,' Senator Levin barked."); *see also* Mathew Goldstein, *Goldman's Timberwolf Deal Leads to Much Howling*, REUTERS (Apr. 27, 2010), http://www.reuters.com/article/2010/04/27/us-goldman-twolf-idUSTRE63Q5C320100427 ; Henny Sender and Francesco Guerrera, *Goldman Seeks to End Fund Row*, FIN. TIMES (Apr. 29, 2010), http://www.ft.com/cms/s/0/d9ec 75fa-5326-11df-813e-00144feab49a.html#axzz1TGIawhpc.

168. *See*, *e.g.*, EDWARD PEKAREK AND CHRISTOPHER LUFRANO, THE GOLDMAN SACHS SWAPS SHOP: AN EXAMINATION OF SYNTHETIC SHORT SELLING THROUGH CREDIT DEFAULT SWAPS AND IMPLICATIONS OF SEC V. GOLDMAN SACHS & CO., *ET AL*., Chapter Two, THE SHORT SELLER HANDBOOK, Elsevier Publishing (forthcoming 2011).

169. FINRA Interpretive Letter, *Permissibility of Electronic Approval of Accounts under NASD Rule 3110(c)(1)(C)* (June 4, 2002), http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002556 (emphasis added).

170. *See* FINRA Customer Code 12206(a):

Exchange Act § 17(a)(1) requires registered Broker-Dealers to create and retain such records, for prescribed periods, as the SEC deems "necessary or appropriate in the public interest, for the protection of investors."[171]

An encouraging aspect of the forthcoming rule change is that FINRA members will be required to retain records for a period of at least six years, for all such books and records required to be preserved by FINRA rules for which no period is specified under applicable Exchange Act rules.[172] Moreover, the revised rules will require members to preserve customer account information that has been updated, for at least six years after any such update, and to retain the most recently updated set of customer account information (or original account information if no updates were made) for at least six years after the date an account is closed.[173]

Expanding the extent of the retention rules to require relevant books and records to be stored for six years in an "easily accessible" place would provide faster access for the SEC, FINRA, as well as other SROs, exchanges and state regulators, as well as greater insight into the workings of Wall Street and would likely enhance detection efforts. Enacting this type of reform will invariably face tremendous obstacles, including financial services industry lobbyist pressure,[174] especially as an SEC staff recommendation was

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> Time Limitation on Submission of Claims
>
> No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this rule.

171. Exchange Act § 17(a)(1), 15 U.S.C. § 78q(a)(1), *available at* http://www.sec.gov/about/laws/sea34.pdf.

172. *FINRA Reg. Notice 11-19*, *supra* note 152; FINRA Rule 4511(b).

173. *FINRA Reg. Notice 11-19*, *supra* note 152; FINRA Rule 4512.

174. Not surprisingly, members of the defense bar have rumbled about *exclusions* of records that should be retained, such as all internal and external email communications, although the cited source is from early 2008, before the recent housing and securities bubbles deflated. *See* Ben A. Indek, *SIFMA Compliance & Legal Division 2008 Annual Seminar*, *Electronic Communications* 21 (Jan. 17, 2008), http://www.morganlewis.com/pubs/Electronic_Communications_ presentationII.pdf:

In a March 23, 2007 letter . . . SIFMA's E-Records Modernization Task Force . . . proposed additional revisions to [Exchange Act] Rule 17a-4(b)(4), including:

already made (January 2011), pursuant to section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, urging the SEC to consider harmonization of certain record retention requirements for Broker-Dealers and Investment Advisers.[175] Considering today's highly charged and polemic political climate, and the depth of the "let's pretend the financial crisis never happened" attitude pervasive among many in and around the beltway, meaningful reform that aims to impose any new regulatory record-keeping burdens will likely be met with hysteria in some legislative circles.[176]

Irrespective of the present political will, or lack thereof, to implement meaningful Wall Street reform on the topic of records retention, among

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> (1) an expansion of the retention *exclusion* to include external emails as well as internal emails;
>
> (2) the *exclusion* from retention of emails of legal and compliance personnel who support functions outside the scope of the revised proposal. . . ;
>
> (3) the *exclusion* of email to and from internal audit staff; and
>
> (4) a proposal that would require firms to implement policies and procedures that describe the functions that are excluded from the firms' retention program.

Id. (emphasis added).

175. SEC staff, *Study on Investment Advisers and Broker-Dealers*, *As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* at 139 (Jan. 2011), http://www.sec.gov/news/studies/2011/913studyfinal.pdf:

> Recommendation: The Commission should consider whether to modify the Advisers Act books and records requirements, including considering a general requirement to retain all communications and agreements (including electronic communications and agreements) related to an adviser's 'business as such,' consistent with the standard applicable to [B]roker-[D]ealers.

Id.

176. Mark Schoeff Jr., *Fiduciary duty skepticism crosses the aisle*, INVESTMENT NEWS.COM (May 18, 2011), http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20110518/FREE/110519918

("They need to move forward and protect consumers," Rep. Carolyn Maloney, D-N.Y said. "What we're seeing [ ] is almost a case of 'let's pretend the financial crisis never happened.'").

others, an enlarged records retention period of this nature would eliminate many, if not most, ESI discovery cost allocation disputes in securities arbitration. This is so, irrespective of the future of "requester pays" in New York and elsewhere, and would ultimately provide a vastly more equitable dispute resolution forum for investors.

A conclusive ruling from the New York Court of Appeals, and/or an unambiguous promulgation of a new CPLR provision, as was recommended emphatically in the February 2010 report, *Electronic Discovery in the New York State Courts*,[177] would also eliminate the continued ambiguity pertaining to ESI discovery cost allocation issues in New York. Such a development would necessarily reduce motion practice on these issues, and likely diminish the time parties waste in FINRA arbitration bickering over ESI discovery cost-shifting, which needlessly delays what is intended to be a speedy proceeding.

No "Requester" for Presumptively Discoverable Material

FINRA has emphasized its newly revised *Discovery Guide* as a primary means to expedite the arbitration process, minimize costs, ensure fairness and encourage expedient dispute resolution.[178] The FINRA *Discovery Guide* lists identify the materials deemed by the SRO to be "presumptively discoverable"[179] and FINRA arbitrators are encouraged to order production "unless in the exercise of discretion, the arbitrator believes there is good cause not to order production."[180] It would be disingenuous for a party to maintain an adversary is a "requester," for cost-shifting purposes, or otherwise, when it pertains to materials delineated by the FINRA *Discovery*

177. *See Electronic Discovery in the New York State Courts*, *supra* note 96.

178. DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 9-5, 9-3 (5th ed. 2009).

179. FINRA Regulatory Notice 11-17, *Revised Discovery Guide and Document Production Lists for Customer Arbitration Proceedings* (Effective Date: May 16, 2011), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123505.pdf ("Document Production List 1 specifies the presumptively discoverable documents that firms/associated persons are required to produce in customer cases.")

180. ROBBINS, *supra* note 178, at § 9-14, 9-17.

Guide.[181] The *Discovery Guide* creates an obligation to produce these presumptively discoverable documents *without any request*.

FINRA is an "Equitable Forum"

Respected securities arbitration academic and founder of the Pace Investor Rights Clinic (PIRC), Professor Barbara Black, observed recently that "[a]rbitration is an equitable forum; investors are not required to state a legal cause of action, and arbitrators are not required to apply the law."[182] Professor Black, with her long-time esteemed colleague, Professor Jill I. Gross, noted years earlier that ". . . less attention is paid to the law and more to the equities of the actual dispute before the arbitration panel."[183] Another respected academic observed that the *FINRA Arbitrator Manual* quoted Aristotle for his concept of equity, highlighting the following Athenian axiom that FINRA has featured over the years:

> Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks to the law, and the reason why arbitrators were appointed was that equity might prevail.[184]

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181. N.B. Many of the *Discovery Guide* categories parallel those identified by Exchange Act Rules 17a-3 and 17a-4.

182. Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 68 (2010).

183. Barbara Black and Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 995 (2002).

184. Constantine N. Katsoris, *Securities Arbitrators Do Not Grow On Trees*, 14 FORDHAM J. CORP. & FIN. L. 49, 52 (2008), *citing Sec. Indus. Conference on Arbitration [SICA], The Arbitrator's Manual* (Aug. 2007). *But see*, Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 123, 145 (2005), *citing Sec. Indus. Conference on Arbitration [SICA]*, *The Arbitrator's Manual 2* (2005) ("In spite of the lack of current statistically significant evidence as to whether arbitrators are applying the law, there are many reasons to believe that they are not. First, each new NASD arbitrator is provided with a copy of the SICA Arbitrators Manual that begins with a reminder to arbitrators that they can ignore the law if fairness so requires.").

The May 2011 iteration of the *FINRA Arbitrator Reference Guide*[185] includes this same equity favoring maxim, and counsel for FINRA has echoed similar remarks in recent years.[186] FINRA has also publicly adopted this position as an organization during the rule-making process.[187]

The July 2010 volume of the manual, *FINRA Dispute Resolution Basic Arbitrator Training*, makes extensive references that encourage arbitrators to utilize equitable principles to resolve ESI discovery issues, underscoring the emphasis FINRA places on equity as its dispute resolution guidepost.[188] The training manual also suggests strongly that to resolve discovery production disputes, arbitrators must initially determine whether a document request is *reasonable*, by first considering the relevance of requested document(s), or its potential to lead to relevant evidence. Only after making that threshold determination, is an arbitrator directed to employ a proportionality test that balances the cost(s) and/or burden(s) of the requested discovery, with a suggestion that the responding party should carry the burden to establish the relevancy of any requested document(s) is somehow disproportionate with its cost or burden.[189]

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185. *FINRA Arbitrator Guide* (May 2011), http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p009424.pdf.

186. Mignon McLemore, Assistant Chief Counsel, FINRA Dispute Resolution, *Response to SEC Deputy Secretary, Florence Harmon RE: Comments, File No. SR-FINRA-2007-021 – Proposed Rule Change to Amend Rules 12206 and 12504 of the Code of Arbitration Procedure for Customer Disputes and Rules 13206 and 13504 of the Code of Arbitration Procedure for Industry Disputes to Address Motions to Dismiss and to Amend the Provision of the Eligibility Rule Related to Dismissals*, at 12 (Sept. 15, 2008), http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p116990.pdf ("Because arbitration is an equitable forum, the panel may consider any evidence or use any method to achieve a fair result").

187. *See* 74 Fed. Reg. 731, 740 (Jan. 7, 2009), *available at* http://edocket.access.gpo.gov/2009/pdf/E9-12.pdf.

188. FINRA Dispute Resolution, Basic Arbitrator Training (July 2010) (on file with author). Readers can contact FINRA personnel to request a copy (Jisook Lee at 212.858.5121 or jisook.lee@finra.org).

189. FINRA, Basic Arbitrator Training, *supra* note 188, at 24:

> To determine whether a document request is reasonable, your first goal will be to determine whether the document is relevant or likely to lead to relevant evidence.
>
> Only after determining that documents are relevant, or likely to lead to relevant evidence, should you consider the cost or burden

The current *FINRA Arbitrator Reference Guide* makes the following statement about ESI cost allocation: "[i]n making any rulings on objections, the chairperson may consider the relevance of documents or discovery requests and the relevant costs and burdens to parties to produce this information."[190] Simply put, a bright-line "requester pays" rule is an inequitable policy when the economic disparity between disputants operates to vanquish fundamental fairness and the search for truth. "Requester pays" is a concept that has no business in an equitable forum such as FINRA, where members are supposed to "observe high standards of commercial honor and just and equitable principles of trade."[191] It may only be an appropriate cost allocation method in rare instances, such as discovery of only the most inaccessible ESI and discovery requests made to certain non-parties,[192] and even then, arbitrators should be encouraged strongly to employ equitable principles when resolving ESI discovery issues of this ilk, on a case-by-case basis, where "requester pays" is a decidedly narrow exception.

FINRA ESI Policy

FINRA Case Administrator Manager of the Northeast Region, Rachel Glasgow, recognized correctly in the January 2008 issue of *The Neutral Corner*, that ESI was elevated to a distinct discovery category by the 2006 amendments to the Federal Rules of Civil Procedure.[193] In her article,

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> of production. *If a party has demonstrated that the cost or burden of production is disproportionate* to the need for the documents, see whether there are alternatives that can lessen the impact, such as narrowing the relevant time frame or scope of the request, or whether other documents can provide the same information.

Id. (emphasis added).

190. *FINRA, Arbitrator Guide*, *supra* note 185, at 24.

191. FINRA Conduct Rule 2010, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.

192. *See*, *e.g.*, *FINRA Arbitrator Guide*, *supra* note 185, at 53; FINRA Customer Code 12513, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4167.

193. *See* Rachel Glasgow, *Electronic Discovery*, THE NEUTRAL CORNER, Jan. 2008, http://www.finra.org/ArbitrationMediation/Neutrals/Education/NeutralCorner/P037817 (emphasis added).

Electronic Discovery, Glasgow identified a number of key ESI types, including: email; website pages; word processing files; databases stored in the memory of computers; magnetic disks, optical disks; flash memory; and metadata.[194] Ms. Glasgow also indicated that "arbitrators must balance the potential relevance of the evidence against the accessibility of the information," and encouraged arbitrators to use discretion to "decrease the burden and cost of production."[195]

As mentioned above, a more recent issue of *The Neutral Corner* included an article, also titled, *Electronic Discovery*, in which its author identified the importance of reasonable discovery requests and the concept of proportionality, while noting "the *Zubulake* decisions have set *the standards nationwide* for courts dealing with e-discovery, and the concepts outlined in these opinions may be applicable to arbitrations when addressing e-discovery issues."[196] It is believed to be the first recognition by FINRA of the importance of *Zubulake* in the context of ESI discovery cost allocation disputes; formerly it had suggested a less comprehensive approach.[197] This too demonstrates another eminently well-reasoned departure from "requester pays."

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194. *Id*.

195. *Id*., *citing* Barbara J. Rothstein, Ronald J. Hedges and Elizabeth C. Wiggins, *Managing Discovery of Electronic Information: A Pocket Guide for Judges*, FEDERAL JUDICIAL CENTER (2007), http://www.fjc.gov/public/pdf.nsf/lookup/eldscpkt.pdf/$file/eldscpkt.pdf . According to Ms. Glasgow, FINRA arbitrators should consider:

> ways to decrease the burden and cost of production by limiting the scope and time frame of the requested information. . . . whether the information can be obtained from a more convenient, less burdensome or less expensive source . . . any available alternatives, the benefits and drawbacks of these alternatives and the usability of the produced format.

Id.

196. Irene C. Warshauer, *Electronic Discovery*, 2 THE NEUTRAL CORNER, at 1-6 (2011), http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p123535.pdf.

197. ROBBINS, SECURITIES ARBITRATION, *supra* note 178, at § 9-18, *How FINRA Recommends Parties Can Deal With ESI Discovery Issues* ("[W]henever appropriate, arbitrators may shift the cost to the requesting party, narrow broad requests and encourage cooperation and discussion among counsel.")

"Corporate Defendants Benefit Most"

There has been significant noise regarding the escalating costs of litigation from the defense bar, with louder voices in the din maintaining that if only a "requester pays" standard was implemented nationally, "efficient" justice would then be served.[198] More than one corporate defense attorney has already acknowledged publicly that "corporate defendants benefit most" from *Lipco* and its legacy.[199] Yet the *Federation of Defense & Corporate Counsel*, an entity describing itself as "[a]n organization of recognized leaders in the legal community dedicated to representation of insurers and corporations,"[200] has recognized recently that "cost-shifting may effectively end discovery,"[201] especially when opposing parties are not financial equals. It urges that "courts must use cost-shifting wisely and only in appropriate circumstances."[202] An ABA publication reached similar conclusions recently, quoting a salient *Zubulake* passage:

> Courts must remember that cost-shifting may effectively end discovery, especially when private parties are engaged in litigation with large corporations. As large companies increasingly move to entirely paper-free environments, the frequent use of cost-shifting will have the effect of crippling discovery in discrimination and retaliation cases. This will both undermine the 'strong public policy favor[ing] resolving disputes on their merits,' and may ultimately deter the filing of potentially meritorious claims.[203]

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198. *See*, *e.g.*, Troy, *Seize the Moment*, *supra* note 110.

199. Michael C. Miller et al., *The Price of Discovery in New York Courts: Requester pays' rule may not be ironclad but take advantage of it whenever possible*, NY LAW J. (Oct. 4, 2010), *available at* http://www.law.com/jsp/nylj/PubArticleNY.jsp?id=1202472615798.

200. FEDERATION OF DEFENSE & CORPORATE COUNSEL, *About Us*, http://www.thefederation.org/process.cfm?pageid=2269.

201. David M. Fuqua and Whitney L. Foster, *Five Pillars of E-Discovery*, 27 (2011), *quoting Zubulake*, 217 F.R.D. at 317-18, http://www.thefederation.org/documents/document.cfm?DocumentID=292.

202. Fuqua et al., *Five Pillars of E-Discovery*, *supra* note 201.

203. Gonzalez, *et al*., *Ten Tips*, *supra* note 142, *quoting Zubulake*, 217 F.R.D. at 317, *citing* Pecarsky v. Galaxiworld.com, Inc., 249 F.3d 167, 172 (2d Cir. 2001).

Many of the clients and prospective clients who come to a non-profit *pro bono* securities arbitration clinic such as PIRC are often desperate for help and have nowhere else to turn, while facing life-changing losses as a result of alleged broker misconduct. Many are unsophisticated retirees who have lost a substantial portion of their savings and who cannot afford to pay hundreds, let alone hundreds of thousands of dollars for ESI discovery to prove they were the victim of wrongdoing. Even where an order permits a prevailing party to tax its opponent(s) for discovery costs, disputants of modest means may be economically barred from obtaining the documentary evidence necessary to assert claims successfully in order to become a prevail party.

Informational Asymmetry of Securities Arbitration

Asymmetrical information exists in "situations where one economic agent knows something that another economic agent doesn't."[204] While increased transparency can offer investors some protection against asymmetric information,[205] a customer who is not a trained securities industry professional is unlikely to even know what records should be sought in securities arbitration. As detailed *supra*, Broker-Dealers are required to maintain a host of different record types within the course of business, but many of these record types are identified by industry jargon or acronyms, rendering them meaningless to the untrained eye. A customer typically possesses few records that are relevant to a securities arbitration claim, beyond trading confirmations, account statements, customer agreements, correspondence and perhaps a prospectus, are often all that the customer has to independently establish misconduct. As such, a customer, or her representative, must generally obtain the proof to support a claim from the opponent(s), who, not surprisingly, are less than enthusiastic about handing over evidence of wrongdoing, should any exist. Within the volumes of records kept by FINRA members may well exist the "smoking gun" of

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204. Paul B. Marrow, *Determining if Mandatory Arbitration is "Fair": Asymmetrically Held Information and the Role of Mandatory Arbitration in Modulating uninsurable Contract Risks*, 54 N.Y.L. SCH. L. REV. 187, 188 (2009/2010), *citing* Hal R. Varian, *Microeconomics Analysis*, 440 (3d ed. 1992).

205. Bernard Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91, 96 (1998).

actionable misconduct, or perhaps something more akin to the fabled "needle in the haystack."[206]

The "requester pays" concept, particularly within the context of a retail customer's securities arbitration claim, can function as an effective bar to discovery (and recovery), and unfairly stacks the deck against a claimant who might otherwise prevail with a meritorious claim, if only the records were revealed. Few things are more inequitable than truth triumphed by economic disparity.[207] This is especially true at a time when "many individual investors perceive the stock market as rigged, with scant confidence in regulators to fix it."[208] Structural inequities, such as the "requester pays" *Lipco* legacy, can only serve to further erode the public's faith in market integrity and threaten the long-term legitimacy of Wall Street, which has become increasingly viewed as a Las Vegas casino, where the "house" always wins.[209] The practical effect of "requester pays" contradicts the "strong public policy" that favors dispute resolution based on the merits,[210] and that contradiction may ultimately deter the filing of potentially

206. G. T. Northup, *Miguel de Cervantes Saavedra: A Memoir. by James Fitzmaurice-Kelly* 29 MODERN LANGUAGE NOTES 145-48 (May, 1914) (book review), *available at* http://www.jstor.org/stable/2917031.

207. *See*, *e.g.*, Donald N. David, *New York Evidence in the Electronic World*, NEW DEVELOPMENTS IN EVIDENTIARY LAW IN NEW YORK, 2011 WL 1574299, at *6 (2011 ed), *citing* David D. Siegel, NEW YORK PRACTICE, § 353, at 578 (4th ed. 2005) ("Professor David D. Siegel, the long-acknowledged guru and author on New York civil practice, who provided, among other things, many of the practice commentaries to the McKinney's version of the Civil Practice Law and Rules, notes that the 'judicial preference' is to require parties to individually pay their own costs associated with the disclosure process and to ultimately allow the prevailing party on the merits to tax such expenses as disbursements and recover them from the losing side.").

208. Patti Domm, *Investors Lack Confidence in Regulators to Fix Markets*, CNBC.COM (Sept. 14, 2010), http://www.cnbc.com/id/39154764/Investors_Lack_Confidence_in_Regulators_to_Fix_Markets; and Peter Gorenstein, *Is The Market Rigged? Survey Says … 'Yes!'*, THE DAILY TICKER (May 5, 2011), http://finance.yahoo.com/blogs/daily-ticker/market-rigged-survey-says-yes-130546433.html (Almost half of 400 investors surveyed worldwide (47%) "found one-on-one meetings with companies regularly lead to price sensitive ['inside'] information being divulged, according to the Rotterdam School of Management.").

209. *The House Always Wins in Vegas and on Wall Street*, MOTLEY FOOL (Mar. 4, 2010), http://caps.fool.com/blogs/the-house-always-wins-in-vegas/349520.

210. Pecarsky v. Galaxiworld.com Ltd., 249 F.3d 167, 172 (2nd Cir. 2001).

meritorious claims, allowing misconduct without consequences, and further reducing what is already a dismal level of public confidence in the domestic capital markets.

Conclusion

The best analytical framework for resolution of ESI discovery cost allocation disputes prudently weighs the benefits and expenses of the ESI discovery sought, guided by a sense of equity and proportionality, both as to the difficulty and cost of production, when determining whether to mandate production, and if so, who should bear the cost. New York courts, as well as tribunals in jurisdictions throughout the United States, are recognizing that ESI discovery is being used as a tactical weapon to bludgeon opponents with costs and distractions.

Informational asymmetry is manifest in securities arbitration, where industry disputants possess the overwhelming majority of documents that are used at hearing to prove that misconduct occurred. Moreover, the relative economic resources of arbitration disputants are typically disparate. This dynamic often leaves a customer-claimant facing the unenviable task of attempting to obtain the proof they were harmed and how that injury was suffered, from a well-financed and potentially recalcitrant respondent. It may also have the effect of discouraging the assertion of valid claims, and offending the "judicial preference" for resolving disputes on the merits. FINRA has recently acknowledged publicly, in its quarterly resource aimed at informing neutrals, that the *Zubulake* framework "set the standards nationwide."

The supposed "general rule" since 2004 in New York has only added inequity. Customer-claimants may be on the receiving end of an application from a Broker-Dealer respondent who seeks to have the customer bear the costs of the respondent's document production. The "rule" was created from whole cloth by a trial court that identified the leading federal authorities on the subject of ESI discovery cost allocation, yet disregarded them all, to instead create a "simpler," yet fallacious and harmful doctrine based on "nothing more than a hearsay statement." For a time, as ESI discovery cost disputes grew in number, other New York courts followed this "rule," apparently without questioning its circular reasoning and other flaws, although that ended convincingly when Justice Eileen Bransten resolved the ESI issues in *MBIA v. Countrywide*.

There has been a swelling sea change in the legal community's perception of "requester pays" recently, including in New York. Leaders on the federal bench have developed a rich body of analytical work that includes the elegant framework offered by *Rowe*, *Zubulake* and their progeny, which exposed the threadbare wardrobe of a short-lived emperor. A host of other influential organizations, comprised mainly of jurists and attorneys, have methodically advanced the enlightened approach of a multi-factor balancing test, especially for ESI that is somehow inaccessible. This is true in New York, as well as in other jurisdictions, and these developments are additional signs that "requester pays" in this state is an imminent anachronism.

FINRA aims to offer investors an equitable forum for dispute resolution, but "requester pays" in the same jurisdiction as Wall Street is anything but equitable. The SEC and the SROs require members to retain a variety of records, for an initial, albeit too brief, period located in an "easily accessible" place. The prevailing authorities in this area are in general accord that the producing party should bear the production cost of such readily available ESI. It is my opinion that the required period of "easily accessible" records retention should be enlarged to track the time limits in the eligibility rule that governs claims in FINRA arbitration. While pragmatism strongly suggests such reform is not feasible in the current political climate, the notion that enlarging the records retention period is not economically feasible is confounded with the advent of affordable "cloud" data hosting. The future of an "efficient" capital market is darkened with substantially declining investor confidence, but efforts to improve the degree of equity for the investing public, including reforms such as an enlightened ESI discovery mechanism, may help to illuminate the horizon.

While we may not have reached the doctrinal tipping point just yet, it is abundantly clear that "requester pays" is fast approaching its twilight. The times they are a changin' and the tide has certainly shifted.

Notes & Observations

A SUMMARY OF THE SEC STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS

Christine Lazaro[1]

I. Introduction[2]

For some time, there has been a debate over what the appropriate standards of care are and should be for both broker-dealers and investment advisers. The standards vary based on where the investment professional is, where the customer is, what types of services are being offered and what responsibilities are assumed. Across the country, there is a complete lack of uniformity. Congress considered this when drafting the Dodd-Frank Wall Street Reform and Consumer Protection Act[3]. Accordingly, pursuant to Dodd-Frank, Congress required the SEC (the "Commission") to conduct a study to examine the current standards of care for both brokers and investment advisers and determine if there were any gaps in the current system. On July 27, 2010, the Commission sought public comment to evaluate "the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, and persons associated with them when providing personalized investment advice and recommendations about securities to retail investors; and whether there are gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for these intermediaries."[4] In response, the Commission received over 3,000 individual comments and over 500 form comments. The Commission also met with a number of groups, including PIABA.

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1. Christine Lazaro is a Supervising Attorney in the Securities Arbitration Clinic at St. John's University School of Law, where she supervises students who represent investors in arbitration claims against brokers. Ms. Lazaro also serves as chairwoman on PIABA's SRO/Legislation Committee and is a member of the New York State Bar Association's Securities Litigation and Arbitration Committee.

2. Members of PIABA's Dodd-Frank Fiduciary Standard Subcommittee contributed to the summary, specifically, Hugh Berkson, Glenn Gitomer, Christine Lazaro, Jeffrey Pederson, Howard Rosenfield, Henry Simpson, Mindy Steuer, Bill Young, and the Chairman of the subcommittee, Joe Peiffer.

3. P.L. 111-203.

4. *S.E.C. Release No. 34-62577; IA-3058*, "Study Regarding Obligations of Brokers, Dealer, and Investment Advisers", available at http://www.sec.gov/rules/other/ 2010/34-62577.pdf.

The Commission issued its report, the "Study on Investment Advisers and Broker-Dealers" (the "Study"), to Congress on January 21, 2011.[5] The Study examined fourteen different items, as directed by Dodd-Frank. The final product was 208 pages long. It examined the current landscape of regulation of both broker-dealers and investment advisers; it looked at the perceptions of investors; and made recommendations. The Study recommended enactment of a uniform fiduciary standard that would apply to both broker-dealers and investment advisers when providing personalized investment advice about securities to a retail customer. The intricacies and the details of this recommendation will be discussed in further detail below.

What follows is a summary of the Study, beginning with the substantive section of the Study, section II. To the extent practical, the headings below following the headings included within the Study. The recommendations referenced and the opinions discussed are those included within the Study, and are not necessarily shared by the contributors to this article.

II. Overview of the Current Business and Regulatory Landscape

A. Current Business Landscape for Investment Advisers and Broker-Dealers

The Study's description of the investment adviser regulatory framework reveals that every regulation stems from the fundamental concept that investment advisers maintain a fiduciary standard obligating them to put their clients' interests before their own. Accordingly, every possible conflict must be revealed so that the client is well informed before hiring the investment adviser, much less accepting the investment adviser's advice.

The Study's description of the broker-dealer framework is very different. The key in the difference in the Study's view of investment advisers and broker-dealers is encapsulated in the following quote from the Study: "Under the antifraud provisions of the federal securities laws and SRO rules, including SRO rules addressing just and equitable principles of trade, broker-dealers are required to deal fairly with their customers."[6] This statement, while at first blush innocuous, reveals the key. Per this statement, the Study presumes that broker-dealers are under no obligation to put their customers'

5. "Study on Investment Advisers and Broker-Dealers", available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

6. See, the Study, p. 50.

interests first. Rather, broker-dealers are simply obligated to treat their customers fairly. The Study notes that the duties and obligations have been developed through Commission and SRO pronouncements, rules, interpretive decisions, opinions, enforcement action orders and, finally, common law. The Study concedes that common law may impose a fiduciary duty under certain circumstances, depending on state law. The Commission and SRO structure does not itself impose or recognize a fiduciary duty for broker-dealers.

1. Investment Advisers

Investment advisers provide a wide range of advisory services to both individuals and institutions. According to the Study, there are more than 11,000 investment advisers registered with the Commission, and they manage more than $38 trillion for more than 14 million clients. There are an additional 275,000 investment adviser representatives registered with states, and more than 15,000 state-registered investment advisers. Of the Commission registered investment advisers, 75% manage individual and small business portfolios. Approximately 92% of the assets under management were in discretionary accounts.[7]

Investment advisers also manage portfolios of pooled investment vehicles. Investment advisers may provide financial planning and pension consulting services, sponsor or manage wrap fee programs, and publish periodicals or newsletters. Over 95% of the registered investment advisers charge fees to clients based on the percentage of assets under management.[8]

2. Broker-Dealers

Broker-dealers handle accounts for both retail and institutional investors. According to the Study, at the end of 2009 broker-dealers held approximately 110 million customer accounts. The Commission oversees approximately 5,100 broker-dealers with over 600,000 registered representatives. Of the 5,100 registered firms, 985 have indicated that they engage in, or expect to engage in, investment advisory services. [9]

7. See, the Study, pp. 6 – 7.

8. See, the Study, p. 7.

9. See, the Study, p. 8.

The products and services offered by broker-dealers fall into two broad categories, brokerage services and dealer services. The Study defines a broker as one who acts as an agent for someone else, and a dealer as someone acting as principal for its own account. Broker-dealers may offer a variety of both brokerage services and dealer services. Broker-dealer compensation is generally transaction-based, earned through commissions, mark-ups and mark-downs, and sales loads. There is no charge for advice that is incidental to the transactions.

The Study recognizes that broker-dealers offer services to a broad range of retail customers, which may include inexperienced investors seeking basic brokerage services and recommendations as well as investors with aggressive investment objectives or unique situations seeking sophisticated investment strategies.

3. Dual Registrants

Many financial services firms offer both investment advisory and broker-dealer services. Approximately 5% of Commission registered investment advisers reported that they were also registered as a broker-dealer, and 22% reported that they had a related person that was a broker-dealer. Approximately 18% of FINRA registered broker-dealers were also registered as investment advisers. Approximately 37% of FINRA registered broker-dealers had an affiliate engaged in investment advisory activities. Approximately 88% of investment adviser representatives were also FINRA registered representatives.[10]

The Study indicates that a number of large financial services firms reported that some of their customers maintain multiple types of accounts and relationships with them. Some of these customers may receive advice from "dual-hatted" personnel that are subject to both investment adviser and broker-dealer regulations. This may provide some benefits for the customers, but may also raise conflicts for the dual registrants that need to be managed.

10. See, the Study, p. 12.

B. Commission and SRO Regulation of Investment Advisers and Broker-Dealers

1. Investment Advisers

a) Overview of Commission Regulation

The Advisers Act was the last in the series of federal statutes which were meant to eliminate the abuses that Congress believed led to the crash of 1929 and the Depression. The objective of the Advisers Act was to protect investors against wrongdoing by those paid to provide advice.

A person or firm who falls within the definition of "investment adviser" must register under the Advisers Act unless either it is exempt from registration or is prohibited from registering. Investment advisers register under the Advisers Act by completing a Form ADV.

Investment advisers may use persons to help solicit clients and prospective clients for advisory services. Because of the inherent conflicts of interest that exist in the investment adviser – solicitor relationship, they must enter into a written agreement requiring the solicitor to make certain disclosures to prospective clients.

b) Regulation Related to the Provision of Personalized Investment Advice to Advisory Clients

The Supreme Court has construed the Advisers Act as establishing a federal fiduciary standard which governs the conduct of investment advisers. According to the Study, the fiduciary standard applies to the entire relationship between the investment adviser and the client. Fundamental to the federal fiduciary standard are the duties of loyalty and care. The duty of loyalty requires an investment adviser to serve the best interests of his clients. The duty of care requires that an investment adviser make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.

The investment adviser must fully disclose to its clients all material information that is intended to eliminate, or at least expose, all conflicts of interest (or potential conflicts of interest) which might incline an investment adviser to offer advice that was not disinterested.

Investment advisers are restricted when entering into principal and agency-cross trades with their clients. If an investment adviser acts as principal on its own account, it must disclose to its client prior to the transaction being completed the capacity in which it is working, the compensation it is receiving and obtain the client's consent. With regard to agency-cross trades, the investment adviser need not receive transaction by transaction consent, but rather may obtain blanket consent which is renewed annually.

Investment advisers owe their clients the duty to provide suitable investment advice. The investment adviser must disclose its investment process to clients, including its methods of analysis and investment strategies. Investment advisers also have the duty to seek best execution for transactions where the investment adviser has the responsibility to select broker-dealers to execute trades, such as when the account is a discretionary account. Investment advisers are also prohibited from using any advertisement that contains any untrue statement of a material fact or is otherwise false and misleading.

Commission registered investment advisers are subject to record-keeping rules. Additionally, investment advisers must have established supervisory procedures which are designed to prevent violations of the federal securities laws and their rules and regulations. Investment advisers must also adopt a written code of ethics. On the Form ADV, investment advisers must disclose information about the disciplinary history of the firm and its personnel.

When an investment adviser has authority to vote a client's proxies, the investment adviser must cast the proxy votes in a manner consistent with the best interests of the client. Investment advisers must disclose to clients how they are compensated for their services. Moreover, investment advisers must charge fees that are fair and reasonable, and must disclose if the adviser's fee is higher than others. When an investment adviser enters into an advisory contract with a client, the contract may not be assigned without the client's consent. To the extent a contract contains a mandatory pre-dispute arbitration clause, the language in the contract must be clear that such clause does not constitute a waiver of any right provided in the Advisers Act.

Investment advisory clients generally do not have a private right of action for damages and other monetary relief against the investment adviser under the Advisers Act, however, clients have a limited private right of action to void the contract and obtain restitution of fees paid. Clients may seek to enforce claims against an investment adviser under the Securities Exchange Act of 1934 (the "Exchange Act") to the extent there is fraud in connection with the purchase or sale of a security. Clients may also pursue state common law or statutory claims against investment advisers.

2. Broker-Dealers

a) Overview of Commission and SRO Regulation

The Exchange Act generally requires broker-dealers to register with the Commission and an SRO. Associated persons must also, as a general rule, register. Finders, those intermediaries who "find" potential investors, must also register. Before approving the membership application, the SRO must consider the firm's ability to: adhere to the applicable rules and regulations, maintain sufficient capital to operate; maintain financial controls; put in place and effectuate a sufficient compliance and supervisory structure; keep proper records; and enforce continuing education standards. The SRO must also consider any other information it has that would lead to a conclusion that the applicant may fail to adhere to the rules and regulations. Broker-dealers, as opposed to investment advisers, need not maintain a stated ethical code.

b) Regulation Related to the Provision of Personalized Investment Advice and Recommendations to Retail Customers

Where the investment adviser framework is based on the fiduciary duty, the law and custom applicable to broker-dealers is based on fairness. The Study addresses the duty to treat clients fairly in some detail. The discussion serves to highlight the difference between such a duty and a fiduciary one. For example, the Study indicates that the antifraud provisions of federal securities law impose a duty for the broker-dealer to deal fairly with a client. The Study states: "Actions taken by the broker-dealer that are not fair to the customer must be disclosed in order to make this implied representation of fairness not misleading."[11]

SRO rules obligate broker-dealers to observe "high standards of commercial honor and just and equitable principles of trade." In practical terms, the broker-dealer must:

- have a reasonable basis for the recommendation in light of a customer's financial situation to the extent known to the broker (suitability);
- engage in fair and balanced communications with the public;
- provide timely and adequate confirmation of transactions;

11. See, the Study, p. 51.

- provide account statements;
- disclose conflicts of interest;
- receive fair compensation both in agency and principal transactions; and
- give customers the opportunity to arbitrate their claims.

FINRA is imbued with the power to enforce these "just and equitable principles of trade."

The Study addresses the antifraud provisions of the Exchange Act, noting that they broadly prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. If there is to be a fiduciary duty imposed, it stems from common law. The Study describes the instances in which courts will find the existence of a fiduciary duty: "Generally, courts have held that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, owe customers a fiduciary duty."[12]

According to the Study, the extent of the broker-dealers' duties stems from the nature of the relationship with the customer. For example, addressing conflict of interest disclosures, the Study notes that if the broker-dealer processes orders but does not recommend securities or solicit customers, the material information to be disclosed is narrow and relates only to the consummation of the transaction. Such a broker-dealer would not have to disclose information about the security or its own economic self-interest in the transaction. But, if the broker-dealer recommends a security, it must "give honest and complete information," and must disclose "material adverse facts of which it is aware."[13] Generally speaking, when recommending a security, the broker-dealer must disclose its own economic interests in the trade, such as whether it will be acting as a principal; third-party compensation paid; whether there is revenue sharing for a mutual fund; and the expenses related to the class of security offered. The Study concludes that such disclosures "allows customers to verify the terms of their transactions and provides disclosure on potential conflicts of interest."[14]

Certain conflicts are acceptable if disclosed (i.e., third party compensation, broker-dealer control, interest or affiliation in the security offered, and conflicts arising from analyst recommendation of securities). However, there are also conflicts that cannot be disclosed away. Broker-

12. See, the Study, p. 54.

13. See, the Study, p. 55.

14. See, the Study, p. 57.

dealers cannot recommend securities they themselves issue, nor can they provide gifts or payment to gain securities business. Broker-dealers cannot borrow money from or loan money to a customer unless there are written procedures in place addressing such transactions. Regulation M generally prohibits those with an interest in an offering from engaging in certainly activities during the security's distribution (in order to avoid price manipulation). Broker-dealers are also prohibited from extending credit to allow customers to buy new issues – thereby discouraging the manufacture of a high demand for the offering.

A broker-dealer's duty to only recommend suitable securities stems from the antifraud provisions of the federal securities laws and the SRO rules. Suitability determinations are fact-specific. The Study seemingly distinguishes an offer from a recommendation: "The more individually tailored the communication to a specific customer or targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a 'recommendation.'"[15] Reading between the lines, it seems that the Study would not find a suitability obligation for securities offered, but not recommended.

The Study addresses what it deems three approaches to suitability under common law: reasonable basis suitability, customer specific suitability and quantitative suitability. Under the first, the broker-dealer must have investigated the security and have adequate information concerning the security recommended. Under the second, the broker-dealer must make inquiry concerning the customer and make a recommendation based on the customer's response. The third requires a broker-dealer that maintains actual or de facto control over a customer account to have a basis to believe the amount of trading in a customer's account is suitable. In other words, churning is a quantitative suitability issue.

Broker-dealers must charge fair and reasonable prices, violations being deemed violations of the antifraud provisions. For example, undisclosed equity markups of more than 10% are deemed fraudulent. Lower markups can be considered fraudulent depending on the circumstances. Markups on debt securities in excess of 4 to 5% are probably fraudulent. "Unfair or unreasonable" underwriting compensation is fraudulent and broker-dealers are obligated to disclose all underwriting compensation in a prospectus. In essence, all aspects of a firm's compensation are subject to scrutiny – including non-cash compensation.

15. See, the Study, p. 60.

The broker-dealer's duty of fairness extends to best execution. While the security price is the dominant factor, other factors are considered in determining best execution, including the order size, speed of competing markets, trading characteristics of the security, availability of information regarding competing markets, availability of competing markets, and cost of access to competing markets.

In its communications with the public, broker-dealers must avoid misleading statements which would violate the antifraud provisions of the securities laws. Such communications must be "fair and balanced."[16] Communications must include material facts and qualifications, not predict or project performance, or make exaggerated claims. Certain broker-dealer communications must be filed with FINRA for approval. For example, a broker-dealer's first year of communications must be approved. Preapproval is also required for registered investment companies, CMOs, security futures and bond mutual funds including bond mutual fund volatility ratings. Other communications must simply be filed with FINRA, such as advertisements regarding registered investment companies, public direct participation programs and government securities. The Study notes that 99,000 communications were reviewed by FINRA in 2008. Of these, 476 investigations were performed regarding 2,378 separate communications.[17]

There are various administrative requirements applicable to broker-dealers, such as the records retention requirements. Broker-dealers must also maintain a certain amount of net capital. The purpose of net capital is described: "to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from SIPC."[18]

The administrative requirements described in the Study also include the broker-dealer's supervision and compliance systems. Broker-dealers must not only establish policies and procedures reasonably designed to detect and prevent violations of laws and regulations, but they must actually enforce those policies and procedures. The policies and procedures must be tested on an ongoing basis to ensure they work.

The supervision obligations must include supervision of outside business activities. Associated persons with outside business relationships must disclose them to the broker-dealer for approval. Such relationships are

16. See, the Study, p. 71.

17. See, the Study, p.72.

18. See, the Study, p. 73.

acceptable unless they interfere or compromise the associated person's responsibilities to the broker-dealer and its customers, or if it would be viewed by the public as part of the broker-dealer's business. Broker-dealers may prohibit outside business activities if circumstances so warrant. Additionally, there are testing and continuing education requirements for associated persons. Customer complaints must be maintained and reported under the requisite rules. Forms BD and U4 are used for the disclosure of certain disciplinary and complaint information.

The Exchange Act provides a private right of action, but violations of the act require proof of scienter. Under Section 17(a) and 10(b) and Rule 10b-5, a misrepresentation or material omission, made with scienter, must be demonstrated. The Study distinguishes violations of FINRA rules, which do not contain a scienter element. The Study explains the difference: "[W]hile the suitability obligation under the federal securities laws arises from the antifraud provisions, the SRO rules are grounded in concepts of ethics, professionalism, fair dealing and just and equitable principles of trade, which gives SROs more authority in dealing with the suitability issues."[19]

The Study properly concludes that arbitration is the *de facto* standard because of the opening account documents used by almost all firms. Arbitrations commonly are based on rule violations, without the scienter requirement. While the SRO rules don't provide a private cause of action in court, plaintiffs often use them to establish a standard of care in the negligence context. SRO rules require that awards be paid within 30 days, with the revocation or suspension of membership serving as a penalty for failure to make payment.

C. State and Other Regulation of Investment Advisers and Broker-Dealers

1. Investment Advisers

a) Overview of State Regulation Intended to Protect Clients

Most small investment advisers are prohibited from registering with the Commission and, instead, are registered and regulated by state regulators. States also retain authority over Commission registered investment advisers under state investment adviser statutes.

19. See, the Study, p. 62.

States generally impose requirements upon state-registered investment advisers that are similar to those imposed by the Advisers Act, however, the requirements do vary by state. States also generally impose registration, licensing or qualification requirements on the investment adviser representatives who are doing business within the state.

b) Other Federal and State Regulation Intended to Protect Advisory Clients

Certain investment advisers are subject to ERISA if they exercise authority or control over the management or disposition of employee benefit plans which are subject to ERISA, provide investment advice for a fee with respect to the plan assets, or have discretionary responsibility or authority to administer a plan.

2. Broker-Dealers

a) Overview of State Regulation Intended to Protect Retail Customers

The Commission has non-exclusive jurisdiction over broker-dealers. Every state requires broker-dealers and their agents to be registered with or licensed by the securities regulators of the states in which they conduct business. If an existing customer is temporarily in another state, the broker-dealer need not register with that state. States may also impose bonding, net capital, custody, financial statement reporting, and recordkeeping requirements on broker-dealers, however, they must conform to federal law.

b) Other Federal and State Regulation Intended to Protect Retail Customers

Broker-dealers are generally not considered fiduciaries for ERISA purposes, as traditional recommendations would not be considered investment advice under ERISA. A broker-dealer may be considered a fiduciary under ERISA if it exercises discretion beyond that permitted under the regulations.

III. Retail Investor Perceptions and Confusion Regarding Financial Service Provider Obligations and Standard of Conduct

The Commission had been studying retail investor perceptions of the standards of care applicable to investment advisers and broker-dealers and their representatives through survey evidence and focus groups for a number of years.

The Study notes that baby boomers control roughly $13 trillion in household investable assets, over 50% of US household investment assets, and nearly one in every six Americans will be 65 or older by the year 2020.[20] The Study points out that many retail investors do not understand or are confused by the different standards of care applicable to investment advisers and broker-dealers and their respective associated persons.

A. Investor and Investor Advocate Comments

Through publicly solicited comments, many investors stated that they did not understand the standards of care applicable to investment advisers and broker-dealers, found the standards of care confusing, and were uncertain about the meaning of the multiple titles used by investment advisers and broker-dealers.

B. Commission-sponsored Studies

1. Siegel & Gale, LLC and Gelb Consulting Group, Inc. Study

Siegel & Gale, LLC and Gelb Consulting Group, Inc. were retained by the Commission in 2004 to conduct focus group testing. The focus group participants had the same issues as those raised by investors in the publicly solicited comments, namely that they did not understand that the roles and legal obligations of investment advisers and broker-dealers are different, and that the different titles used are confusing. The participants also did not understand terms such as “fiduciary”.

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20. See, the Study, pp. 93 – 94.

2. RAND Report

The Commission retained RAND in 2006 to conduct a study of broker-dealers and investment advisers.

a) Firm Analysis

RAND found it difficult to identify with certainty the business practices of investment advisers and broker-dealers. RAND noted that it could be difficult for investors to understand the differences in the services provided by financial firms as the information was not presented uniformly, with some firms providing so much information it would be difficult to process and others providing scant information. RAND found that the firms believed investors tend to trust a particular firm without necessarily understanding the firm's services and responsibilities.

b) Investor Survey

Survey respondents and focus group participants reported that they did not understand the differences between investment advisers and broker-dealers, and found the titles used confusing. Focus group participants noted that "the interchangeable titles and 'we do it all' advertisements made it difficult to discern broker-dealers from investment advisers."[21] Participants also did not understand the legal duties owed to investors by investment advisers and broker-dealers. "The primary view of investors was that the financial professional – regardless of whether the person was an investment adviser or a broker-dealer – was acting in the investor's best interest."[22]

c) RAND's Conclusion

RAND came to the conclusion that the "financial services market had become more complex over the last few decades in response to market demands for new products and services and the regulatory environment."[23]

21. See, the Study, p. 98.

22. See, the Study, p. 98.

23. See, the Study, p. 99.

Therefore, there has been a blurring of the distinctions between investment advisers and broker-dealers.

C. CFA Survey

Industry advocates and certain industry groups also conducted a survey. The results of the survey again suggest that investors do not understand the differences between investment advisers and broker-dealers, nor do they understand that there are differing standards of conduct related to each.

D. Conclusion

The Study indicates that, based on the comments, studies and surveys, investors do not understand the differences between investment advisers and broker-dealers. This is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[24] The Study concludes that "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It is also important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."[25]

IV. Analysis and Recommendations

A. General Differences in Investment Adviser and Broker-Dealer Regulation

As discussed above, investment advisers and broker-dealers are subject to different regulations. Investment Advisers are fiduciaries to their clients and are regulated under the Advisers Act. There is generally a principles-based approach to regulating investment advisers. An investment adviser

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24. See, the Study, p. 101.

25. See, the Study, p. 101.

must eliminate, or at least disclose, all conflicts of interest that might incline an investment adviser to render advice that is not disinterested.

Broker-dealers are typically not fiduciaries to their clients except in rare instances. Broker-dealers are governed through the Commission's antifraud authority in the Securities Act of 1933 and the Exchange Act as well as SRO rules based on Exchange principles. Theirs is characterized as a predominantly rules-based approach that focuses on rules embodying principles of fairness and transparency to relationships between broker-dealers and their customers. Federal securities laws and SRO rules address broker-dealer conflicts in three ways: express prohibition, mitigation, and disclosure.

B. Standards of Conduct

The main difference in the standard of conduct between the two is that investment advisers are held to a fiduciary duty and broker-dealers generally are not. The fiduciary duty of an investment adviser includes both the duty of loyalty as well as the duty of care. On the other hand, a broker-dealer's standard of conduct is primarily characterized as an obligation to deal fairly with customers and to observe high standards of commercial honor and just and equitable principles of trade. Broker-dealers are also subject to a number of specific obligations including a duty of suitability, as well as requirements to disclose certain conflicts.

The Commission Staff believes the differences are significant and not well understood by retail customers. Investors generally expect that an investment professional is acting in their best interests. With this background in mind, the Commission Staff made the following recommendation[26]:

> The Commission should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:
>
>> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interests

26. See, the Study, pp. 109 – 110.

> of the customer without regard to the financial or other interests of the broker, dealer, or investment adviser providing the advice.

The Study states that such a standard would not have any direct bearing on other persons who may be characterized as fiduciaries other than investment advisers and broker-dealers. In addition, the uniform fiduciary standard would overlay on top of the existing investment adviser and broker-dealer regimes and would supplement, and not supplant them. It balances concerns about the impact of regulatory change on investor access to low-cost products and services by not per se eliminating particular products, services, or compensation schemes.

C. Implementing the Uniform Fiduciary Standard

The uniform fiduciary standard should contain, at a minimum, the duties of loyalty and care that are encompassed in the duty as it is applied to investment advisers. The Commission Staff recommends that the Commission provide guidance on the components of the uniform fiduciary standard through both rule making and interpretive guidance.

1. Duty of Loyalty

The duty of loyalty is a fundamental aspect of the fiduciary standard under the Advisers Act. To comply with the duty of loyalty, broker-dealers would have to eliminate or disclose material conflicts of interest. Commission-based compensation does not violate the fiduciary standard. Nor does the fiduciary standard require that a broker-dealer have a continuing duty of care or loyalty after providing personalized investment advice.

a) Disclosure

The Staff recognizes that there are various disclosures currently made by both investment advisers and broker-dealers at different times throughout the relationship with the customer. The Staff also recognizes that the disclosures need to be clear and consistent. The Staff recommends a uniform approach to disclosure that would provide the customers of both investment advisers and broker-dealers key information at the outset of the relationship and at appropriate times thereafter.

The Staff also recommends that the Commission explore the utility and feasibility of a summary disclosure document that would describe in clear, summary form, a firm's services, charges, and conflicts of interest. The Staff believes it is the firm's obligation, and not the customers', to ensure that material conflicts of interest are fully, fairly and clearly disclosed so that they are understood. The Staff recommends that the Commission consider whether certain conflicts should be prohibited, and when it may be appropriate to impose specific disclosure and consent requirements.

b) Principal Trading

Dodd-Frank section 913 (g) required the Commission to consider a fiduciary standard no less stringent than Advisers Act Sections 206 (1) and (2), however, it omitted 206 (3), which refers to principal trading. The Staff interprets this as a Congressional intent not to mandate the restrictions regarding principal trading against broker-dealers, although the Commission has the authority to do so.

The Staff recognizes that principal trading has the potential for raising conflicts of interest. The Staff recommends that, at a minimum, under a uniform fiduciary standard, a broker-dealer should disclose its conflicts of interest, but it would not necessarily need to follow the same specific notice and consent requirements of the Advisers Act. The Staff does recognize that broker-dealers would remain subject to the obligations related to suitability, best execution, and fair and reasonable pricing and compensation when engaging in principal trading.

The Staff recommends that the Commission offer specific rulemaking and/or guidance as to how a broker-dealer may engage in principal trading and fulfill its fiduciary duty. The Staff also recommends that the Commission revisit the principal trading rules as they apply to investment advisers and determine if those rules should be changed.

2. Duty of Care

Both investment advisers and broker-dealers have duties of care, which incorporate among other things, a duty to investigate, a duty of best execution, and a duty to charge reasonable prices. The Staff recommends that the Commission specify the minimum professional obligations of investment advisers and broker-dealers under the duty of care, either through rulemaking and/or guidance.

The Staff recommends that the Commission develop professional standards regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice. The Staff also recommends that the Commission explicitly provide that any rulemaking or guidance is meant to provide a minimum expectation for the appropriate standard of conduct and would not establish a safe harbor or otherwise prevent the Commission from applying a higher standard of conduct based on specific facts and circumstances.

3. Personalized Investment Advice About Securities

The Staff recommends that the Commission define "investment advice" through rulemaking and/or interpretive guidance. While the Advisers Act focuses on investment advice, the broker-dealer regulatory regime focuses on recommendations. Under the uniform fiduciary standard, the term "personalized investment advice about securities" could be interpreted in a way that is consistent with the scope and interpretive history of both regulatory regimes.

At a minimum, the definition should encompass the making of a recommendation, as developed under the broker-dealer regulation, but should not include "impersonal investment advice" as developed under the Advisers Act. Additionally, other actions or communications which would be considered advice under the Advisers Act should be included in the definition.

a) Retail Customers

The Staff recommends that the Commission define "retail customer". The Staff recommends that the Commission also specify that advice provided to a group of retail customers under circumstances in which members of the group reasonably would believe that the advice is intended for them should be covered by a uniform fiduciary standard. Additionally, the Staff recommends that the Commission consider whether the standard should be extended to persons other than retail customers.

4. Investor Education

The Staff recommends that the Commission continue its investor education initiatives. The Staff suggests that the Commission design improved curriculum materials to assist retail investors, sponsor investor education workshops, and work in partnership with non-profit and community organizations to implement financial literacy programs designed to help investors understand the uniform fiduciary standard.

D. Harmonization of Regulations

This section addresses additional areas of differences between current investment adviser and broker-dealer regulations.

1. Advertising and the Use of Finders and Solicitors

a) Advertising and Other Communications

The Staff has reviewed the differences between investment adviser and broker-dealer regulations relating to advertising. Current differences include the following:

- Under certain circumstances, a registered principal of a broker-dealer must approve a communication before distributing it to the public, and certain communications must be filed with FINRA for approval. No such requirements exist for investment adviser communications.
- Specific content restrictions may differ. For example, investment advisers are prohibited from using testimonials in advertisements and restricted in using past specific recommendations. Broker-dealers are not prohibited from using testimonials. As another example, there is less detailed and extensive guidance regarding the use of performance information and the circumstances under which performance information is considered misleading for broker-dealers, than there is for investment advisers.

The Staff recommends that advertising and customer communication rules and guidance should be made consistent for broker-dealers and investment advisers. At a minimum, internal pre-use review requirements should be consistent and/or investment advisers should be required to designate employees to review and approve advertisements.

b) Use of Finders and Solicitors

The Staff has reviewed differences in regulations regarding the use of finders and solicitors. Currently, a solicitor/finder who causes an investor to retain the services of a broker-dealer must itself register as a broker-dealer. A solicitor/finder who causes an investor to retain the services of an investment advisory firm is not required to register as an investment adviser. However, the solicitor must disclose material conflicts, the adviser has an obligation to supervise the solicitor, and the adviser must treat the solicitor as an associated person to the extent the solicitor acts as such. The Staff recommends that the Commission should consider whether to provide additional guidance or harmonize existing requirements so as to ensure that retail customers understand the conflicts associated with solicitors/finders.

2. Remedies

The Staff has looked at the differences in remedies under current law. Current differences include the following:

- Broker-dealer customers typically are required to arbitrate before FINRA and FINRA rules require broker-dealers to arbitrate with customers, and prescribe the content and form of pre-dispute arbitration clauses in customer agreements. No such requirements exist for clients of investment advisers.
- Broker-dealer customers have private rights of action under certain provisions of the Exchange Act; investment adviser clients have a very limited private right of action under the Advisers Act.
- Broker-dealers are required by FINRA rules to pay awards within 30 days of receipt or face suspension or cancellation of membership. Investment advisers do not face such sanctions.

While the above differences are noted, the Staff does not recommend any action in this regard because Dodd-Frank section 921 (relating to ending or limiting agreements which require customers to arbitrate disputes) provides the Commission with the opportunity to review these issues in greater detail.

3. Supervision

The Staff has reviewed differences in supervisory requirements between broker-dealers and investment advisers. Broker-dealers have more specific supervisory requirements than investment advisers under current law. The Staff recommends that the Commission should consider adopting a single set of universally applicable requirements for supervision. Alternatively, the Commission should consider whether supervisory structure requirements should be scaled based on the size and nature of the broker-dealer/investment adviser.

4. Licensing and Registration of Firms

The Staff has reviewed differences in requirements for the licensing and registration of firms. Currently, investment advisers register on Form ADV part 1 and broker-dealers register on Form BD. Broker-dealers must also satisfy FINRA's membership requirements, which include presenting a business plan and description of the nature and source of capital, the financial controls to be employed, the supervisory system and copies of certain procedures, a membership interview, compliance with applicable state licensing, establishment of a supervisory system and a membership agreement. Investment advisers are not subject to this level of review.

The Staff does not believe that requiring a uniform form for both broker-dealers and investment advisers would help to protect investors. The Staff believes a uniform form would create confusion and be burdensome for firms who are not already dual registrants. However, in instances where the forms ask for the same or similar information, they should be made as uniform as feasible. The Staff believes a more substantive review of investment adviser registration applications could improve investor protection but it is not feasible for the Commission to undertake this responsibility without additional resources. Nonetheless, it recommends that the Commission consider requiring a more substantive review.

5. Licensing and Continuing Education Requirements for Persons Associated with Broker-Dealers and Investment Advisers

The Staff has reviewed the differences between licensing and continuing education requirements for persons associated with broker-dealers and investment advisers. Associated persons of broker-dealers must be registered with FINRA, disclose their employment and disciplinary histories and keep such disclosures current, meet qualification requirements to effect securities transactions and fulfill continuing education requirements. No comparable requirements exist for investment adviser personnel.

The lack of uniform federal licensing and continuing education requirements for investment adviser personnel may be a gap in regulation, but the Staff recognizes that the Commission does not have the infrastructure, nor the resources to administer an education and testing program. However a private organization could develop such a program. The Staff therefore recommends that the Commission could consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.

7. Books and Records[27]

There are currently differences in books and records requirements. Broker-dealers must retain all communications received and sent and all written agreements relating to a firm's business as such. Investment adviser retention rules are more limited. The Staff recommends that investment advisers should be required to retain the same books and records as broker-dealers.

E. Alternatives to the Uniform Fiduciary Standard

This section considers the options of repealing the broker-dealer exclusion and/or imposing the standard of care applied under the Advisers Act for providing personalized investment advice about securities and other requirements of the Advisers Act upon broker-dealers.

The Staff recognizes that while the foregoing options could have certain benefits (i.e. dividing financial services into two categories, simplifying regulation, helping to reduce investor confusion), any such benefits would be outweighed by the potential negative outcomes. Such potential drawbacks include: 1)they could prevent the Commission from evaluating the existing regulatory regimes and applying the best elements of each to investment advisers and broker-dealers; 2) they might result in fewer investor choices; and 3) they would likely be more costly for investors and the industry (see Section V). The Staff also believes the uniform fiduciary standard would provide investor protection and be a better approach in achieving uniform regulation.

27. There is no number 6 in the Study.

V. Cost Analysis

This section discusses the costs that could be incurred by investors, broker-dealers, investment advisers, and their associated persons as a result of the Commission's adoption of the uniform fiduciary standard. The Costs Analysis essentially makes the following observations based upon comments, academic sources, and reports the Commission received:

- Commentators expressed a view that adoption of the uniform fiduciary standard would generally increase administrative and compliance costs to broker-dealers.
- Commentators have expressed a concern about the potential increase in litigation expenses, which may result from the adoption of the uniform fiduciary standard.
- Commentators have indicated that adoption of the uniform fiduciary standard would increase insurance costs for broker-dealers.
- The Study noted that application of the uniform fiduciary standard to broker-dealers might cause them to register as investment advisers and possibly de-register as broker-dealers. This may result in brokerage accounts being converted into investment advisory accounts subject to advisory fees. This conversion may involve certain upfront fees to the converting customers.
- The Study noted that the industry's increased compliance and administrative costs might be passed along to the retail investors and result in reduced services and products, which may no longer be profitably provided.
- As a result of these increased costs, broker-dealers might decide not to sell securities and bonds as a principal, resulting in a lower quality of execution.
- Custodial fees may be imposed on accounts which are not subject to an investment advisory fee or accounts may be subject to investment advisory fees regardless of the level of trading in those accounts, leading to the potential of "reverse churning."
- Any additional costs which may be passed on to the retail customer would negatively impact the profitability of their investments.

Notwithstanding these additional costs and burdens, the Staff recommends the adoption of the uniform fiduciary standard.

HOW SAFE ARE YOUR SAVINGS?
HOW COMPLEX DERIVATIVE PRODUCTS IMPERIL SENIORS' RETIREMENT SECURITY

John F. Wasik[1]

SUMMARY

For far too long, brokers have been selling their older clients complex investments known as "structured products." Structured products are the black boxes that bedeviled Wall Street in 2007-2008 on a nearly catastrophic level. They continue to be sold in smaller packages to Main Street investors. While some of them may manage risk to some degree, they are difficult to understand and pose myriad risks to unsuspecting investors. These products are so risky, and so costly in fees, that some of them are almost sure money losers. They entered retirement portfolios like Trojan horses, and then destroyed people's life savings. Yet the financial meltdown of 2008 has not chastened Wall Street. Brokers and banks continue to sell these high-risk investments to people who can't afford major losses. Last year, banks and brokers sold more than $52 billion of these products —including at least $32 billion by the top banks alone — mostly because they are hugely profitable to the banks and brokers themselves.

Individual investors have lost at least $113 billion and counting from Wall Street's most toxic retail investments, which go by myriad names such as reverse convertibles and principle-protected notes or enhanced notes. Actual losses could be ten times that, since most burned investors don't confront their brokers or win back their money.

Many individual investors are still struggling to recover catastrophic losses suffered from investing in complex derivative-based vehicles that tanked in 2008. Now, long after the top banks were bailed out and

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Editors Note: This is a rapidly evolving subject. Shortly after the study was prepared, FINRA and the SEC issued investor alerts on structured notes. The State of Georgia has subpoenaed UBS, Ameriprise and Morgan Stanley regarding reverse convertibles. See generally, http://www.investmentnews.com/article/20110721/FREE/110729986, http://www.sec.gov/investor/alerts/structurednotes.htm and http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P123947.

1. John F. Wasik is an award-winning investigative writer, columnist for Reuters and the author of THE CUL-DE-SAC SYNDROME: TURNING AROUND THE UNSUSTAINABLE AMERICAN DREAM (*www.johnwasik.com*) and twelve other books.

recapitalized by taxpayers and the Federal Reserve, Wall Street continues to sell these dangerous complex products, which lie in wait, ready to unleash a shocking new wave of financial pain.

This latest round of Wall Street chicanery involves opaque derivatives once sold exclusively to sophisticated institutional investors, who only held small portions of them in multi-billion-dollar portfolios. In recent years, these complex "structured" derivative products — wagers based on other financial instruments — have been repackaged by Wall Street as ways to preserve principal for yield-starved Main Street investors.

Few investors fully understand what they've been sold, or understand that these products are like a ticking time bomb. When these products are sold to seniors, as they frequently are, it threatens their retirement security, as the investments are loaded with risky derivatives and contain no viable income guarantees. Even when investors discover that they've lost money, the system is designed to thwart efforts to recover such losses.

This trend was documented by more than a year's worth of research involving interviews with investors, state securities regulators, investors' attorneys and officials with the Securities and Exchange Commission (SEC). This paper examines what these investments are, how they are sold and what Congress and the SEC need to do to protect investors.

INTRODUCTION

Greed meets unbridled trust. This has been the narrative in thousands of cases where older, income-oriented investors turned their money over carte blanche to brokers, who consistently and methodically abused their client relationships.

Far too often, brokerage houses have left high-commission-generating brokers unsupervised, allowing brokers to peddle investments labeled "safe and secure" that can easily blow up and shatter the retirements of older investors.

Though these products are being sold by nearly every large bank and brokerage house — including such bailout recipients as Goldman Sachs and Bank of America — they are far too complicated and risky for the average investor.[2] Most investors who buy these vehicles have no idea how they work or how unsecure they are.[3]

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2. This article does not refer to any structured vehicles that carry FDIC insurance.

3. Jean Eaglesham, *Complex Bond Faces Regulators' Scrutiny*, THE WALL STREET JOURNAL (March 31, 2011).

As wages have stagnated and pensions have evaporated, investors feel less secure, vulnerable to the impact of undersaving, unemployment or market downturns. Portfolios are not only falling short in terms of retirement goals, they are not keeping up with the cost of living. And when investors feel financially insecure, they are more likely to buy higher-yield vehicles in an attempt to make up shortfalls. Because their confidence and retirement kitties are bruised, they take more risk in hopes of gaining higher returns.

Historically low yields on savings vehicles like certificates of deposit have further eased the way for the sale of structured products.[4]

Millions are vulnerable to the suggestion that they can quickly close the gap in their retirement savings.

According to the 2011 Retirement Confidence Survey, from the Employee Benefit Research Institute, confidence is at the most pessimistic level ever measured in nearly two decades of conducting the survey.[5]

Most of these products come under the loosely defined title of "complex income-oriented" or "structured notes." They are derivatives (based on the value of a stock, bond or index) combined with an underlying investment such as a bond, stock or index.*

The first wave of structured product losses was triggered by the September 2008 failure of Lehman Brothers, the biggest bankruptcy in US history. Lehman had sold unsecured debt in the form of so-called "principal protected notes" through brokers. When the firm collapsed, all of the notes became worthless. Investors lost billions, and have only begun to see compensation from the brokerage houses that sold them the notes.

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4. Mark Whitehouse, *Fed's Low Interest Rates Crack Retirees' Nest Eggs*, THE WALL STREET JOURNAL (April 4, 2011), http://online.wsj.com/article/SB10001424052748703410604576216830941163492.html.

5. *Retirement Confidence*, EMPLOYEE BENEFIT RESEARCH INSTITUTE (2011) http://www.ebri.org/pdf/surveys/rcs/2011/FS1_RCS11_Confidence_FINAL1.pdf .

Table 1 *STRUCTURED PRODUCT SALES BY TOP SELLERS*[6]
(January – November, 2010)

Provider	**Sales** (in billions)	**Market Share**
Morgan Stanley	$8.38	18%
Bank of America	$7.46	16%
Barclays	$6.32	13%
JP Morgan	$4.21	9%
Goldman Sachs	$3.97	8%

Source: Structuredretailproducts.com, November 24, 2010.

In April of this year, securities regulator FINRA fined UBS Financial Services $2.5 million and ordered the firm to pay $8.25 million in restitution for misleading investors in the sale of the Lehman notes.[7]

"It's unbelievable," says Margery Bronster, the former attorney general of Hawaii who now represents broker victims. "It's a completely under-reported area. People had no idea what they were purchasing."[8]

Those who are most vulnerable have saved and invested all of their lives. They believed in the good faith of their brokers and the global brand names of their financial-service employers. Through saving and conservative investing, they did well over time. That success, ironically, has made them prime targets for rapacious brokers and agents. Additionally, many are targeted because they are highly trusting, cognitively impaired or at facing severe health issues.[9]

"Brokerage firms target the elderly with high-commission products and intense sales pressure," says Andrew Stoltmann, a Chicago attorney who has represented hundreds of wronged investors. "Unfortunately most investors don't realize their broker is little more than a commissioned salesperson,"

6. *Structured Product Sales by Top Sellers*, STRUCTURED RETAIL PRODUCTS (2010), http://www.structuredretailproducts.com.

7. Press release, FINRA, FINRA Fines UBS Financial Services $2.5 Million (April 11, 2011), http://www.finra.org/Newsroom/NewsReleases/2011/P123479.

8. Interview with Margery Bronster, plaintiffs' attorney (2011); see also http://www.bhhawaii.net/firm%20info/Lawyers/890719.aspx.

9. For information about the particular vulnerability of seniors, see, for example, Federal Bureau of Investigation, *Fraud Target Senior Citizens,* http://www.fbi.gov/scams-safety/fraud/seniors, and Washington State Department of Financial Institutions, *The Older Investors*, http://www.dfi.wa.gov/sd/olderinvestors.htm.

with no legal requirement to watch out for their clients' best interest. "The result," Stoltmann continues, "is that seniors are taken for billions each year."[10]

Louis Straney, a securities arbitration consultant in Santa Fe, New Mexico, has been involved in Wall Street dealings since the junk-bond days of the 1980s. He frequently serves as an expert witness for investors trying to get their money back from brokers who sold them structured products.

"In my three decades of Wall Street experience, I have not seen any other product as absurdly destructive as retail investments linked to structured products," Straney said. "Deservingly, the architects and marketers of these bizarre investments are facing a long-term battle with investor rage and regulatory scrutiny."[11]

Unlike Ponzi schemes, structured products are sold every day by licensed brokers. Many mutual funds contained them. And individual investors often have them in their portfolios unawares. Yet they are based on the same flawed casino reasoning that tanked global financial markets in 2008.

Ironically, many brokers I interviewed have told me they don't fully understand how they work or what's behind them.[12] Bryan Lantagne, of the Massachusetts Secretary of State's office, which is currently investigating reverse convertible structured notes, echoed that point, noting that a lack of adequate broker training is a major problem. "You can't properly disclose the risk benefits if you don't really understand what you're selling," he said. "More often than not the commission [is all] they understand."[13]

Regulators have been aware of how dauntingly complex and risky they are for more than six years, yet still permit their sale to uninformed investors.[14]

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10. Interview with Andrew Stoltmann, plaintiffs' attorney (2010); see also http://www.investmentfraudpro.com.

11. Email from and interview with Louis Straney, consultant and arbitration expert (2010).

12. Interview with Lawrence Weinman, investment advisor (2010); see also http://www.lweinmanadvisorla.com/.

13. Email from Bryan Lantagne, director, Securities Division, Massachusetts Secretary of State Office (2010).

14. FINRA Notice To Members 05-59 (September, 2005), http://www.finra.org/Industry/Regulation/Notices/2005/P014998; Regulatory Notice 09-73 (December, 2009), http://www.finra.org/Industry/Regulation/Notices/2009/P120597; Regulatory Notice 10-09 (February, 2010), http://www.finra.org/Industry/Regulation/Notices/

In fact, regulators typically only catch wind of inappropriate sales once people have lost millions. And most who get caught in such toxic investments don't file complaints. They are ashamed that they were burned by a broker they have known for years, someone they considered a friend.

Wall Street has managed to sweep this largely invisible scandal under the rug. These products, unfortunately, were barely addressed by the Dodd-Frank financial reform law and could continue to harm investors for years to come.

Table 2: *FINRA/NASD NOTICES TO BROKERS ABOUT STRUCTURED PRODUCTS*

Notice No.	**Date**	**Warning**
05-59	9/2005	Structured products sales
09-73	12/2009	Principal protected – notes
10-09	2/2010	Reverse Convertible sales
10-51	10/2010	Commodity-linked structured products

Source: www.finra.org

The Sting: Targeting Seniors

One popular structured product that was pitched directly to income-oriented investors smarting over low savings yields was called, deceptively, a "principal protected note." Underwritten by Lehman Brothers and sold by most major brokerage firms, the notes appeared to answer the cry of millions of investors living on their interest: How do I get a higher secure yield? Brokerage houses like UBS Investments, a division of the Swiss Bank, seized upon this concern and sold more than $1 billion of these notes, issued by Lehman.[15]

But when Lehman collapsed under the weight of its own debt and toxic securities in September 2008, Main Street investors were wiped out. Their

2010/P120921; and Regulatory Notice 10-51 (October, 2010), http://www.finra.org/Industry/Regulation/Notices/2010/P122290.

15. Bradley Keoun and David Scheer, *Lehman Good-for-Retirement Notes Worth Pennies for UBS Clients*, BLOOMBERG (Nov. 2, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBJ_0ULSgrjY.

supposedly low-risk investments turned out to be unsecured Lehman debt. Most had no idea what they owned.

Charles Replogle of Vero Beach, Florida, told that they were safe, bought the 6-percent-yielding Lehman notes from UBS for his mentally disabled brother and his 86-year-old mother. He trusted his broker, a friend whom he had known since he was 9. The Replogles lost every penny of the $130,000 they invested in the notes.[16]

"There was no mention of Lehman Brothers," Replogle said. "I felt UBS deceived us. You can't sell a guaranteed product and not guarantee it."

Similarly, Rob Brunhild of West Bloomfield, Michigan, invested in the Lehman notes through UBS for his family trusts and his 80-year-old mother. He expected, he said, a "good solid return with minimal risk. The broker implied that they were like [U.S.] treasuries."

His family lost $275,000 when Lehman tanked.[17]

"I had to tell my mother," Brunhild said. "Mom lived off of this money."

Even relatively sophisticated investors like Tricia Flanagan, 58, a real estate agent in Kiawah Island, South Carolina, who had earlier been burned in the dot-com crash of 2001, got taken in by the UBS/Lehman pitch.[18]

Flanagan had invested $225,000 in the notes, and lost everything — even though she had tried to get out of her investment once it was apparent Lehman was in trouble. She, too, had placed her utmost trust in her broker — and her broker talked her out of selling.

In the end, her retirement fund was lost and she had to hire an attorney to file an arbitration claim in an attempt to get her money back. Efforts to contact her former broker were unsuccessful.

"There were people who knew we were sitting ducks," Flanagan said. "I'm very honest and good at what I do. I was vulnerable, though, and felt I was targeted."

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16. Interview with Chris Replogle, investor, through attorney Chris Vernon (2010); see also http://www.lehmannotes.com/2011/03/wall-street-using-principal-protected-notes-and-other-structured-products-to-borrow-collateral-free-.html.

17. Interview with Robert Brunhild, investor, through attorney Chris Vernon (2010); see also http://www.lehmannotes.com/2011/03/wall-street-using-principal-protected-notes-and-other-structured-products-to-borrow-collateral-free-.html.

18. Interview with Patricia Flanagan, investor, through attorney Jacob Zamansky (2010); see also http://www.zamansky.com/news-media/news/2011/how-safe-are-your-savings.html.

Retired Houston policeman Jerry Jones, 59, lost more than $109,000 in Lehman preferred stock, even though his broker assured him his investment would be "similar to a CD" in its level of safety.[19]

When contacted, Allison Chin-Leong, a spokesperson for UBS, denied any wrongdoing. "UBS properly sold Lehman structured products to UBS clients, following all regulatory requirements, well-established sales practices and client disclosure guidelines," she said. "Any client losses were the direct result of the unexpected and unprecedented failure of Lehman Brothers, which affected all Lehman bondholders."[20]

Chris Vernon, an attorney based in Naples, Florida, represents dozens of older investors, including the Replogles and Brunhilds, in their fight against brokers.

"Clearly Wall Street was — and still is — targeting fixed-income investors," Vernon said. "Most of them are retirees seeking a steady source of income while guarding against any material loss of principal."

Vernon's firm has filed more than two dozen claims totaling more than $10 million since 2008, "the vast majority of which" were filed in 2009 or 2010. He likens brokers targeting older investors for structured and derivative product sales to what Willie Sutton said about why he robbed banks — "Cause that's where the money is."[21]

Vernon is hardly alone. Across the country, claims relating to structured products have surged. When I surveyed attorneys nationwide representing clients who got stung by structured products, most said they are seeing a large wave of claims by income-oriented investors who got saddled with these unsuitable products. Many are just now taking action for losses they sustained in 2008.[22]

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19. Interview with Jerry Jones, through his attorney Debra Hayes (2010); see also http://www.dhayeslaw.com/index.php?n=3&sn=9.

20. E-mail from Allison Chin-Leong, spokesperson for UBS; see also http://www.businessweek.com/news/2010-07-02/sec-said-to-review-principal-protected-note-sales.html (article no longer available) and http://www.housingwire.com/2010/11/15/lehman%E2%80%99s-structured-notes-clearly-flawed-law-firms-allege.

21. Interview with Chris Vernon, attorney (2010); see also http://www.lehmannotes.com.

22. Interviews with Debra Hayes, attorney, Jacob Zamansky, attorney, Chris Vernon, attorney, and several members of the Public Investors Bar Association (2010); see also http://www.piaba.org.

Joe Borg, an Alabama state securities director who is probing a number of cases involving income-oriented investments who lost money, said, "There's no doubt that structured products are targeted toward older folks. There's the issue of outliving their money when it is tied up in low-yielding CDs and bonds. They're a scared group."

State regulators interviewed for this report have seen complaints rise in the most populous areas and fear the problem is going to get much worse.[23] On the federal level, FINRA, the Financial Industry Regulatory Authority, has jurisdiction. In most of FINRA's complaint categories in 2009, the year after the crash, the number of problems are double what they were the year before.[24] These numbers largely reflected investors who got scorched in 2008 — and more of these individuals are coming forward every day. Last year, both the SEC and state securities agencies set up special task forces to police structured products.[25]

But accountability has been scarce. Under most securities brokerage contracts, investors waive the right to sue and must sign a binding arbitration agreement that forces them to seek redress through an arbitration forum run by the securities industry itself.[26]

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23. Interviews with North American Securities Administrators Association, including state regulators David Massey (North Carolina), Denise Crawford (Texas), Tanya Solov (Illinois), Bryan Lantange (Massachusetts), Joe Borg (Alabama), Matt Kitz (Missouri), general counsel Rex Staples, and spokesman Bob Webster (2010); see also http://www.nasaa.org.

24. Financial Industry Regulatory Authority, *Dispute Resolution Statistics*, as updated through February, 2011, http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics//.

25. North American Securities Administrators Association formed a working group to explore issues related to structured products, see *Standing Strong for Investors, 2010-2011 Report* (2011), http://www.nasaa.org/content/Files/NASAA_2010_2011_Report.pdf; U.S. Securities and Exchange Commission, Enforcement Division, Structured and New Products Unit, see *The Securities and Exchange Commission Post-Madoff Reforms* (2010), http://www.sec.gov/spotlight/secpostmadoffreforms.htm#revitalize.

26. U.S. Securities and Exchange Commission, *Arbitration*, http://www.sec.gov/answers/arbproc.htm.

Table 3: *ARBITRATION CASES FILED BY TYPE*

Type of Controversy	2007	2008	2009	2010	Jan/Feb 2011
Margin Calls	45	64	128	83	15
Churning	133	212	306	270	36
Unauthorized Trading	174	248	478	397	46
Failure to Supervise	830	1,029	2,691	2,372	320
Negligence	891	1,602	3,405	2,698	364
Omission of Facts	275	1,201	2,453	1,941	255
Breach of Contract	953	1,658	2,802	2,184	300
Breach of Fiduciary Duty	1,616	2,836	4,206	3,162	446
Unsuitability	695	1,181	2,473	1,974	259
Misrepresentation	739	2,005	3,408	2,601	339
Online Trading	1	3	0	0	0

Each case can be coded to contain multiple controversy types. Therefore the column in this table cannot be totaled to determine the number of cases served in a year.

Source: FINRA.org

As indicated in Table 3 above, the bulk of the investor arbitration complaints registered by FINRA involved negligence, breach of fiduciary duty, breach of contract or misrepresentation. Translation: Investors were duped into buying inappropriate investments. While FINRA does not disclose which type of these vehicles the complaints were based on, at least some of these abuses involved structured products and other risky securities. The table also shows that after 2007, the abuses surged.

TOXIC PRODUCTS

Before The Meltdown

Many of the worst complex derivative and structured products were sold before the market meltdown of 2008. Investors are still trying to recover billons – at least $113 billon, by our estimate – through class-action lawsuits and broker arbitrations.

Auction Rate Securities

These complex derivative products were pitched as if they were safe money market funds (which are required by law to invest only in low-risk securities).[27] Yet when the $330 billion ARS market failed and banks froze them in 2008, investors were stuck. So far, multiple settlements between regulators and investors have returned more than $90 billion to individual investors through repurchase agreements, although some investor complaints are still pending.

Investors who haven't been made whole are sitting on an estimated $100 billion in losses.[28]

Fannie Mae And Freddie Mac Preferred Stocks

These were pitched in late 2007 and early 2008 as the ultimate high-yielding safe bet. Brokers sold these stocks, special issues of the giant mortgage companies, as if they were as sound and secure as Treasury securities. It was known by at least 2006 that both companies had severe accounting irregularities and had purchased large quantities of highly risky subprime mortgages.[29] But brokers told investors that the government would cover them if the companies got into trouble.[30] The U.S. Treasury ended up taking over both companies in late 2008, but the receivership wiped out the

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27. See, for example, U.S. Securities and Exchange Commission, *Money Market Funds*, http://www.sec.gov/answers/mfmmkt.htm.

28. Daisey Maxey, *Still Frozen After All These Years*, THE WALL STREET JOURNAL (October 30, 2010), http://online.wsj.com/article/SB10001424052702304879604575582272276490314.html; PHIL TRUPP, RUTHLESS: HOW ENRAGED INVESTORS RECLAIMED THEIR INVESTMENTS AND BEAT WALL STREET 213 (2010).

29. The Associated Press, *Settlement Will Cost Freddie Mac $50 Million*, N. Y. TIMES, Sept. 28, 2007, http://www.nytimes.com/2007/09/28/business/28freddie.html; Jeremy Peters, *Fannie Mae to Pay $400 Million in Fines*, N. Y. TIMES, May 23, 2006, http://www.nytimes.com/2006/05/23/business/23cnd-fannie.html?hp&ex=1148443200&en=a5146da7199f987c&ei=5094&partner=homepage; *Fannie Mae and Freddie Mac: End of Illusions*, THE ECONOMIST (July 17, 2008), http://www.economist.com/node/11751139.

30. See, e.g., Zamansky & Associates, *Fannie and Freddie Mac Stock Losses, Briefing Paper*, http://www.zamansky.com/cases/fannie-mae-and-freddie-mac-stock-losses.html.

value of the newest preferred stock and most of the common stock. Neither Treasury nor Congress made any effort to make small investors whole.[31] Several institutional and small investor class-action suits are pending,[32] but as of this writing, the Obama Administration has yet to decide what to do with the companies.[33] It seems unlikely that preferred stockholders will ever be made whole.

Total investor losses have not yet been estimated.[34]

Lehman Brothers Principal-Protected Notes

Brokers sold as safe what were later revealed to be unsecured loans from the New York investment bank. When the firm became the largest US bankruptcy in history in September 2008 the notes became worthless, even though they were promoted as low-risk. The State of New Hampshire is suing one of the largest sellers — UBS Investments — and other states are investigating.

On April 11 of this year, FINRA fined UBS Financial Services $2.5 million and ordered the firm to pay $8.25 million in restitution for "omissions…that effectively misled some investors" in the sale of the Lehman notes. (UBS neither admitted nor denied the charges.)[35] Individual investors are still pursuing arbitration claims against brokers who sold the

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31. Seth Lipner, *How Fannie and Freddie Unloaded Their Trash*, FORBES (July 7, 2010), http://www.forbes.com/2010/07/07/fannie-mae-subprime-intellignet-investing-freddie-mac_print.html; James Hagerty, Ruth Simon and Damian Paletta, *U.S. Seizes Mortgage Giants*, THE WALL STREET JOURNAL, Sept. 8, 2008, http://online.wsj.com/article/SB122079276849707821.html.

32. Patricia Hurtado, *Fannie Mae Investor Sues Citigroup, Merrill Over Stock Drop*, BLOOMBERG, Sept. 5, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=awGWI3NJX3Rs.

33. Tamara Keith, *What's Next: Life After Fannie and Freddie*, National Public Radio – Planet Money (March 30, 2011), http://www.npr.org/blogs/money/2011/03/31/134863027/whats-next-life-after-fannie-and-freddie.

34 . Interview with Peter Safirstein, attorney, (2010); see also, http://www.milberg.com/people/bio.aspx?bioid=56.

35. Press Release, FINRA, FINRA Fines UBS Financial Services $2.5 Million (April 11, 2011) http://finra.org/Newsroom/NewsReleases/2011/P123479.

notes. UBS denies any wrongdoing while it was selling the notes.

Investors initially lost more than $8 billion.[36]

Medical Capital Holdings (Medcap)

These high-yield, private-placement securities were sold by brokers as "safe and secure," according to one burned investor who filed an arbitration claim; a way to profit from loans to hospitals in the form of promissory notes.[37] But Medcap investors lost substantial sums of money. The State of Massachusetts has sued the primary broker of these securities, Securities America, for fraud, charging that it failed to reveal risks to investors. Other actions have been taken by FINRA and the SEC, and many individual investors have pursued arbitration claims. In April of this year, Ameriprise Financial agreed to pay $150 million to settle claims against its Securities America broker/dealer unit, involving the sale of notes from Medcap and Provident Royalties. A statement issued by Ameriprise acknowledged that "the frauds allegedly committed by Medical Capital and Provident Royalties have harmed many investors and companies, including Securities America."[38]

Investors have lost an estimated $700 million.[39]

Morgan-Keegan Bond Funds

According to FINRA, investors in bond funds issued by this brokerage firm (the parent company was the bank Regions Financial) were told by

36. Bradley Keoun, *supra* note 15; *UBS Lehman Principal Protected Notes*, LAWYERS AND SETTLEMENTS, http://www.lawyersandsettlements.com/case/ubs-lehman-brothers-securities-fraud-principal.html.

37. Susanne Craig, *Financial Fraud Case Pits Arbitration vs. Class Action*, N. Y. TIMES, March 4, 2011, http://dealbook.nytimes.com/2011/03/04/financial-fraud-case-pits-arbtration-vs-class-actions/.

38. James J. Greene, *Ameriprise to Pay $150 Million to Settle Securities America Charges,* ADVISORONE (April 21, 2011), http://www.advisorone.com/article/ameriprise-pay-150-million-settle-securities-america-charges.

39. Maddox Hargett & Caruso, P.C., *MedCap Investors Want Answers From Securities America* (2010), http://www.investorprotection.com/blog/2010/01/28/medcap-investors-want-answers-from-securities-america/.

brokers that these funds were safe, conservative investments, only to experience huge losses due to highly risky investments in mortgage securities that plummeted in value in 2008. The Alabama Securities Commission is suing the company on behalf of investors, who have filed arbitration claims against the company, claiming the risks of these investments weren't fully disclosed. Other states — mostly in the Southeast — are investigating as well.[40]

Kathy Ridley, a spokesperson for Morgan-Keegan, denied that the company had any responsibility for the losses. "After years of consistent success, the Funds ultimately suffered unprecedented losses due to the global collapse of the financial markets," she said. "This was a stunning turn of events for all global markets. Morgan Keegan conducted business ethically and responsibly throughout this disastrous period."[41]

Investors lost an estimated $1 billion.[42]

Citigroup MAT/ASTA Funds

These were actually a series of risky municipal arbitrage hedge funds pitched to conservative investors, who were assured by brokers that their money was invested in a safe fixed-income alternative. Some marketing materials even called them "an attractive alternative" to a bond index. Sold by Smith Barney and Citigroup Private Bank between 2002 and 2007, the funds lost from 70 to 97 percent of their value in early 2008.

In November 2010, SEC officials probed the failure of the funds, investigating claims that in-house brokers at Citi had misled investors about

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40. *Morgan Keegan To Face Regulators Over RMK Bond Losses*, SUBPRIME & FIXED INCOME INVESTMENT LOSSES (2010), http://www.subprimelosses.com/blog/index.php/category/firms-under-investigation/morgan-keegan-bond-funds/.

41. E-mail from Kathy Ridley, Morgan Keegan spokesperson (2010).

42. Alabama Securities Commission, *Joint Administrative Proceeding SC-2010-0016*, http://www.asc.state.al.us/Orders/2010/SC-2010-0016/MK%20Notice%20of%20Intent%20-%2009302010.pdf. FINRA, however, offers a lower estimate of $1 billion. See Press Release, FINRA, FINRA Files Complaint Against Morgan Keegan & Company for Misleading Customers Regarding Risks of Bond Funds and Advertising, Other Violations (April 7, 2010), http://www.finra.org/Newsroom/NewsReleases/2010/P121250.

how risky the funds were.[43] In April of this year, two individual investors were awarded $54 million in a securities arbitration claim; Citigroup spokesperson Alexander Samuelson told the New York Times, "We are disappointed with the decision, which we believe is not supported by the facts or law."[44]

Initial loss to investors: almost $2 billion.[45]

Schwab Yield-Plus Fund

Like so many income investments, the YieldPlus short-term bond fund was touted by Schwab representatives as equivalent in security to money market funds, according to FINRA. And like the Morgan-Keegan funds, it contained volatile mortgage securities, including uninsured subprime loans, which crashed in late 2008.[46] Schwab spokesperson Sarah Bulgatz denied any wrongdoing. "The decline of the YieldPlus fund was caused by the credit crisis and unprecedented housing market collapse of 2007-2008," she said. "Even in the face of the credit crisis, the average Yield Plus shareholder lost only 7.5 percent of his or her investment." [47]Many investors lost much more than that.

Investors lost an estimated $1.1 billion.[48]

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43. Randall Smith, *Citi Debt Funds Probed by SEC*, THE WALL STREET JOURNAL (Nov. 6, 2010), http://online.wsj.com/article/SB10001424052702303738504575568411913835550.html.

44. Gretchen Morgensen, *A Crack in Wall Street's Defenses*, N. Y. TIMES (April 23, 2011), http://www.nytimes.com/2011/04/24/business/24gret.html?_r=2. For the FINRA award, see http://www.investorprotection.com/pdf/hosier-award.pdf.

45. MAT/ASTA Arbitration Report, Vol. 1, PAGE PERRY LLC (September, 2011), http://www.pageperry.com/files/mat_asta_arb_report_sep_2010_final_.pdf.

46. Press Release, FINRA, FINRA Orders Schwab to Pay $18 Million to Investors for Improper Marketing of YieldPlus Bond Fund, (Jan. 11, 2011), http://www.finra.org/Newsroom/NewsReleases/2011/P122755?utm_source=feedburner&utn_medium=feed&utm_campaign=Feed%3A+FINRANews+%28FINRA+News%29.

47. E-mail from Sarah Bulgatz, spokesperson for Charles Schwab & Co., Inc.; see also, http://www.advisorone.com/article/sec-finra-charge-schwab-2-executives-over-yieldplus-fund?page=0,0.

48. Floyd Norris, *At Schwab, Unkept Promise to Investors*, N.Y. TIMES (Jan. 13, 2011), http://www.nytimes.com/2011/01/14/business/14norris.html?n=Top/

PRODUCTS STILL BEING SOLD

These vehicles are still on the market and have been named by SEC, FINRA and state regulators as posing extraordinary risks to investors.

Reverse Convertibles

These derivative vehicles, which promise a yield of up to 30 percent, have also been a consistent source of complaints from investors. These bonds are derivatives based on stock prices, so if the underlying stocks plummet in value — and there are thousands of them — investors could lose serious money.[49] Many of the investor complaints regarding reverse convertibles come from the Northeast, and the State of Massachusetts is currently investigating these products. About $18 billion of these products have been sold since 2008.[50]

Although they are slow to react, regulators continue to crack down on brokers who sold these vehicles to retired investors, hinting at the scope of the problem. In February 2010, FINRA fined H&R Block Financial Advisors $200,000 and suspended a broker for the firm for selling reverse convertibles to a retired couple (Block neither admitted nor denied the charges).[51] In

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Reference/Times%20Topics/People/S/Schwab20%Charles%20R.?ref=charlesrschwab&pagewanted=all.

49. Jonnelle Marte, *A High-Yield Bet to Steer Clear Of?* SMARTMONEY (March 25, 2011), http://smartmoney.com/investing/bonds/a-highyield-bet-to-avoid-now-1301062332243/; Scott Dubowsky, *Investors Reversal of Fortune With Reverse Convertibles*, TRADERS MAGAZINE (August 31, 2010), http://tradersmagazine.com/news/reverse-convertibles-106297-1.html?zkPrintable=true.

50. The figure of $18 billion was reached by combining figures from three sources: see Dubowsky, *supra* note 49; Marte, *supra* note 49; and Maddox, Hargett & Caruso, *Reverse Convertibles Back in News*, INVESTOR PROTECTION (March 29, 2011), http://www.investorprotection.com/investor-news/2011/03/29/reverse-convertibles-back-in-news/. According to these sources, in 2008 investors bought $7 billion in reverse convertibles and in 2010 investors bought $6.76 in reverse convertibles, a 55% increase over 2009 ($4.36 billion). Thus, from 2008 to 2010 investors spent about $18 billion.

51. Press Release, FINRA, FINRA Fines H&R Block Financial Advisors $200,000 for Inadequate Supervision of Reverse Convertible Notes Sales, Suspends and Fines Broker for Unsuitable Sales to Retired Couple (Feb. 16, 2010), http://www.finra.org/Newsroom/NewsReleases/2010/P120914.

October 2010, FINRA fined broker Ferris Baker Watts LLC (of RBC Wealth Management) $500,000 for "inappropriate sales" of these products, and ordered the firm to pay $190,000 to a total of fifty-seven Ferris account holders who were at least 85 years old or had a modest net worth. (With this settlement, too, the firm neither admitted nor denied the charges.)[52] FINRA continues to investigate other marketing abuses and investor losses involving the notes. Total investor losses are unknown, but are sure to skyrocket in the case of another market crash. FINRA issued a warning about these products, calling them "complex investments" that feature "risks that can be difficult for individual investors and investment professionals alike to evaluate." "You could wind up," the warning continues, "with shares of a depreciated — or even worthless — asset."[53]

Other Structured Products And Broker-Sold Vehicles.

FINRA and state regulators are also probing losses from such products as reverse/inverse exchange-traded funds, "Regulation D" private placements, and other "principal-protected" products.[54] FINRA continues to probe cases in which highly risky investments are sold to older investors. The agency is reorganizing its enforcement division and recently appointed a new enforcement chief. And FINRA's chairman, Richard G. Ketchum, has proposed that the agency take over regulation of investment advisors from the SEC.[55]

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52. Press Release, FINRA, FINRA Orders Ferris, Baker Watts to Pay Nearly $700,000 for Inappropriate Sales of Reverse Convertible Notes (Oct. 20, 2010), http://www.finra.org/Newsroom/NewsReleases/2010/P122291.

53. *Reverse Convertibles – Complex Investment Vehicles*, FINRA, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P120883.

54. NASAA, *Standing Strong*, *supra* note 25; *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy and Hold Investors*, FINRA http://www.finra.org/investors/ProtectYourself/InvestorAlerts/MutualFunds/P119778.

55. Ben Protess, *A Regulator Moves Postcrisis to Expand Power Over Wall Street*, N.Y. TIMES (April 25, 2011), http://dealbook.nytimes.com/2011/04/25/postcrisis-a-regulator-moves-to-expand-power-over-wall-st/.

INAPPROPRIATE INVESTMENTS

Craig McCann, PhD, a securities litigation expert with the Securities Litigation and Consulting Group in Fairfax, Virginia, has written several papers analyzing structured products in depth and is widely considered the leading analyst of these products. In one paper, "Are Structured Products Suitable for Retail Investors," written with Dengpan Luo, PhD, and published in 2006, he dissects whether investors would fare better investing in a structured product or investing directly in stocks or bonds.[56] His conclusion:

> Structured products can be too complex and opaque for retail investors and registered representatives (brokers) to understand. This complexity and opaqueness allows structured products to survive in the marketplace despite their marked inferiority to traditional portfolios of stocks and bonds.

Jake Zamansky, who has represented structured product investors in arbitration cases, found that today's income-oriented investors don't fully understand what they are being sold.[57] "These structured products are opaque and complicated. People don't understand the risks and costs. SPs [structured products] are sold and not bought. Nobody asks for them."

BIG LOSSES AHEAD?

The big appeal for structured products is this: they claim to offer "protection" of principal. The trouble is this claim often turns out to be completely false.

Nearly three years after the 2008 meltdown, investors are still trying to recover their losses. As investor claims poured in, arbitration filings against brokers soared in 2009 to more than 7,000, compared to less than 5,000 in the previous year, according to FINRA, the securities industry regulator.[58] The main reasons for those filings, according to a FINRA overview, were

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56. Craig McCann & Dengpan Luo, *Are Structured Products Suitable for Retail Investment*, SECURITIES LITIGATION AND CONSULTING GROUP (2006), http://www.slcg.com/pdf/workingpapers/StructuredProducts.pdf.

57. Interview with Jacob Zamansky, attorney (2010); see also, http://www.zamansky.com/cases/structured-products-arbitration.html.

58. *Dispute Resolution Statistics*, FINRA (as updated through February, 2011), http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics//.

"breach of fiduciary duty, misrepresentation, negligence, breach of contract, failure to supervise, and unsuitability."[59]

According to Janet Tavakoli, a consultant on structured finance who has written several books on these products, "these notes flunk the suitability and appropriateness test for retail investors. They also flunk the test for most investment managers, investment advisors and pension fund managers. Retail investors may find that the managers who are supposed to protect their interests are in fact collecting fees and turn a blind eye to the risks." [60]

Only a handful of academics and industry analysts have carefully studied structured products, but many of those who have say that these products are clearly unsuitable for most conservative investors and simply shouldn't be sold to them.

Any yet, like variable annuities — another perennially oversold investment — structured products are sold aggressively.[61]

Christopher Whalen, an industry observer, is managing director of Institutional Risk Analytics in Torrance, California. He predicted the collapse of the mortgage securities market in 2007 and has criticized banks and brokers alike for their poor disclosure in selling structured products. He has also pointed out that many of the products are illiquid, meaning they can't easily be resold since there's little or no market for them and most of them are unlisted securities not traded on exchanges.[62] In a presentation to FINRA regulators in November 2010, he called complex structured notes a "wolf in sheep's clothing."[63]

It's difficult to say who's been burned the worst by the inappropriate selling of these products to retail investors. Tracking of investor complaints is poor. Older investors are less likely to file complaints, investors' attorneys

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59. *FINRA Dispute Resolution Fact Sheet*, FINRA, http://www.finra.org/Arbitration Mediation/AboutFINRADR/Overview/Factsheet/.

60. JANET TAVAKOLI, STRUCTURED FINANCE AND COLLATERALIZED DEBT OBLIGATIONS (2d ed. 2008) http://www.tavakolistructuredfinance.com/books.html; email from Janet Tavakoli, attorney (2010).

61. Mark Schoeff, Jr., *Annuity Tax Alteration May Hurt Middle Class*, INVESTMENT NEWS (March 6, 2011), http://www.investmentnews.com/article/20110306/REG/303069977.

62 . Zeke Faux & Jody Shenn, *Structured Notes Are Wall Street's 'Next Bubble,' Whalen Says*, BLOOMBERG (Aug. 9, 2010), http://www.bloomberg.com/news/2010-08-09/structured-notes-are-wall-street-s-next-bubble-institutional-risk-says.html.

63. Christopher Walen, *Complex Structured Notes: Risk & Return* (Nov. 4, 2010), http://www.rcwhalen.com/pdf/finra_1010.pdf.

say.[64] When they do, they are forced into the industry's arbitration system, run by brokerage regulator FINRA. As shown in Table 4, FINRA didn't even track structured products or "derivative securities" complaints until 2008.[65] And yet they were one of the top sources of investor complaints that year.

***Table 4**: SECURITY TYPES INVOLVED IN ARBITRATION CASES*

Type of Security*	2007	2008	2009	2010	Jan/Feb 2011
Corporate Bonds	71	163	373	239	23
Certificate of Deposit	16	31	71	41	7
Mutual Funds	395	1069	1556	863	111
Options	110	149	275	161	37
Common Stock	790	773	1367	862	139
Limited Partnerships	19	33	73	80	8
Annuities	243	236	300	208	27
Preferred Stock	26	115	481	232	31
Variable Annuities	---	47	300	279	36
Derivative Securities**	---	801	607	228	11
Auction Rate Securities**	---	299	276	149	16

** Each case can be coded to contain multiple security types. Therefore the columns in this table cannot be totaled to determine the number of cases served in a year.*
*** Tracking of these statistics began on January 1, 2008.*
Source: FINRA

Even bond mutual funds held derivative perils for investors, as several of them, most notably ones sold and managed by the Schwab (YieldPlus) and Morgan- Keegan brokerages, suffered large losses when they invested in mortgage securities in 2008. Both companies pitched their funds as secure income alternatives, according to FINRA, and both attributed all losses in those funds to the housing crisis.

Louis Kelly, 67, a retired mail carrier in Bessemer, Alabama, lost $100,000 in the Morgan-Keegan RMK Select Intermediate bond fund, which

64. The FBI has also found this. See *Fraud Target: Senior Citizens*, FEDERAL BUREAU OF INVESTIGATION, http://www.fbi.gov/scams-safety/fraud/seniors.

65. *Dispute Resolution Statistics*, FINRA (as updated through February, 2011), http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics//.

lost money in mortgage securities. He received $50,000 in a settlement from the company. He was sold the fund by a broker he knew, whose employer was a bank holding company, Regions Financial.

"I told them [Morgan-Keegan] that I wanted a safe investment and wanted the bulk of principal to remain intact," Kelly said. "I just wanted a steady income. I have a small Air Force and Post Office pension. It didn't cripple me, but I'd like to have it all back." The bank denies any wrongdoing.[66]

Ed and Rod King, two retired brothers from the Tuscaloosa, Alabama, area, lost $420,000 in the Morgan-Keegan bond funds. Ed King said the funds were touted by their broker friend as "safe and secure."[67]

"Most people don't know what they have yet," said Joe Borg, the Alabama state securities director. He is currently suing brokerage firm Morgan-Keegan on behalf of investors over bond fund losses involving mortgage securities. "The big wave is yet to come."[68]

BROKEN ACCOUNTABILITY

The myriad drawbacks of structured products haven't impeded Wall Street in the least because no regulator has halted their highly profitable sales. With the promise of high commissions and double-digit yields, sales will continue to climb — until the next market downturn. Brokers will likely continue to sell structured products aggressively, because they can reap from 3 to 10 percent commissions selling them, versus a typical 1 to 3 percent for a plain vanilla bond.[69]

Banks are enamored of these vehicles, too, because they can charge more than 1 percent for underwriting fees — 1 percent or less is typical for a plain vanilla bond — a cost that is passed along to investors. In an era in which bond yields have been lackluster and commissions have been driven down by

66. Interview with Louis Kelly (2010); see also, http://www.bhflegal.com/CM/FirmNews/BHF-Hits-Morgan-Keegan-1.1Million-Award.asp.

67. Interview with Ed King through his attorney Andrew Stoltmann (2010).

68. E-mail from and interviews with Joe Borg, Securities Commissioner, State of Alabama (2010).

69. Interviews with Debra Hayes, attorney, Jacob Zamansky, attorney, Chris Vernon, attorney, and several members of the Public Investors Bar Association (2010); see generally http://www.piaba.org.

deep-discount brokers, structured products have become a money machine for the largest "wire house" brokerage firms and mega banks.

Many investors first hear of these vehicles in a bank lobby, when inquiring about how to pursue higher yields. With most savers struggling to find a decent yield above 1 percent, reverse convertibles look incredibly appealing.[70] But brokers gloss over the fact that these are inappropriate investments for those who are income-oriented.

"Elderly people have a comfort level with bank introductions to brokers," said Geoff Evers, a Sacramento-based lawyer who has handled reverse convertible cases for investors. "One client was a 90-year-old retired widow who was sold reverse convertibles for 92 percent of her portfolio" and lost significant money, he said. "No client would've bought these investments if they knew what they were."[71]

As noted above, if investors facing steep losses choose to fight their brokers directly, they'll typically be compelled to use the industry's own arbitration forum, as nearly every brokerage firm requires investors to sign a mandatory binding arbitration agreement that waives their right to sue in court.[72]

Since the industry's self-regulator, FINRA, runs the securities arbitration forum, it's the equivalent of trying a malpractice suit in a system run by doctors (though arbitration panels do always include at least one "public," or non-industry, arbitrator).[73]

While arbitration can be less costly and much more efficient than court trials, complainants almost never get punitive damages, and may only appeal in the rare case of fraud involving an arbitrator.[74] In the vast majority of

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70. Mark Whitehouse, *Fed's Low Interest Rates Crack Retirees' Nest Eggs*, THE WALL STREET JOURNAL (April 4, 2011), http://online.wsj.com/article/SB10001424052748703410604576216830941163492.html.

71. Email from and interview with Geoff Evers, attorney (2010); see also http://www.everslaw.com.

72. *Arbitration*, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/answers/arbproc.htm.

73. *SEC Gives Regulatory Approval for NASD and NYSE Consolidation,* U.S. SECURITIES AND EXCHANGE COMMISSION (July 26, 2007), http://www.sec.gov/news/press/2007/2007-151.htm.

74. *Tour of the Dispute Resolution Process*, see specifically section *Decisions and Awards*, FINRA, http://www.finra.org/ArbitrationMediation/Parties/Overview/OverviewOfDisputeResolutionProcess/.

cases, according to industry observers, brokerage firms urge investors to settle for a fraction of what they lost.

It's not known if investors get a fair hearing when they use the industry's arbitration forum. Only settlement amounts that go through arbitration are made public,[75] leaving aside any deals cut outside of the arbitration process. And even these are only available in individual PDF files, making searches impossible. In addition, the industry does not always comply with state laws regarding fraud compensation.[76]

The arbitration panels also do not write opinions or explanations of how they arrived at their decisions. And no one but the attorneys, arbitrators and the complainant may attend the hearings unless both parties give written consent. Even regulators are forbidden from sitting in on hearings without this express written permission.

As some investors have discovered, even when they win, they lose — after they subtract FINRA's arbitration fee[77] and legal costs from an already meager settlement. NASAA, the North American Securities Administrators Association, studied this problem some years ago and compiled a report, but has refused to release it.[78]

In February, the SEC signed off on a new FINRA proposal to give investors the option of an all-public arbitration panel — meaning a panel without any industry representatives.[79] In addition, Dodd-Frank required the SEC study the mandatory arbitration of securities disputes and to consider allowing investors direct access to the courts.[80]

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75. These may be found at http://brokercheck.finra.org/.

76. Email from and interview with Tanya Solov, Director, Securities Division, Illinois Secretary of State's office, http://www.cyberdriveillinois.com/departments/securities/home.html, (2010).

77. For FINRA's arbitration fee schedule, see http://apps.finra.org/Arbitration Mediation/arbfeecalc/1/.

78. The author appealed to NASAA's board of directors to make the report public, but was denied.

79. Press Release, FINRA, SEC Approves FINRA Proposal to Give Investors Permanent Option of All Public Arbitration Panels (Feb. 1, 2011), http://www.finra.org/Newsroom/NewsReleases/2011/P122877.

80. Defense Research Institute, *The Future of Mandatory Securities Arbitration Under the Dodd-Frank Act*, 13 THE BUSINESS SUIT, no. 9, Dec. 6, 2010, at 1, *available at* http://www.fwlaw.com/Securities_Arbitration_Under_Dodd-Frank.pdf.

Louis Straney, the securities arbitration consultant based in New Mexico, reviewed hundreds of cases in 2008 and found that punitive damages are rare, awarded in perhaps 5 percent of cases. He also found that investors only win awards covering attorneys' fees and costs less than 15 percent of the time.[81]

"A 'win' in arbitration often amounts to recovery of only a fraction of the losses incurred by the investor," said Tanya Solov, director of the securities division of the Illinois Secretary of State, who participated in NASAA's unpublished study, mentioned above.

"In certain circumstances, the sum awarded amounts to less than the costs and fees the investor paid out of pocket to pursue the case."[82]

Like most of the state regulators I interviewed, Solov was highly critical of the FINRA arbitration system. She saw it as unfair that investors should have to pay fees to try to get their money back.

Brokerage firms, with billions in resources at their disposal, can choose to delay and deny claims at will. Solov disputed the industry's claim that court trials for aggrieved investors would be more costly or burdensome.

"These cases aren't complicated," Solov said. "Investors settle [with brokerage firms] out of frustration. Arbitration should be optional when there's unequal bargaining power. Investors should have a choice."

Nearly all of the state regulators I interviewed, especially those in the most populous states, said they see structured products as part of a new wave of investor losses. As this report was being prepared, NASAA organized a task force to study structured/derivative products abuses, which have been reported in more than a third of the states I surveyed.[83]

A BETTER INVESTOR PROTECTION POLICY: RECOMMENDATIONS

Investors will never be reasonably protected unless they know, up front, in plain language exactly what they are buying.

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81. Email from and interviews with Louis Straney, consultant and arbitration expert (2010); Louis Straney, *Rethinking Self-Regulatory Organization Arbitration Awards*, 15 PIABA BAR JOURNAL, no. 2 (Summer, 2008) at 29.

82. Email from and interview with Tanya Solov, *supra* note 76.

83. NASAA, *supra* note 25.

They also need to be protected from the ravages of unmonitored, commission-based brokers and agents. The most meaningful improvement would be to make all brokers, financial advisors and agents fiduciaries, whose principal legal obligation is to protect their clients' best interests. Investors should have the ability to sue these professionals in a court of law if they are wronged.

In a welcome development, the SEC recommended in a January 2011 report that brokers become fiduciaries. But this idea is still only in the proposal stage, and it's not yet clear how stringent those rules might be, how soon they might be imposed or whether the SEC would have the funding to enforce them.[84] The agency's work has been imperiled by GOP congressmen who want to gut the Dodd-Frank law and severely curtail funding for the SEC and other regulators.[85] SEC chairwoman Mary Schapiro told this reporter on April 8 that the fiduciary rule would be reconsidered in the second half of 2011 after the agency conducts more "economic analysis." The rule was opposed by the two Republican members on the agency board and has been lobbied against by the industry.[86] Schapiro also said the new rule was tabled for now, because the agency was more focused on meeting deadlines for new rules regarding derivatives.

Here are some recommendations for the SEC and Congress to consider that would promote long-term investor protection and retirement security:

Transparency

Completely overhaul the term sheets and prospectuses for structured products, retail derivatives and variable annuities.

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84. *Study on Investment Advisers and Broker-Dealers*, U.S. SECURITIES AND EXCHANGE COMMISSION (Jan. 2011), http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

85. Stephanie Condon, *GOP Targets Wall Street Reform, Says Its Hindering Job Growth*, CBS News (March 15, 2011), http://cbsnews.com/8301-503544_162-20043420-503544.html; John Curran and Jesse Hamilton, *Schapiro SEC Seen Ineffectual Amid Dodd-Frank Funding Curbs*, BLOOMBERG (March 30, 2011), http://www.bloomberg.com/news/2011-03-31/schapiro-sec-seen-ineffectual-amid-dodd-frank-funding-curbs.html.

86. Kathleen McBridge, *Reaction to SEC's Fiduciary Study is Entwined with Politics,* ADVISORONE (Jan. 24, 2011), http://www.advisorone.com/article/reaction-sec-s-fiduciary-study-entwined-politics.

Require full disclosure in plain language on page one of the full costs and expenses of the product, its liquidity, a concise risk analysis and an exact assessment of how much of the investment could be lost. The disclosed expenses should include: commissions, underwriting fees, bid/ask spreads and all other internal costs. Investor warnings should be as clear and visible as those on tobacco products.

Conflicts of interest between brokers, wholesales, issuers, and other third parties should be clearly explained on page one of all marketing materials given to clients.

Appropriate Sales

Structured/derivative product sales should be barred for retired or highly conservative investors. Someone should only be considered an eligible buyer if he or she is an accredited investor with more than $2 million in non-real estate assets.

Exceptions should only be allowed if that person (a) has previously invested in options or futures, (b) has opened and understands a margin account and (c) has a basic knowledge of how derivatives work.

Brokers, advisors and agents should be prohibited from selling structured products if the sale would weight a client's portfolio with more than 15 percent of the vehicles.

Sales, transfers or rollovers from individual retirement accounts or other retirement funds into other investments without independent review by fiduciary advisors or planners should be prohibited.

All financial advisors, brokers and agents should be required to present two low-cost alternatives to each complex, structured security they seek to sell.

A certified list should be created by the SEC or another consumer protection agency of "safe harbor" products that feature low costs, guaranteed income and liquidity.

If an investor demonstrates cognitive impairment, any asset sales or transfers should required the approval of an independent fiduciary, family member or attorney.

Better reporting of suspicious financial transactions should be implemented that coordinates families, health care professionals, elder-law attorneys and aging specialists.

The use by brokers of titles such as "senior" or "retirement" specialist should be barred by FINRA and the SEC except by professionals who are fiduciaries and experienced retirement planners. Certified financial planners, registered investment advisers and elder law attorneys are examples of fiduciaries.

Accountability

All brokers and agents selling financial products should be unequivocal fiduciaries who are legally bound to place the client's interests above those of the firm.

A joint system between the SEC, FINRA and state regulators should record all consumer complaint information by firm and product. This data should be easily accessible online, or by phone or email request.

Investors should be given the right to opt out of FINRA industry arbitration forums to access the civil court system and should be informed of this option upon signing of any brokerage agreement.

FINRA should make available detailed profiles of arbitrators – including how they have ruled in each case they have heard – to all investors and their attorneys.

FINRA should make settlement and arbitration data readily available to third parties such as regulators, researchers and investors.

NASAA members should make complaint and enforcement action information available by firm and product, easily searchable online.

Outreach and education needs to be improved to identify victims and provide assistance and intervention.

SAMPLE STRUCTURED PRODUCT DISCLOSURE

This is a suggested template for a complex derivative-based income or structured product disclosure:

> WARNING: **This product may be hazardous to your wealth. Do not invest in this product if you need the money to pay living expenses or can't afford any loss in principal.**
>
> THIS PRODUCT IS SOLD BY BROKER X AND UNDER-WRITTEN BY BANK Y. IT IS NOT GUARANTEED BY ANY FEDERAL AGENCY.

Can I lose money?
Yes, under certain conditions. There is the risk that your underlying investment will decline in value or that the issuer will go bankrupt. Your principal is not guaranteed.

How much will it cost me?
The broker commission is 10% annually (paid upon purchase). The bank underwriting fee is 1%. Both fees are non-refundable. If you invest $1,000, only $890 will be put to work. You will also incur a commission if you sell this product back to a broker plus any loss in principal.

Will I be able to get my money out quickly?
No, this is an unlisted security with little or no secondary market. Your broker may be able to buy it back, but at a 10% discount or more. Buyback is not guaranteed.

Is this product recommended for risk-averse, income-oriented investors?
No, only investors placing less than 10% of their total net worth should consider this investment.

What are the additional risks and conflicts of interest?
You may lose money on the bid/ask spread within the contract. Poor performance by the derivative contracts contained within the contract could also result in losses. There is a risk that the issuer will be unable to pay a return on the note. There may also be an options pricing risk, meaning you could lose money on embedded derivatives contracts, and an interest rate risk, meaning you could lose money if interest rates rise. The seller receives a fee from the issuing bank and may have other conflicts.[87]

CONCLUSION

Will another financial crisis trigger the collapse of structured products? It's hard to say because most of the products escape full regulation and few

87. The disclosure form should also include a graph clearly showing the product's likely performance under best, moderate and worst-case scenarios, as well as a graph of a sample comparison of a non-structured product or portfolio.

are vetted for sale by regulators.[88] They could easily be headed for trouble and investors because they are, like the mortgage-backed securities that collapsed in 2008, based on opaque derivatives.

The underfunded SEC and the industry regulator FINRA simply can't keep up with problem products and scams. While FINRA issues periodic investor alerts and "member notices," the industry rarely bars even the most vexing investments.

Since FINRA does not post the number and amounts of settlements in an easily accessible way — one has to search broker by broker and download individual PDF files — comparisons are nearly impossible. In addition, the amounts of any settlements reached without going to arbitration may not be reported to FINRA at all. Who are the worst actors? What are the most dangerous products? How much are they costing investors? All of this information should be readily available, but is not.

Securities firms have latched onto a false argument: that the 2008 meltdown was a rare event and debacles like the Lehman Brothers failure were isolated problems. This has paved the way for complex, high-risk derivative products to continue to be sold to conservative, income-oriented investors.

"The sale of Lehman and other structured notes by UBS is a classic example of why doing business with a Wall Street firm is hazardous," said attorney Chris Vernon, who represents the Replogle and Brunhild families. "They periodically use their own client base — including many fixed income investors — as a dumping ground for defective products they cook up in their home office and then pitch worldwide to their financial advisors."

UBS, like other brokers, claimed that no one could have foreseen Lehman's catastrophic failure, although UBS had been lending money to Lehman and likely was aware of some of its financial woes prior to the crash.

Whoever was at fault, it's undeniable that thousands of investors were shorn of retirement funds by brokerage firms that should have known better — and brokers who either weren't told of the dangers of these investments or didn't choose to tell their clients.

Investors are still continuing to come forward to file arbitration claims against brokerage firms. Few will recover all that they lost. Yet structured products continue to come to market every day and are sold vigorously by every major brokerage firm.

While the new Consumer Financial Protection Bureau will not have oversight over the securities industry, the SEC has endorsed some changes

88. Email from and interview with Tanya Solov, *supra* note 76.

that will help protect investors, primary among them the recommendation to make brokers "fiduciaries" (see above) who will be legally liable if they ignore clients' investment objectives.[89] The agency needs to quickly finalize a strong pro-investor rule of this kind and work with FINRA to further overhaul investment disclosure and suitability rules.

Still, as long as the watchdogs are understaffed and underfunded and education for brokers and investors is lacking, investors won't be insulated from the securities industry. Congress should continue to generously fund the SEC and make its budget independent of politics, perhaps by linking it to securities transaction taxes.

This report doesn't assert that all structured products are bad or that a savvy investor can't find a suitable vehicle through an advisor. In terms of retirement security, though, the vast majority of investors would be better off seeking more transparent, lower-risk alternatives and employing an advisor who does not take a commission — and thus has no stake in recommending such products.

Investors will continue to be preyed upon as long as brokers, banks and insurers are allowed to place profits above the best interests of their clients. This practice needs to change if investors are truly to be protected.

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89. *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act – Accomplishments*, U.S. SECURITIES AND EXCHANGE COMMISSION (2011), http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml.

MANDATORY SECURITIES ARBITRATION AFTER FINRA RULE 12403(d): THE DEBATE REMAINS THE SAME

Benjamin J. Warach[1]

INTRODUCTION

This paper will examine how the newly enacted Financial Industry Regulatory Authority ("FINRA") Rule 12403(d) affects the need for regulatory oversight of mandatory securities arbitration in customer securities disputes. FINRA Rule 12403(d) allows parties to customer securities arbitrations to prevent individuals with financial industry affiliations from serving on the arbitration panel of their hearing. The effect of this Rule is relevant given the new authority of the Securities and Exchange Commission ("SEC") and the Bureau of Consumer Financial Protection under the Dodd-Frank Wall Street Reform and Consumer Protection Act to limit or prohibit mandatory consumer arbitration agreements if either agency finds these arbitration procedures to be unfair to consumers (including brokerage firm customers).

Although FINRA Rule 12403(d) may provide customers with a more impartial arbitration panel, it is this author's opinion that the rule has no impact on other problematic aspects of mandatory securities arbitration. Accordingly, this paper will argue that FINRA Rule 12403(d) should not seriously alter the regulators' evaluation of mandatory securities arbitration's fairness to consumers.

I. Mandatory Securities Arbitration, Recent Legislation, and FINRA Rule 12403(d)

Financial Industry Regulatory Authority ("FINRA") arbitration represents the primary venue for customers to resolve disputes against their

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financial advisors and brokerage firms.[2] As part of opening an account, most brokerage firms require their customers to sign a pre-dispute arbitration agreement.[3] This agreement compels customers to resolve any future securities disputes that arise out of or relate to their account through FINRA arbitration and therefore prevents customers from bringing such claims in court.[4] Various politicians, scholars and consumer rights activists have criticized brokerage firms' employment of pre-dispute arbitration clauses and have questioned the fairness to customers of the securities arbitration process.[5] In contrast, proponents of mandatory securities arbitration contend

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2. *See*, *e.g.,* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 706 (2010) ("The largest investor arbitration forum is administered by FINRA."); *see also* FINRA Arbitration and Mediation, http://www.finra.org/ArbitrationMediation/ (last visited April 7, 2011)("FINRA operates the largest dispute resolution forum in the securities industry to assist in the resolution of monetary and business disputes between and among investors, securities firms and individual registered representatives.").

3. *See*, e.g., Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 61 (2010) ("Currently, virtually all broker-dealers include in their customers' agreements a predispute arbitration agreement (PDAA) that requires customers to arbitrate their disputes before the Financial Industry Regulatory Authority (FINRA) arbitration forum.").

4. *Id.*

5. *See, e.g.,* Igor M. Brin, *The Arbitration Fairness Act of 2009*, 25 OHIO ST. J. ON DISP. RESOL. 821, 823-34 (2010); *see also* Richard M. Alderman, *Why We Really Need the Arbitration Fairness Act It's All About Separation of Powers*, 12 J. CONSUMER & COM. L. 151 (2009). This author argues,

> In fact . . . consumer arbitration is not about an alternative forum for dispute resolution, it is about a modification of substantive rights. Consumer arbitration is often simply a way for a business to reduce the number of disputes, avoid the courts and juries, and achieve more favorable results. Arbitration is not about relocating or simplifying consumer dispute resolution; it is about eliminating consumer disputes and controlling their resolution.

Moreover, political concern with mandatory arbitration has been voiced through such proposed legislation as the Arbitration Fairness Act of 2009 (H.R. 1020, 111th Cong. (2009); S. 931, 111th Cong. (2009)) and through the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Both of these pieces of legislation are discussed *infra*.

that it is fair to consumers and that consensual pre-dispute arbitration clauses do not violate consumer rights.[6]

Recent political developments – such as the Arbitration Fairness Act of 2009 ("AFA")[7] and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[8] – reflect growing political mistrust of pre-dispute arbitration clauses in general, including their widespread use by brokerage firms in customer contracts. For example, the AFA called for the

6. For an overview of proponents' arguments in support of mandatory arbitration, see Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 PACE L. REV. 1174 (2010) (arguing that "securities arbitration is markedly different from other forms of consumer arbitration" and discussing a variety of reasons why regulators should not interfere with mandatory securities arbitration); Alicia J. Surdyk, *On the Continued Vitality of Securities Arbitration: Why Reform Efforts Must Not Preclude Predispute Arbitration Clauses*, 54 N.Y.L. SCH. L. REV. 1131 (2010) (arguing that mandatory arbitration should not be eliminated but that the FINRA arbitration process should be made more transparent); Stephen J. Ware, *What Makes Securities Arbitration Different from Other Consumer and Employment Arbitration?*, 76 U. CIN. L. REV. 447 (2008) (discussing how arbitration of disputes in the securities industry differs from general consumer and employment arbitration and arguing, inter alia, that "the law should enforce contractual arbitration clauses, not so much because of the virtues . . . in arbitration, but because of the virtues . . . in each party's freedom to choose whether or not to obligate itself to use arbitration."); Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 493 (2008) (discussing various factors that promote securities arbitration's fairness to consumers).

7. Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. (2009); S. 931, 111th Cong. (2009). For a general discussion of the Arbitration Fairness Act of 2009, see Mark C. Watler, *Arbitration of Securities Cases and the Arbitration Fairness Act of 2009*, 13 J. Consumer & Com. L. 55, 56 (2010) (providing a general discussion of the Arbitration Fairness Act and arguing against its enactment); see also Igor, *supra* note 5, at 834-841 (discussing the positions of proponents and critics of the Arbitration Fairness Act); see also Alderman, *supra* note 5, at 151-52 (arguing in support of the Arbitration Fairness Act's enactment). The Arbitration Fairness Act of 2009 will be discussed more extensively *infra*.

8. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). For a general discussion of Dodd-Frank's potential impact on securities arbitration, see Gross, *supra* note 6, at 1178-83; see also Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act,* 13 U. PA. J. BUS. L. 59, 60-61 (2010). The Dodd-Frank Wall Street Reform and Consumer Protection Act will be discussed more extensively *infra*.

abolition of pre-dispute arbitration clauses from all consumer contracts.[9] Relatedly, Dodd-Frank has charged two regulatory agencies – the Securities and Exchange Commission ("SEC") and the newly established Bureau of Consumer Financial Protection – to review the fairness of pre-dispute arbitration clauses.[10] Dodd-Frank grants these agencies the authority to limit or prohibit mandatory arbitration agreements if either finds them to be unfair to consumers.[11]

In response to growing political concerns against mandatory arbitration, FINRA enacted Rule 12403(d), which allows customer claimants in securities cases to prevent financial industry affiliated individuals from serving on the arbitration panel of their case.[12] Prior to FINRA's enactment of this Rule, its rules required that one member of each three-arbitrator panel be a securities industry representative.[13]

This paper critically analyzes whether FINRA Rule 12403(d) changes the debate on mandatory arbitration given current legislative concerns. Some authors have argued that FINRA Rule 12403(d) enhances the fairness of securities arbitration to the extent that federal regulatory agencies, pursuant to Dodd-Frank, should refrain from prohibiting mandatory arbitration clauses

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9. H.R. 1020; S. 931.

10. Dodd Frank § 921; § 1028 (a)-(b).

11. Dodd Frank § 921 (providing the SEC with authority to "prohibit, or impose conditions or limitations on" the use of pre-dispute arbitration agreements between financial service providers and their customers). Dodd Frank § 1028 (a)-(b) (charging the Bureau of Consumer Financial Protection with studying pre-dispute arbitration agreements and providing the Bureau with authority to impose limitations on the use of such agreements if it "finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers.").

12. *See* FINRA Rule 12403(d). For an overview of this rule, see Notice to Parties – New Optional All Public Panel Rules, http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P122873 (last visited April 8, 2011).

13. *See* FINRA Rule 12403(c); *see also* Notice to Parties – New Optional All Public Panel Rules, http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P122873 (last visited April 8, 2011) (discussing customers' option to choose between the "Optional All Public Panel Rule 12403(d)" and the pre-existing "Majority Public Panel Rule 12403(c)").

in customer securities contracts.[14] However, this paper argues that FINRA Rule 12403(d) will not seriously alter regulatory evaluation of the fairness of mandatory securities arbitration to consumers.

Part II of this paper provides a historical overview of mandatory securities arbitration in the United States, including applicable legislation and case law. Part III discusses issues that comprise the current debate on mandatory securities arbitration. Part IV examines FINRA Rule 12403(d). Part IV posits that this rule change does not significantly alter the mandatory securities arbitration debate and, therefore, that it should not substantially affect regulatory evaluation of the fairness to consumers of securities arbitration . Part V offers a summation and conclusions.

II. Historical Context for The Mandatory Securities Arbitration debate: Caselaw and Legislative Developments

In two landmark rulings, the United States Supreme Court has articulated a policy of enforcing pre-dispute arbitration agreements in customer securities disputes. Nevertheless, recent legislation has demonstrated Congressional concern with such agreements. These rulings and the subsequent legislative response to pre-dispute arbitration agreements will now be discussed.

A. Landmark Supreme Court Rulings on Mandatory Securities Arbitration

The United States Supreme Court's decisions in *Shearson/American Express v. McMahon* ("McMahon")[15] and *Rodriguez de Quijas v. Shearson/American Express, Inc.* ("Rodriguez de Quijas")[16] established the enforceability of pre-dispute arbitration agreements in customer securities

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14. For example, in a recent post on "ADR Prof Blog," Professor Jill Gross of Pace University Law School stated, "I predict that the SEC's Dodd-Frank study of FINRA arbitration will now conclude that [FINRA Rule 12403(d)] enhances the fairness of the forum. As a result, the SEC will refrain from prohibiting mandatory securities arbitration." Jill Gross, *SEC Approves All Public Panel Option for FINRA Customer Arbitrations*, http://www.indisputably.org/?p=2031 (last visited April 8, 2011).

15. Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 220 (1987).

16. Rodriguez de Quijas v. Shearson/Am. Exp., Inc., 490 U.S. 477, 477 (1989).

contracts. In 1987, the *McMahon* Court ruled that customer securities claims arising out of the Securities and Exchange Act of 1934 are subject to mandatory arbitration if customers signed pre-dispute arbitration agreements.[17] The Court interpreted the Federal Arbitration Act ("Arbitration Act")[18] to "[establish] a federal policy favoring arbitration, requiring that the courts rigorously enforce arbitration agreements."[19] In 1989, *Rodriguez de Quijas* extended the validity of pre-dispute arbitration agreements to claims arising out of the Securities Act of 1933.[20]

The Court based these holdings on its interpretation of the Congressional intent underlying the Arbitration Act.[21] In *McMahon,* the Court stated that

> The Arbitration Act, standing alone, therefore mandates enforcement of agreements to arbitrate statutory claims. Like any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command. The burden is on the party opposing arbitration, however, to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue. If Congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent "will be deducible from [the statute's] text or legislative history," or from an inherent conflict between arbitration and the statute's underlying purposes.[22]

Rodriguez de Quijas similarly based its decision on Congress' intent to expand the power of arbitration agreements in passing the Arbitration Act.[23] The Court held,

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17. *McMahon*, 482 U.S. at 220.

18. Federal Arbitration Act, 9 U.S.C.A § 2 (1947). This provision, entitled "Validity, irrevocability, and enforcement of agreements to arbitrate" states,

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

19. *McMahon*, 482 U.S. at 220.

20. *Rodriguez de Quijas*, 490 U.S. at 477.

21. *McMahon*, 482 U.S. at 226-27; *Rodriguez de Quijas*, 490 U.S. at 483.

22. *McMahon*, 482 U.S. at 226-27.

23. *Rodriguez de Quijas*, 490 U.S. at 483.

> Finally, in *McMahon* we stressed the strong language of the Arbitration Act, which declares as a matter of federal law that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Under that statute, the party opposing arbitration carries the burden of showing that Congress intended in a separate statute to preclude a waiver of judicial remedies, or that such a waiver of judicial remedies inherently conflicts with the underlying purposes of that other statute.[24]

Although *McMahon* and *Rodriguez de Quijas* establish the validity of pre-dispute arbitration agreements, both reserve the possibility that future congressional legislation may invalidate such agreements.[25] Recent pro-consumer legislation, including the AFA and Dodd-Frank, may invalidate pre-dispute arbitration clauses and overturn the *McMahon* and *Rodriguez de Quijas* decisions.[26]

B. Legislative Developments Concerning Mandatory Securities Arbitration

Although courts currently hold that pre-dispute arbitration agreements in customer securities contracts are enforceable pursuant to Section 2 of the Federal Arbitration Act,[27] congressional legislation has articulated concerns with such agreements. This legislation includes the Arbitration Fairness Act of 2009 ("AFA")[28] and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[29].

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24. *Id*.

25. *Id.*; *McMahon*, 482 U.S. at 226-27.

26. *See, e.g.,* Tamara Hoffbuhr-Seelman, *The Future of Mandatory Securities Arbitration Under the Dodd-Frank Act,* THE BUSINESS SUIT, Dec. 6, 2010, http://www.fwlaw.com/Securities_Arbitration_Under_Dodd-Frank.pdf; *see also* Gross, *supra* note 6, at 1178-83; *see also* Black, *supra* note 8, at 60-61.

27. *McMahon*, 482 U.S. at 226-27; *Rodriguez de Quijas*, 490 U.S. at 483.

28. Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. (2009); S. 931, 111th Cong. (2009).

29. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

1. *The Arbitration Fairness Act ("AFA")*

In 2009, the House and Senate introduced bills to enact the AFA.[30] If passed, the AFA would have voided all pre-dispute mandatory arbitration agreements, including those used in customer securities disputes.[31] Although the AFA never made it to a vote in either house, its introduction demonstrated growing legislative concern with binding pre-dispute arbitration agreements.[32]

The AFA's findings section states that "The Federal Arbitration Act … was intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power," but notes that this legislative intention was disrupted by Supreme Court decisions that "have changed the meaning of the [Federal Arbitration Act] so that it now extends to disputes between parties of greatly disparate economic power, such as consumer disputes."[33] The AFA's findings state that

> Most consumers … have little or no meaningful option whether to submit their claims to arbitration. Few people realize, or understand the importance of the deliberately fine print that strips them of rights; and because entire industries are adopting these clauses, people increasingly have no choice but to accept them. They must often give up their rights as a condition of having a job, getting necessary medical care, buying a car, opening a bank account, getting a credit card, and the like. Often times, they are not even aware that they have given up their rights.[34]

The AFA's findings suggest that the absence of an appeals process in arbitration "undermines the development of public law for … consumer

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30. Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. (2009); S. 931, 111th Cong. (2009).

31. The AFA proposed a variety of amendments to the Federal Arbitration Act's text. These amendments included the insertion of a clause into the Federal Arbitration Act that stated, "No predispute arbitration agreement shall be valid or enforceable if it requires arbitration of (1) an employment, consumer, or franchise dispute; or (2) a dispute arising under any statute intended to protect civil rights."

32. For a summary of the AFA's progression in the House of Representatives, see http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.1020:. Similarly, for a summary of the AFA's progression in the Senate, see http://thomas.loc.gov/cgi-bin/bdquery/z?d111:SN00931:.

33. Arbitration Fairness Act of 2009, H.R. 1020 § 2, 111th Cong. (2009); S. 931 § 2, 111th Cong. (2009).

34. *Id*.

rights"[35] and that, as a result, "arbitrators enjoy near complete freedom to ignore the law and even their own rules."[36] The lack of transparency of arbitration compromises consumer rights.[37]

2. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

Congress passed Dodd-Frank in 2010.[38] It authorized two regulatory agencies to review the fairness to consumers of pre-dispute arbitration clauses.[39] It established the Bureau of Consumer Financial Protection (the "Bureau"),[40] vested it with the authority to regulate consumer financial products and services[41] and directed it to "conduct a study of, and … provide a report to Congress concerning, the use of agreements providing for arbitration of any future dispute between [financial services providers] and consumers in connection with the offering or providing of consumer financial products or services."[42] Upon the findings of such a study, Dodd-Frank authorizes the Bureau to prohibit or limit financial service providers' use of pre-dispute arbitration agreements in customer contracts if doing so is "in the public interest and for the protection of consumers."[43]

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35. *Id*.

36. *Id*.

37. *Id*. The AFA's findings pertaining to arbitration's transparency state,

> Mandatory arbitration is a poor system for protecting civil rights and consumer rights because it is not transparent. While the American civil justice system features publicly accountable decision makers who generally issue written decisions that are widely available to the public, arbitration offers none of these features.

38. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

39. *Id*. at § 921; § 1028 (a)-(b).

40. *Id*. at § 1011. Dodd-Frank provides that "There is established in the Federal Reserve System, an independent bureau to be known as the 'Bureau of Consumer Financial Protection', which shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws."

41. *Id*.

42. *Id*. at § 1028(a).

43. *Id*. at § 1028(b).

Dodd-Frank conferred similar authority upon the SEC to prohibit or limit financial service providers' use of pre-dispute arbitration agreements in customer contracts.[44] It authorizes the SEC to

> prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.[45]

III. An Overview of the Mandatory Securities Arbitration Debate

The debate over pre-dispute arbitration agreements in the securities customer context centers around a variety of issues, including (1) the freedom of contract, (2) the SEC's regulatory oversight of FINRA, (3) the transparency of the FINRA arbitration process, and (4) the FINRA Customer Code's protection of customer due process rights. Part III of this paper discusses the positions of proponents and critics on each of these issues. Part IV analyzes FINRA Rule 12403(d) and its effect, if any, on the mandatory arbitration debate.

A. Freedom of Contract and Voluntariness of Pre-Dispute Arbitration Agreements

Proponents of mandatory securities arbitration argue that pre-dispute arbitration agreements should remain enforceable as a matter of consumers' freedom of contract.[46] They say that pre-dispute arbitration agreements are "nothing more than a contract to resolve a dispute extrajudicially and in a

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44. Dodd-Frank § 921.

45. *Id*.

46. *See, e.g.,* Surdyka, *supra* note 6, at 1143-1145; *see also* Robert A. de By, Amy L. Rudd, *Court Is Not the Answer for Securities Arbitration Disputes*, 25 ALTERNATIVES TO HIGH COST LITIG. 129, 133 (2007) (arguing that "the consumer has a choice, and therefore acts voluntarily, even where an adhesion contract is concerned. The consumer can choose to simply walk away from the contract, or choose a different provider.").

private forum" and that parties should be held to these agreements if they enter into them.[47] One proponent argued that

> investors are free to choose to submit to the arbitration clause, thereby enjoying the benefits associated with capitalism and a free marketplace. Investors are equally free, however, to pursue the alternate, yet equally free choice to invest by other means--that is to say, no one forces the hand of the investor into the stock market or other financial investments.[48]

Critics of mandatory securities arbitration argue that pre-dispute arbitration agreements are inherently involuntary, do not reflect meaningful consumer choice and are therefore unfair to consumers. They argue that this involuntariness and unfairness result from consumers' lack of bargaining power with their brokerage firms in negotiating the terms of pre-dispute arbitration agreements,[49] their frequent unawareness of the arbitration clauses in the agreements they sign[50] and their frequent unawareness of the legal consequences of entering these agreements.[51] One author noted that "Customers often fail to read the form agreements that contain mandatory-binding-arbitration clauses, and even when they do read them, they

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47. Peter B. Rutledge, *Arbitration Reform: What We Know and What We Need to Know*, 10 CARDOZO J. CONFLICT RESOL. 579, 579 (2009).

48. *See, e.g.,* Surdyka, *supra* note 6, at 1144-1145.

49. *See, e.g.,* Darren P. Lindamood, *Redressing the Arbitration Process: An Alternative to the Arbitration Fairness Act of 2009*, 45 WAKE FOREST L. REV. 291, 292 (2010) (noting that "Critics point to substantial problems with the current arbitration system. Problems originate when corporate employers or manufacturers insert arbitration agreements into contracts, and the individual employee or consumer has little or no influence on the terms."); *see also* Joshua T. Mandelbaum, *Stuck in A Bind: Can the Arbitration Fairness Act Solve the Problems of Mandatory Binding Arbitration in the Consumer Context?*, 94 IOWA L. REV. 1075, 1088 (2009) ("In many of the transactions where businesses use mandatory binding consumer arbitration, the bargaining power rests predominantly with the business.").

50. *See* Arbitration Fairness Act of 2009, H.R. 1020 § 2, 111th Cong. (2009); S. 931 § 2, 111th Cong. (2009); *see also* Mandelbaum, *supra* note 49, at 1088.

51. *See, e.g.,* Lindamood, *supra* note 49, at 292. Here, Lindamood notes that "Not only are individuals unable to influence or avoid agreeing to these arbitration clauses, most consumers and employees *are unaware that they have waived the right to bring a future claim in a court of law* [emphasis added]."

frequently do not understand those clauses. . . . This means that the use of mandatory binding arbitration is often nonconsensual."[52]

B. The SEC's Regulatory Oversight of FINRA

Proponents of mandatory securities arbitration argue that SEC oversight of FINRA ensures that it remains procedurally fair to customers.[53] For example, a law school professor t says that "the SEC robustly exercises its extensive authority to oversee the primary securities SRO, FINRA, including its dispute resolution arm. This SEC oversight is designed to ensure that FINRA rules, including its Code of Arbitration Procedure, are fair and protect investors."[54]

In contrast, critics of mandatory securities arbitration argue that SEC oversight of FINRA does not adequately protect customers' interests.[55] One such critic states:

> As a general matter, investors benefit from Securities and Exchange Commission ("SEC") mandated discosures because such rules and regulations create transparency in the marketplace for debt and equity instruments and other investment vehicles. *However, when investments take a turn for the worse and small investors seek to bring actions against the industry professionals who allegedly caused them harm, the SEC has ironically taken a "hands-off" approach to the arbitration system run by securities-industry insiders* [emphasis added].[56]

Similarly, a recent study of the SEC – as authorized by Dodd-Frank – may refute proponents' contention that the SEC exercises robust regulatory

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52. *See* Mandelbaum, *supra* note 49, at 1088.

53. *See, e.g.,* Mark C. Watler, *Arbitration of Securities Cases*, 47 HOUS. LAW. 18, 19 (2009) ("Since it is usually an investor's sole remedy, FINRA's arbitration program is subject to extensive oversight by the SEC, and ultimately by Congress."); *see also* Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1186; *see also* Gross, *supra* note 6 (McMahon Turns Twenty), at 503 ("SEC oversight [of FINRA] has led to fair forum rules.").

54. Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1186.

55. *See, e.g.,* Surdyk, *supra* note 6, at 1133.

56. *Id*.

oversight over FINRA.[57] The study stated that "The SEC should … enhance oversight of the Financial Industry Regulatory Authority (FINRA)"[58] and that "The SEC currently does not employ a consistent set of metrics or standards by which to assess the regulatory efficacy of [SRO's, such as FINRA]."[59] The study noted that the SEC has access to only a limited portion of the filing data that FINRA gathers, thereby frustrating regulatory oversight.[60], The suggestion study's opinion that "The SEC should institute clearer processes for SRO rule proposals and the SEC's review thereof"[61] implies that the SEC's oversight of FINRA rule proposals is less comprehensive than proponents of mandatory arbitration would have us believe.

Although the SEC oversees FINRA's rule making process, it does not regulate how individual arbitrators apply FINRA's rules in customer cases.[62] The wide discretion that FINRA affords to arbitrators in conducting arbitrations and the practical absence of an appeals process for reviewing Awards prevents SEC oversight – no matter how great – from ensuring that arbitrators fairly administer FINRA's rules.[63] These facts lead one to the conclusion that SEC oversight alone cannot ensure customers will be treated fairly once compelled into arbitration.

C. Transparency of the FINRA Arbitration Process

One advocate of mandatory securities arbitration argues that FINRA Dispute Resolution "actively promotes transparency of the arbitration process."[64] She states that FINRA's "user-friendly website is replete with guides, resources and links to materials that are helpful to users of the forum

57. *See US Securities and Exchange Commission Organizational Study and Reform*, BOSTON CONSULTING GROUP, Mar. 10, 2011, *available at* http://www.sec.gov/news/studies/2011/967study.pdf.

58. *Id*. at 8.

59. *Id*. at 65.

60. *Id*. at 218.

61. *Id*. at 8.

62. *See* Surdyk, *supra* note 6, at 1133.

63. *Id*.

64. Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1188.

– both parties and their representatives."[65] She notes that FINRA "recently amended its rules to require arbitrators to write an explained decision, if all parties jointly request one"[66] and that it did so "[t]o enhance arbitrator accountability."[67] However, this rule seems to be no more than window dressing since it is doubtful that *all* parties will agree on anything substantive, let alone that their panel should issue an explained Award.

Critics of mandatory arbitration forcefully disagree that FINRA arbitration is a transparent process.[68] One author notes, "Opponents . . . point out that arbitration is not transparent because hearings are held in private, written decisions are not always published."[69] Accordingly, the availability of "guides, resources and links to materials"[70] may be insufficient to consumers who are worried about arbitrator accountability; such resources may promote arbitration efficiency but do nothing to ensure the transparency of arbitrator decisions.

FINRA rules do not require arbitrators to issue an explanation for their decision unless all parties to the dispute jointly request such an explanation by at least twenty days prior to the first hearing date.[71] Absent a timely joint request by all parties, arbitrators may voluntarily issue an explanation for their decision but are not compelled to do so.[72] Nor, in that instance, would they be compensated for such an undertaking. Moreover, arbitrator explanations are by no means comprehensive even when parties request

65. *Id*.

66. *Id*.

67. Id.

68. *See, e.g.,* Mandelbaum, *supra* note 49, at 1092 (suggesting that a combination of an absence of written arbitration decisions and "the fact that most arbitration proceedings are private, closed hearings" renders the arbitration process "a vacuum of information about arbitration and its outcomes."); *see also* Brin, *supra* note 5, at 828 (noting opponents' contention of the absence of transparency from the arbitration process); *see also* Georgios Zekos, *Realities of Securities Arbitration in the USA Today*, 12 VJ 33, 52 (2008) (quoted *infra*).

69. Brin, *supra* note 5, at 828.

70. Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1188.

71. *See* FINRA Rule 12514(d) ("At least 20 days before the first scheduled hearing date, all parties must submit to the panel any joint request for an explained decision under Rule 12904(g).").

72. *See* FINRA Rule 12904(f) ("The award may contain a rationale underlying the award.").

explained decisions.[73] One author notes the potential consequences of arbitrators not explaining or not adequately explaining the decisions they issue:

> Without written opinions, the risk of discriminatory and illegitimate awards is significant. Due process demands that the parties are able to identify at least something of the arbitrator's reasoning. Without a concise justification for the award the parties have no reliable indicia of whether the arbitrator's award was founded on the material facts or a suitable interpretation and application of law. An arbitrator who is obliged to render a reasoned written opinion will be more prudent in evaluating the evidence and less likely to be influenced by bias. Accountability guides arbitrators to be more cautious when they reason their conclusions.[74]

A number of factors may impede the transparency of securities arbitration by dissuading or preventing parties from seeking explained decisions. These factors include the cost of explained decisions,[75] their utility to parties,[76] the deadline by which parties must apply for them,[77] and FINRA's requirement that parties must request them jointly.[78] First, FINRA charges parties $400 for an explained decision,[79] a cost that arbitrators may assign to either or both parties.[80] This expense may be difficult to bear, especially for customers with smaller claims or less affluent customers.[81]

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73. *See* Surdyk, *supra* note 6, at 1140. This author observes that "arbitration awards, unlike court decisions, generally do not contain a detailed explanation of the arbitrators' rationale and findings and are never memorialized as a published, written document."

74. Zekos, *supra* note 68, at 52.

75. *See* FINRA Rule 12904(g)(5) ("The chairperson will receive an additional honorarium of $400 for writing the explained decision . . . The panel will allocate the cost of the chairperson's honorarium to the parties as part of the final award.").

76. *See infra* note 82.

77. *See* FINRA Rule 12514(d), *supra* note 71.

78. *Id*.

79. *See supra* note 75.

80. *Id*.

81. Although proponents of mandatory securities arbitration argue that arbitration is inexpensive, at least relative to the costs of litigation or other forms of consumer arbitration (*see, e.g.,* Gross, *supra* note 6 (*The End of Mandatory Securities*

This expense may outweigh the utility of explained decisions; the meagerness of arbitrator explanations and the absence of a meaningful ability to appeal arbitration Awards may render explained decisions meaningless and unjustified by their added cost.[82]

The deadline by which FINRA requires parties to request explained decisions may also impede the transparency of securities arbitration.[83] Parties' desire for an arbitrator's explanation may emerge after FINRA's deadline, currently 20 days prior to the first hearing date.[84] One FINRA Regulatory Notice, entitled "Explained Arbitration Decisions: SEC Approves Amendments to Require Arbitrators to Provide an Explained Decision at Parties' Joint Request," notes that:

> The absence of explanations in awards has been a common complaint *of non-prevailing parties* in FINRA's arbitration forum, especially customers and associated persons. The amendments [to FINRA rules that provide for explained decisions] are intended to address this complaint

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Arbitration?), at 1188 (noting that "FINRA subsidizes forum fees by charging securities industry parties a greater percentage of its costs than investors" and that "The [FINRA] Customer Code provides for the waiver of filing fees upon ample demonstration of financial hardship."), other authors have emphasized the financial burden on investors that securities arbitration imposes. *See, e.g.,* Laurence M. Landsman, *Major Reform to Rules Governing the Broker-Investor Relationship is on the Way,* 56 CORP. SEC. & BUS. F. 2, 2 (January, 2011). Landsman comments,

> The benefits [of securities arbitration], however, come at significant monetary and strategic costs which are disproportionately borne by members of the investing public. For example, the cost of bringing a FINRA arbitration proceeding can be prohibitively expensive to an investor compared to the relatively well-funded brokerage firm. In a claim seeking more than $100,000 in damages, an investor faces fees of thousands of dollars regardless of the outcome—significantly more than the cost of filing a lawsuit. Investors also face substantial costs of retaining expert witnesses to testify on issues of liability and/or damages, whereas respondent brokers and brokerage firms often rely on the testimony of employees rather than outside experts to provide such evidence.

82. For a discussion of the difficulty that parties face in appealing arbitrator decisions, see Zekos, *supra* note 68, at 41. Moreover, this topic is discussed further *infra*.

83. *See* FINRA Rule 12514(d), clarified *supra*, note 71.

84. *Id*.

and increase investor confidence in the fairness of the arbitration process [emphasis added].[85]

FINRA acknowledges that explained decisions are most valuable to non-prevailing parties.[86] Parties may not perceive the value of an explained decision by the deadline FINRA's rule imposes and may not feel the need to request one by this time.[87]

Lastly, FINRA rules require that all parties to the arbitration must jointly request an explained decision for the arbitration panel to issue one.[88] This requirement renders a party's ability to obtain an explained decision – however worthwhile one may be – contingent upon an adversary or adversaries' discretion. Each of these barriers, alone or in combination, impedes the transparency of FINRA arbitration to customers.

D. FINRA Customer Code's Protection of Customer Due Process Rights

Proponents of mandatory securities arbitration argue that FINRA's Customer Code ensures that arbitration is procedurally fair to customers.[89] However, one such proponent admits that:

85. Explained Arbitration Decisions: SEC Approves Amendments to Require Arbitrators to Provide an Explained Decision at Parties' Joint Request, Regulatory Notice 9-16 (Mar. 2009), *available at* http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_09-16.pdf.

86. *Id*.

87. In this regard, attorney overconfidence in the likelihood of prevailing in arbitration may work to clients' disfavor. For empirical findings regarding attorney overconfidence in litigation, see Jane Goodman-Delahunt, Pär Anders Granhag, Maria Hartwi, & Elizabeth F. Loftu, *Insightful or Wishful: Lawyers' Ability to Predict Case Outcomes,* 16 PSYCHOL. PUB. POL'Y & L. 133, 133 (2010) (finding that attorneys were overconfident in their predictions of prevailing at trial.).

88. *See* FINRA Rule 12514(d), clarified *supra*, note 71; *see also* FINRA Rule 12904(g)(1) (confining explained decisions to "when all parties jointly request an explained decision.").

89. *See, e.g.,* Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1186-89; *see also* Gross, *supra* note 6 (*McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*), at 515; *see also* Watler, *supra* note 7, at 58-59.

> In the securities context, FINRA's newly overhauled Customer Code – recently approved by the SEC after years of rule-making activity – includes no formal "Due Process Protocol" and thus no formal recognition of the full spectrum of due process rights that are recognized via protocols in other forums.[90]

This writer and others argue that various FINRA Customer Code provisions protect customers' due process rights *despite* the Code's lack of an explicit due process protocol.[91] These Customer Code provisions include language requirements for the content and form of brokerage firms' pre-dispute arbitration clauses,[92] fair notice of pleadings,[93] an opportunity to be heard (applicable only to cases involving an amount in dispute of greater

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90. Gross, *supra* note (*McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*), at 502-503.

91. *Id.* at 503.

92. *See* FINRA Rule 3110(f) (establishing requirements for brokerage firms' use of pre-dispute arbitration agreements for customer accounts); *see also* Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1186. For a brief discussion of this provision, see Securities and Exchange Commission Investor Advisory Committee Panel on Securities Arbitration – Financial Industry Regulatory Authority Statement on Key Issues (May 17, 2010), *available at* http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-finra.pdf. This article states,

> when firms use these agreements, FINRA regulates their content and form (FINRA Rule 3110(f)). Predispute arbitration clauses in investor agreements must be highlighted and preceded by specified language stating, among other matters, that parties to a predispute arbitration agreement are giving up the right to sue each other in court; and that arbitration awards are generally final and binding. The contract also must contain a highlighted statement immediately preceding the signature line that states that the contract contains a predispute arbitration agreement, and the firm must give a copy of the agreement to the investor, who must acknowledge receiving it. FINRA rules also protect investors by prohibiting agreements that would limit the ability of any investor to file any claim in arbitration or that limits the power of arbitrators to make any award. For example, arbitrators can and do award punitive damages in favor of investors.

93. *See* FINRA Rule 12300. Amongst its provisions, this Rule requires that "(b) The parties must serve all other pleadings and other documents directly on each other party. Parties must serve all pleadings on all parties at the same time and in the same manner, unless the parties agree otherwise."

than $25,000),[94] a right to represent oneself or to be represented by an attorney or other third party,[95] a hearing location that is convenient for the customer,[96] and a customer's ability to prevent individuals with industry affiliations from serving on the arbitration panel.[97]

Critics of mandatory securities arbitration contend that a combination of broad arbitrator discretion and the virtual inability of parties to appeal awards prevent FINRA and the SEC from ensuring the procedural fairness of each individual arbitration.[98] These critics assert that customers face great difficulty in attempting to vacate inequitable arbitration Awards due to the "manifest disregard of the law" standard of review that courts use to evaluate arbitration decisions. One critic summarizes this argument:

> The "manifest disregard of the law" standard of review is accepted at state and federal judicial levels in the United States. *Vacatur* under "manifest disregard" is fitting only if the arbitral panel intentionally ignores the governing law. The alleged disregard must go beyond mere error of law — it must be shown that the arbitrators knew the law and chose to ignore it. Additionally, the "manifest disregard" standard requires some judicial inquiry into reasons for the arbitrator's decision. It has been observed that this requirement will be virtually impossible to meet where the arbitrator has not given reasons. Where an award seems to show manifest disregard of the law, courts sometimes take into

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94. *See* FINRA Rule 12600. A "simplified arbitration" process, involving no hearing, is applied to cases involving amounts in dispute of $25,000 or less. *See* FINRA Rule 12800(a).

95. *See* FINRA Rule 12208(a)–(c) (stipulating that a party may represent itself at arbitration, may be represented by an attorney, or may be represented by a party that is not an attorney).

96. *See* FINRA Rule 12213(a). This provision provides that the Director of FINRA Dispute Resolution

> will select the hearing location closest to the customer's residence at the time of the events giving rise to the dispute, unless the hearing location closest to the customer's residence is in a different state, in which case the customer may request a hearing location in the customer's state of residence at the time of the events giving rise to the dispute.

97. *See* FINRA Rule 12403(d).

98. *See, e.g.,* Surdyk, *supra* note 6, at 1133 (noting critics' contention that "when injured investors are most in need of SEC-enforced protections, which encourage proper disclosure, they are instead med with an arbitration process that can appear to be the very antithesis of transparent.").

> account the absence of reasons in determining applications to vacate. Reasoned awards are quite rare in securities arbitration. Federal and state laws do not oblige arbitrators to explain their awards. Until recently SRO's have discouraged their arbitrators from giving reasons for their awards because explanations were seen as almost inviting judicial review. … It follows that, with the prevailing absence of written reasons, judicial *vacatur* under the "manifest disregard" standard is not common in securities matters.[99]

FINRA's Customer Code provisions cannot guarantee investors the standard due process protections of court because parties to arbitration are simply not entitled to those protections.[100] Courts have held that because arbitration does not constitute a "state action," disputants are not entitled to due process protections.[101] Even as one supporter of pre-dispute arbitration agreements admits, "In the securities context … most courts addressing the issue have concluded that the Due Process Clause is inapplicable to arbitrations administered by FINRA because [arbitration] is a matter of private contact."[102] Due process protections are simply not a reality of private arbitration, in the securities field or otherwise.

IV. FINRA Rule 12403(d) and Its Impact on The Mandatory Arbitration Debate

FINRA Rule 12403(d) should not significantly change government regulators' perception of the fairness to customers of mandatory securities arbitration. Regardless of whether FINRA Rule 12403(d) enhances the impartiality of arbitration panels, it does not resolve many of the fundamental concerns that underlie the mandatory securities arbitration debate. The debate on the fairness of mandatory securities arbitration remains largely the same despite this rule change.

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99. Zekos, *supra* not 68, at 42-44.

100. *See* Gross, *supra* note 6 (*McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*), at 501-02.

101. *Id*.

102. *Id*.

A. The FINRA Arbitrator Selection Process and Rule 12403(d)

FINRA assigns three-arbitrator panels to resolve customer claims that exceed $100,000.[103] It determines the composition of these panels as follows:

(1)FINRA randomly generates three separate lists, each list containing 10 arbitrator candidates; these include a "chair-qualified arbitrator" list, a "public arbitrator" list and a "non-public arbitrator" list.[104] Arbitrator candidates are ineligible to be either "chair-qualified" or "public" arbitrators if they possess certain affiliations with the financial services industry.[105] By contrast, candidates on the "non-public" arbitrator list must possess certain affiliations with the financial services industry.[106]

(2) FINRA sends these lists to each of the parties.[107]

(3) The parties independently rank the candidates on each list that they desire to serve on the arbitration panel and "strike" those that they do not. (FINRA has traditionally provided each party with up to four "strikes" per list.)[108]

(4) FINRA determines the composition of the arbitration panel by ordering the candidates on each list according to the parties' combined rankings and removing the candidates that any party has struck.[109] Prior to FINRA Rule 12403(d), FINRA would appoint the top candidate on each of the three lists to the arbitration panel.[110]

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103. *See* FINRA Rule 12401(c) (stipulating also that FINRA will assign three-arbitrator panels to claims involving "unspecified" monetary relief or claims in which the relief requested is non-monetary).

104. *See* FINRA Rule 12403(c)(1)(A); *see also* FINRA Rule 12403(d)(1)(A).

105. *See* FINRA Rule 12400(c) (establishing eligibility for chairperson roster); *see also* FINRA Rule 12100(u) (establishing eligibility for "public arbitrator" classification).

106. *See* FINRA Rule 12100(p) (establishing eligibility for "non-public" arbitrator classification).

107. *See* FINRA Rule 12403(c)(2); *see also* FINRA Rule 12403(d)(2).

108. *See* FINRA Rule 12403(c)(3); *see also* FINRA Rule 12403(d)(3).

109. *See* FINRA Rule 12403(c)(4); *see also* FINRA Rule 12403(d)(4) (both of these Rules stipulate that "[FINRA] will . . . add the combined rankings of claimants and the respondents together, to produce a single combined ranking number for each arbitrator, excluding all arbitrators stricken by a party.").

110. *See* FINRA Rule 12403(c) (providing for an arbitration panel comprised of a "chair-qualified" arbitrator, a "public" arbitrator, and a "non-public" arbitrator).

FINRA Rule 12403(d), enacted in early 2011, eliminates the requirement that a "non-public" arbitrator serve on three-arbitrator panels in customer securities disputes.[111] This Rule allows customers who elect an all-public arbitrator selection option to strike all ten "non-public" candidates, thereby preventing industry affiliates from serving on their arbitration panel.[112] They can still have a non-public arbitrator on the panel but this is no longer a requirement.

B. Criticism of "Non-Public" Presence on Three-Arbitrator Panels

Prior to FINRA Rule 12403(d)'s enactment, critics of FINRA arbitration argued that "non-public" arbitrators created an unfair pro-industry bias. One author notes, "For years, investors and their advocates have complained that the presence of an industry arbitrator on panels creates an unfair bias in favor of the industry members who are accused of wrongfully causing investment losses."[113] In 2008, the North American Securities Administrators Association ("NASAA") called for an "immediate action to improve the fairness of the system of securities arbitration, beginning with the removal of the mandatory industry representative from arbitration panels used to resolve securities disputes involving customers and industry."[114] Empirical research may confirm industry affiliates' tendency to side with brokers or brokerage firms in securities disputes. One study concluded that:

> prior employment relationships may affect arbitration awards. Arbitrators who act as attorneys for brokerage firms or brokers may tend to side with brokerage firms and brokers in customer arbitration proceedings, perhaps

111. *See* FINRA Rule 12403(d); *see also Notice to Parties – New Optional All Public Panel Rules,* http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P122873 (last visited Apr. 10, 2011) (discussing FINRA Rule 12403(d)).

112. *See* FINRA Rule 12403(d)(3)(A)(i).

113. *See* Block & Landsman, *Victory for Investors – Securities Arbitrations Now Offer All-Public Arbitrators*, Investment Fraud Lawyer Blog, http://www.investmentfraudlawyer-blog.com/2011/02/victory-for-investors---sec-ap.html (last visited Apr. 10, 2011).

114. North American Securities Administrators Association, *State Securities Regulators Say New Study Clearly Shows Investors View Securities Arbitration as Biased and Unfair, http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/8081.cfm* (last visited Apr. 10, 2011).

> because those attorneys have a more sympathetic view of the industry generally. Alternatively, attorneys who have worked for brokerage firms may have greater industry expertise, which causes them to be more skeptical of investors' claims.[115]

FINRA Rule 12403(d) allows customers to eliminate the appearance of arbitrator panel bias. However, as the next section discusses, the absence of a compulsory industry affiliate from panels resolves neither the majority of issues surrounding the debate over mandatory securities arbitration nor eliminates pro-industry bias from arbitration panels.

C. FINRA Rule 12403(d) and the Mandatory Securities Arbitration Debate

Regardless of whether FINRA Rule 12403(d) enhances the perceived or actual impartiality of arbitration panels, this Rule should not significantly alter regulatory evaluation of the fairness of mandatory securities arbitration to consumers. It does not affect the majority of issues surrounding the ongoing mandatory securities arbitration debate and the actual utility of the Rule to customers remains unclear.

1. FINRA Rule 12403(d), Freedom of Contract and Voluntariness of Pre-Dispute Arbitration Agreements

FINRA Rule 12403(d) leaves the majority of issues surrounding the mandatory securities arbitration debate unresolved. It does not change the circumstances under which customers sign mandatory arbitration agreements; it does not affect the debate over the voluntariness of such agreements.[116] Regulators must distinguish the fairness of FINRA arbitration to consumers once a dispute has arisen from the voluntariness of pre-dispute arbitration agreements. FINRA Rule 12403(d) potentially affects the former but not the latter. Regulatory evaluation of customer assent to pre-dispute arbitration agreements remains warranted. Regulators should analyze the quality of customer consent to pre-dispute arbitration agreements in light of

115. Stephen J. Choi, Jill E. Fisch, A. C. Pritchard, *Attorneys As Arbitrators*, 39 J. L. STUD. 109, 129 (2010).

116. *See* Part III(A), *supra*, for a discussion of the debate over the voluntariness of customer assent in pre-dispute arbitration agreements.

the bargaining power disparities between investors and securities firms,[117] widespread investor unawareness of the arbitration agreements in which they enter[118] or the legal consequences of those agreements when entering them[119] and the ubiquitous presence of such agreements in the retail securities industry.[120]

2. *FINRA Rule 12403(d) and the SEC's Regulatory Oversight of FINRA*

Nor does FINRA Rule 12403(d) alter the debate on either the adequacy of SEC oversight or the ability of this oversight to ensure that securities arbitration is fair to customers. As noted earlier, a recent study indicates that current SEC oversight of FINRA – including the SEC's evaluation of FINRA rule proposals – may be inadequate to protect investor interests.[121] Even assuming *arguendo* the adequacy of SEC oversight of FINRA rule proposals, the change in arbitration panel composition does not enhance the SEC's ability to monitor or review individual arbitration proceedings; the SEC's oversight of securities arbitration remains limited to its evaluation of FINRA rule proposals. Although such regulatory oversight is important to ensuring fair resolution of securities disputes, it alone cannot ensure that arbitrators will equitably apply FINRA's rules.

3. *FINRA Rule 12403(d) and the Transparency of the FINRA Arbitration Process*

FINRA Rule 12403(d) has no impact on the transparency of arbitration. FINRA continues to allow arbitration panels to issue Awards with little or no legal, equitable or factual justification absent a request by all parties for an

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117. *See, e.g.,* Lindamood, *supra* note 49, at 292; *see also* Mandelbaum, *supra* note 49, at 1088.

118. *See* Arbitration Fairness Act of 2009; *see also* Mandelbaum, *supra* note 49, at 1088.

119. *See* Lindamood, *supra* note 49, at 292.

120. *Id*. at 293.

121. *See US Securities and Exchange Commission Organizational Study and Reform*, *supra* note 57, at 8.

explained decision.[122] Their reasoning remains a mystery. Even where parties request explained decisions, the explanations that arbitrators issue may be inadequate.[123] Simply stated, the appearance of a panel's impartiality, which FINRA Rule 12403(d) promotes, does not guarantee its actual impartiality.[124] The absence of compulsory and detailed arbitrator explanations from Awards, while praised by proponents of mandatory arbitration as enhancing the efficiency of arbitration,[125] prevents any meaningful review by the courts of the fairness of individual arbitrations to customers.[126]Given the practical inability of consumers, regulators and courts to fully review individual arbitration awards, the perception of arbitrator impartiality that FINRA Rule 12403(d) creates may further insulate arbitration wards from more exacting political or regulatory scrutiny.

4. The Actual Impact of FINRA Rule 12403(d)?

FINRA Rule 12403(d) may have a less significant impact on customer securities disputes than proponents predict. In fact, one proponent's own assessment of the pilot data of this Rule is that it may not substantially alter the arbitration process for many customers. The author, a law professor, states,

> For example, FINRA's Public Arbitrator Pilot Program gives investors in eligible cases the right to opt into the pilot in order to gain the option to strike all non-public arbitrators, and thus avoid the appointment of an industry-affiliated arbitrator in customer cases. Theoretically, strategic and rational investors should opt into the program whenever eligible, as it only enhances their choices as to the composition of their arbitration

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122. *See* FINRA Rule 12514(d).

123. *See* Surdyk, *supra* note 6 at 1140.

124. For an evaluation of arbitrator impartiality and criticism of FINRA's "public arbitrator" definition as permitting unwarranted conflicts of interest, see subsection 5, *infra*.

125. *See, e.g.*, Marilyn Blumberg Cane & Ilya Torchinsky, *Explaining "Explained Decisions": NASD's Proposal for Written Explanations in Arbitration Awards*, 16 U. MIAMI BUS. L. REV. 23, 32 (2007)("requiring arbitrators to explain their reasoning undermines one purpose of arbitration, which is to provide a relatively inexpensive, quick, efficient, and informal means of private dispute settlement.").

126. *See* Zekos, *supra* note 68, at 52.

> panels in three-arbitrator cases. Yet, through December 31, 2009, barely half of investors (fifty-four percent) opted into the program. And, in those cases, less than half (forty-nine percent) struck all proposed non-public arbitrators. Thus, giving investors the choice of dispute resolution mechanisms under the proposed regime might not lead to rational decision-making and might not maximize investors' interests.[127]

Other data suggest that 73% of customers who were eligible to participate in the pilot program selected "non-public" arbitrators either by ranking one or more "non-public" arbitrators during arbitrator selection or by declining to participate in the pilot program.[128] Although the utility of this Rule to customers remains unknown, it may not have a fundamental impact on securities arbitration. Nevertheless, providing investors with the ability to strike *all* industry affiliates may itself enhance customer confidence in the fairness of securities arbitration.[129] Further evaluation of the benefits of this Rule to customers remains warranted.

5. *Criticism of "Public Arbitrator" Definition and Relevance to FINRA Rule 12403(d)*

Certain investor rights advocates argue that FINRA's "public arbitrator" definition fails to properly differentiate between individuals with and without industry affiliation in certain circumstances.[130] This contention implicates FINRA Rule 12403(d), given the assumption of this Rule that an "all-public"

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127. Gross, *supra* note 6 (*The End of Mandatory Securities Arbitration?*), at 1191 referencing 1 FINRA, The Neutral Corner 7 (2010)).

128. *Public Arbitrator Pilot Program Summary Sheet With Interim Results*, http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P122535 (last visited Apr. 19, 2011).

129. *See* 1 FINRA, The Neutral Corner 3 (2010)*, available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p123215.pdf (quoting FINRA Chairman and Chief Executive Officer Richard Ketchum, "We believe that giving investors the ability to have an all-public panel will increase public confidence in the fairness of our dispute resolution process.").

130. *See* Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator Release No. 57492 (Mar. 13, 2008) (summarizing advocates' arguments pertaining to FINRA's definition of "public arbitrator.").

arbitration panel may be more impartial than a panel containing a designated industry affiliate. FINRA defines "non-public arbitrator" as

> (p) Non-Public Arbitrator
>
> The term "non-public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and: (1) is, or within the past five years, was: (A) associated with, including registered through, a broker or a dealer (including a government securities broker or dealer or a municipal securities dealer); (B) registered under the Commodity Exchange Act; (C) a member of a commodities exchange or a registered futures association; or (D) associated with a person or firm registered under the Commodity Exchange Act; (2) is retired from, or spent a substantial part of a career engaging in, any of the business activities listed in paragraph (p)(1); (3) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in paragraph (p)(1); or (4) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities futures or options or supervises or monitors the compliance with the securities and commodities laws of employees who engage in such activities. For purposes of this rule, the term "professional work" shall not include mediation services performed by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.[131]

FINRA defines "public arbitrator" as :

> (u) Public Arbitrator
>
> The term "public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and: (1) is not engaged in the conduct or activities described in paragraphs (p)(1)–(4); (2) was not engaged in the conduct or activities described in paragraphs (p)(1)–(4) for a total of 20 years or more; (3) is not an investment adviser; (4) is not an attorney, accountant, or other professional whose firm derived 10 percent or more of its annual revenue in the past two years from any persons or entities listed in paragraphs (p)(1)–(4); (5) is not an attorney, accountant, or other professional whose firm derived $50,000 or more in annual revenue in the past two years from professional services rendered to any persons or entities listed

131. FINRA Rule 12100(p).

> in paragraph (p)(1) relating to any customer disputes concerning an investment account or transaction, including but not limited to, law firm fees, accounting firm fees, and consulting fees; (6) is not employed by, and is not the spouse or an immediate family member of a person who is employed by, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business; (7) is not a director or officer of, and is not the spouse or an immediate family member of a person who is a director or officer of, an entity that directly or indirectly controls, is controlled by, or is under common control with, any partnership, corporation, or other organization that is engaged in the securities business; and (8) is not the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (p)(1)–(4). For purposes of this rule, the term immediate family member means: (A) a person's parent, stepparent, child, or stepchild; (B) a member of a person's household; (C) an individual to whom a person provides financial support of more than 50 percent of his or her annual income; or (D) a person who is claimed as a dependent for federal income tax purposes. For purposes of this rule, the term "revenue" shall not include mediation fees received by mediators who are also arbitrators, provided that the mediator acts in the capacity of a mediator and does not represent a party in the mediation.[132]

As Rule FINRA Rule 12100(u) demonstrates, FINRA grants "public arbitrator" status to individuals who are affiliated with firms that received up to 10% of their last two years' annual compensation from financial industry sources[133] where that compensation does not exceed $50,000.[134] Critics argue that the "public arbitrator" designation should exclude individuals who work for firms that receive *any* compensation from the financial services industry and that FINRA's "public arbitrator" designation fails to adequately filter industry affiliates from the "public arbitrator" pool.[135] In response, FINRA

132. FINRA Rule 12100(u).

133. FINRA Rule 12100(u)(4).

134. FINRA Rule 12100(u)(5).

135. *See* Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator Release No. 57492 (Mar. 13, 2008); *see also* Dan Jamieson, *FINRA Urged to Cut Industry Ties for Arbitrators*, Investment News, (Sept. 4, 2007), http://www.investmentnews.com/article/20070904/FREE/70831005.

contends that revenue limitation provisions enhance “public arbitrator” impartiality.[136]

Future regulatory evaluation of mandatory securities arbitration should analyze the potential conflicts of interest that FINRA’s “public arbitrator” categorization permits and the effectiveness of arbitrator disclosure in mitigating those conflicts.[137] Although such analysis exceeds the scope of this paper, it is evident that the benefit to consumers of FINRA Rule 12403(d) relies on the integrity of FINRA’s “public arbitrator” definition.

6. *Dodd-Frank and the Future of McMahon and Rodriguez de Quijas*

As discussed earlier, the landmark *McMahon* and *Rodriguez de Quijas* decisions validated the use in the American financial services industry of pre-dispute arbitration agreements in customer securities accounts.[138] The Supreme Court premised these holdings, in part, on a belief that securities arbitration adequately protects consumer rights.[139] For example, the *McMahon* decision held that “the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights”[140] and that

> there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is

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136. *See* Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator Release No. 57492 (Mar. 13, 2008).

137. Arbitrators must disclose their potential conflicts of interest to parties pursuant to FINRA Rule 12405(a)–(c). Moreover, as noted in the SEC’s Order Approving Proposed Rule Change to Amend the Definition of Public Arbitrator Release No. 57492 (Mar. 13, 2008), FINRA justified the current compensation limitation provisions in its “public arbitrator” definition, in part, “because arbitrators must continually update their disclosure reports and, when selected to serve on a case, must complete a checklist and take an oath confirming that the arbitrator’s disclosures are true and complete, the procedures are sufficient.”

138. *See McMahon*, 482 U.S. at 227-28; *see also Rodriguez de Quijas*, 490 U.S. at 480-81.

139. *See McMahon*, 482 U.S. at 232-34; *see also Rodriguez de Quijas,* 490 U.S. at 481-83.

140. *McMahon*, 482 U.S. at 232.

> limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute.[141]

Given this understanding of securities arbitration, the Supreme Court concluded that

> the mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 [an earlier decision that invalidated brokerage firms' use of pre-dispute arbitration agreements] is difficult to square with the assessment of arbitration that has prevailed since that time. This is especially so in light of the intervening changes in the regulatory structure of the securities laws. Even if *Wilko*'s assumptions regarding arbitration were valid at the time *Wilko* was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority.[142]

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141. *Id*.

142. *Id*. at 233; *see also* Wilko v. Swan, 346 U.S. 427, 435 (1953), *overruled by Rodriguez de Quijas,* 490 U.S. 477. The *Wilko* Court held, in part:

> we think the right to select the judicial forum is the kind of 'provision' that cannot be waived under s 14 of the Securities Act. . . . While a buyer and seller of securities, under some circumstances, may deal at arm's length on equal terms, it is clear that the Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers.
>
> When the security buyer, prior to any violation of the Securities Act, waives his right to sue in courts, he gives up more than would a participant in other business transactions. The security buyer has a wider choice of courts and venue. He thus surrenders one of the advantages the Act gives him and surrenders it at a time when he is less able to judge the weight of the handicap the Securities Act places upon his adversary.
>
> Even though the provisions of the Securities Act, advantageous to the buyer, apply, their effectiveness in application is lessened in arbitration as compared to judicial proceedings. . . . As their award may be made without explanation of their reasons and without a complete record of their proceedings, the arbitrators' conception of the legal meaning of such statutory requirements as 'burden of proof,' 'reasonable care' or 'material fact,' . . . cannot be examined. Power to vacate an award is limited.

Regulatory evaluation of mandatory securities arbitration, pursuant to Dodd-Frank, should investigate the Court's characterizations of the fairness of securities arbitration to investors in light of the current debate on mandatory securities arbitration. This debate continues more than two decades after the *McMahon* and *Rodriguez de Quijas* decisions and despite the benefits to customers that FINRA Rule 12403(d) provides.

V. Conclusions

The validity of pre-dispute arbitration agreements in the securities industry remains the topic of ongoing debate. Congressional legislation empowers the SEC and Bureau of Consumer Financial Protection to review the widespread practice – in the financial services industry and elsewhere – of employing such agreements. Proponents of mandatory securities arbitration argue that FINRA arbitration is fair to customers and, therefore, that government regulators should not interfere with pre-dispute arbitration agreements. They argue that FINRA Rule 12403(d) – which allows customers to prevent industry representatives from being on their arbitration panels – further justifies regulatory non-interference.

However, the facts lead this writer to conclude that FINRA Rule 12403(d) fails to significantly alter the mandatory securities arbitration debate. Although the Rule allows customers to eliminate the appearance of bias from industry representation on arbitration panels, pilot data suggests that the Rule's effects may be modest. Most importantly, the "all public panel" Rule does not affect the majority of issues surrounding mandatory securities arbitration. FINRA Rule 12403(d) should not significantly alter regulatory perception of the fairness to securities customers of mandatory arbitration.

Notes & Observations

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Palmer S. Albertine, Kathy M. Albertine, Jon D. Albright, Sam Davis, Suzan Davis, William D. Irvine, Amy R. Irvine, Peter Tashie, and Kendall S. Tashie v. Morgan Keegan & Company, Inc. and Regions Financial Corporation

FINRA Case No. 09-01327

The causes of action relate to the purchase in Claimants' accounts of the following funds: RMK Multi-Sector High Income; RMK Strategic Income Fund; RMK High Income Fund; RMK Advantage Income Fund; and, RMK Select Intermediate Bond Fund.

The broker that sold the Morgan Keegan funds was no longer affiliated with Respondents. During the hearing, he offered testimony that indicated the firm's declining reputation made it difficult for him to do business.

Claimants asserted the following causes of action: (1) misrepresentations and omissions; (2) breach of fiduciary duty; (3) unsuitable investments; (4) negligence; (5) failure to supervise; (6) breach of contract; and (7) vicarious liability; (8) violation of FINRA rules; and, (9) violation of the Securities and Exchange Act.

In the Statement of Claim, Claimants requested: (1) compensatory damages in an amount in excess of $1,600,000.00; (2) interest on the foregoing amount; (3) any and all costs of this action; and, (4) such other and further relief as the undersigned arbitrators (the "Panel") deemed just and proper.

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

Respondents attempted to sever the claims of the five separate Claimant families; however, they were unsuccessful. The Panel granted Respondent's Motion to Strike evidence related to regulatory allegations pertaining to Morgan Keegan. The Panel denied Respondent's Motion in Limine to Exclude Improper Derivative Claims. The Panel also denied Respondent's Motion in Limine to Exclude Irrelevant and Inadmissible Regulatory Materials.

Following the conclusion of the hearing, and prior to the issuance of the Award, Claimants William D. Irvine and Amy R. Irvine withdrew their

1. Jason M. Kueser is with The Kueser Law Firm, in Lees Summit, Missouri. Mr. Kueser can be reached at *jason@jmkesquire.com.*

claims against Respondents with prejudice. Following the conclusion of the hearing, and prior to the issuance of the Award, all Claimants withdrew their claims against Respondent Regions Financial Corporation without prejudice.

Award: The Panel found that Respondent was liable on the claims of misrepresentations and omissions, unsuitable investments, negligence, failure of supervision, breach of contract, vicarious liability, violation of FINRA rules, and violation of the Securities and Exchange Act and ordered Respondent to pay Claimants, as follows:

Compensatory damages in the sum of $33,382.00 to Claimants Palmer S. Albertine and Kathy M. Albertine;

Compensatory damages in the sum of $105,844.00 to Claimant Jon D. Albright;

Compensatory damages in the sum of $254,642.00 to Claimants Sam Davis and Suzan Davis;

Compensatory damages in the sum of $458,625.00 to Claimants Peter Tashie and Kendall S. Tashie;

Expert witness fees for Dr. McCann in the sum of $28,500.00 to Claimants Palmer S. Albertine, Kathy M. Albertine, Jon D. Albright, Sam Davis, Suzan Davis, Peter Tashie, and Kendall S. Tashie;

The sum of $600.00 representing reimbursement of the non-refundable portion of the claim filing fee previously paid by Claimants to FINRA Dispute Resolution; and

The Panel also ordered Morgan Keegan to pay all Hearing Session Fees ($26,850.00).

Claimants' Counsel: Dale Ledbetter, Esq. and G. Robert DeLoach, Esq., Ledbetter & Associates, P.A. (Fort Lauderdale, Florida)

Respondent's Counsel: Terry R. Weiss, Esq., Greenberg Traurig, L.L.P. (Atlanta, Georgia) and Jennifer Tomsen, Esq., Greenberg Traurig, L.L.P. (Houston, Texas)

Claimant's Expert: Craig McCann, Securities Litigation & Consulting Group (Fairfax, Virginia); Jim Gatewood.

Respondent's Expert: Steve Scales, Secure Financial Services, Inc. (Colchester, Vermont); Kjell Ekdahl.

Arbitrators: Monica I. Salis (Public Chairperson); Mary P. Bass (Public); Teresa A. Dunn (Public)

This case is significant because despite Morgan Keegan's argument that damages should have been based on NOP, the panel awarded 100% of the market-adjusted damages, as presented by Claimant's damages expert. In addition, the Panel assessed all hearing session fees and expert witness fees to Morgan Keegan. These expenses were substantial because the arbitration hearing involved four different families (one had settled prior to issuance of the award) and took nine days.

Emmett E. Carter, Jr., individually and on behalf of the Emmett E. Carter, Jr. Individual Retirement Account v. James R. Holdman, Leslie M. Hausse, Scott D. Johnson, NWT Financial Group, LLC, and Penson Financial Services, Inc.

FINRA Case No. 09-04093

Respondent Holdman was a promoter for two hedge funds, Silverwing (more conservative) and Greenwing (less conservative). He originally opened accounts for his hedge funds through a broker-dealer known as E.A. Direct ("EAD"). Holdman was a registered rep of EAD. EAD cleared through Penson Financial Services. In 2007, EAD failed and Penson helped Holdman transfer his license to NWT Financial Group.

When Penson orchestrated the transfer of Holdman's license and accounts to NWT, there was no evidence that Penson ever told NWT about Claimant's IRA account, which was invested in the hedge funds. For some reason, two other accounts belonging to Claimant were transferred to NWT; however, the account at issue in the arbitration claim was not.

NWT said it couldn't supervise something Penson never told it about, and the evidence showed that after E.A. Direct went out of business, the only statements Claimant received concerning the account containing his hedge funds were on Penson "primary broker" type statements. Stated another way, Penson appears to have unintentionally inherited the "orphaned" account. The orphan account theory developed shortly before the hearing based on discovery.

Claimant argued that even if Penson inherited the orphan account, NWT was still responsible for Claimant's losses because it failed to follow its own guidelines with regard to the supervision of customer account. Claimant also presented evidence that showed Penson failed to follow its own procedures regarding the valuation of IRA accounts. Claimant did not know that his accounts were losing value because the hedge fund promoter was producing phony statement values and Penson's statements showed the same value throughout the life of the account.

Claimant was unsophisticated and invested more than $1 million in retirement savings he had accumulated with a Fortune 500 company. He was not aware that the hedge funds would engage in naked options trading. He was also not informed that Holdman was not managing the funds, but rather, that Respondent Johnson would manage the fund. Ultimately, all but approximately 10% of Claimant's life savings was lost.

Claimant asserted the following causes of action against Respondents Holdman, Hausse, and Johnson: (1) violation of Louisiana securities laws; (2) breach of fiduciary duty; (3) negligence; and, (4) fraud.

Claimant asserted the following causes of action against Respondent NWT: (1) violation of Louisiana securities laws; (2) vicarious liability; and, (3) negligent supervision.

Claimant asserted the following causes of action against Respondent Penson: (1) breach of contract; and (2) breach of fiduciary duty.

In the Statement of Claim, Claimants requested (1) Compensatory damages in an amount in excess of $1,000,000.00; (2) exemplary damages; (3) attorneys' fees; (4) statutory damages pursuant to violation of Louisiana securities laws; (5) expectation losses; (6) costs; and, (7) other and further relief as the Panel may deem just and proper.

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

Prior to the arbitration hearing, Claimant dismissed his claims against Respondents Johnson and Hausse with prejudice. Respondent Holdman did not appear at the evidentiary hearing.

Award: The Panel found that Respondents NWT, Penson, and Holdman were jointly and severally liable and ordered these Respondents to pay Claimants compensatory damages of $851,368.74, plus interest at the legal rate in the state of Louisiana from the date of filing until the date the award was paid, plus $17,798.50 in costs and expert fees incurred by Claimant.

The Chairperson of the Arbitration Panel, F.A. Little, Jr., issued a three-page dissent stating his disagreement with the award issued by the Panel. The Chairperson's dissent reflected his opinion that Claimant should bear some responsibility and that the amount of the award should be no greater than $700,000, with Claimant and Respondent Holdman being jointly responsible for one third of that amount ($233,333).

Claimants' Counsel: W. Andrew Clayton, Jr., Esq. and Jessica L. Clayton, Esq., The Law Offices of Johnson, Browning & Clayton (Sarasota, Florida)

Respondent's Counsel: Respondent James R. Holdman was represented by MacAllynn J. Achee, Esq. (Baton Rouge, Louisiana); Respondent Leslie M. Hausse was represented by Claude F. Reynaud, Jr., Esq., Breazeale, Sachse & Wilson, LLP (Baton Rouge, Louisiana); Respondent Scott D. Johnson was represented by Lonny A. Myles, Esq., Myles, Cook & Day, Attorneys at Law (Zachary, Louisiana); Respondent NWT Financial Group, LLC was represented by David Gaba, Esq., Golbeck Roth, PLLC (Seattle, Washington); and Penson Financial Services, Inc. was represented by Mark G. Hanchet, Esq., Mayer Brown, LLP (New York, New York).

Claimant's Experts: Jim Lenaghan, former manager of Pershing's IRA department (IRA custodian liability); Howard Berg, Jackson Grant Investment Advisors, Inc. (suitability and supervision); Nick Vu, ETA Associates (damages); John Jorgensen, Sylint Group, Inc. (computer forensics re: 430,000 page electronically produced document production by Respondent Penson Financial).

Respondent's Expert: Thomas Francko, former general counsel at Pershing (Penson – IRA expert). Mark McCloskey (NWT Financial - suitability and supervision)

Arbitrators: Frank A. Little (Public Chairperson - Dissented); Daniel Bivins (Public); Frederick S. Duncan (Public)

This case is significant because it represents a full recovery of out of pocket losses sustained by a hedge fund investor, plus interest from the date of filing, and expert witness fees. The award is also significant in that the Panel assessed liability against the clearing firm and IRA custodian jointly and severally with the broker and the broker-dealer Respondents. Claimant immediately filed a petition to confirm the award in state court and Respondent filed a Motion to Vacate on the grounds that the arbitrators acted in manifest disregard of the law in issuing the amount of damages awarded. Claimant ultimately prevailed at the state court hearing and the arbitration award was confirmed.

Gerald D. Hosier, individually and as trustee of the Gerald D. Hosier U/A/D 10/04/99, Brush Creek Capital LLC, and Jerry Murdock, Jr. v. Citigroup Global Markets Inc.

FINRA Case No. 09-03297

Claimants were sold positions in various municipal bond hedge funds, including, but not limited to: MAT Finance, MAT Two, MAT Three, MAT Five, ASTA Finance, ASTA Three, and ASTA Five. In addition to Mat and ASTA, one of the claimants also purchased Carlyle Capital Corp, CSO Partners and a leveraged swap on Pine Grove Partners. Both claimants were sophisticated, high net worth investors and were sold these investments by one of the largest producers in the Smith Barney system.

Claimants asserted the following causes of action: (1) breach of fiduciary duty; (2) breach of written contract; (3) constructive fraud; (4) violation of FINRA rules; (5) unsuitability; (6) failure to supervise; and (7) respondeat superior. In the Statement of Claim, Claimants requested: (1) General and compensatory damages in an amount according to proof but not less than \$48,190,417.00 minus residual value and/or amounts withdrawn; (2) Lost opportunity costs in an amount according to proof; (3) Fees, commissions, or other remuneration paid to Respondent by Claimants; (4) Cost of proceedings; (5) Punitive damages in an amount according to proof; (6) Interest at the legal rate on all sums recovered; (7) Attomeys' fees and costs; (8) Rescission; and, (9) Such other and further relief as the Panel deems just and appropriate.

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

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant, as follows:

Compensatory damages in the amount of $21,683,679.00 to Claimants, Gerald D. Hosier, individually and as trustee of the Gerald D. Hosier U/A/D 10/04/99;

Interest on the aforementioned award of $21,683,679.00 at the Colorado statutory rate of 8% per annum, accruing from the 31st day after service of this award if it remains unpaid, until final payment of the award, to Claimants, Gerald D. Hosier, individually and as trustee of the Gerald D. Hosier U/A/D 10/04/99;

Compensatory damages in the amount of $8,472,212.00 to Claimant Brush Creek Capital LLC;

Interest on the aforementioned award of $8,472,212.00 at the Colorado statutory rate of 8% per annum, accruing from the 31st day after service of this award if it remains unpaid, until final payment of the award, to Claimant Brush Creek Capital LLC;

Compensatory damages in the amount of $3,903,057.00 to Claimant Jerry Murdock, Jr.;

Interest on the aforementioned award of $3,903,057.00 at the Colorado statutory rate of 8% per annum, accruing from the 31st day after service of this award if it remains unpaid, until final payment of the award, to Claimant Jerry Murdock, Jr.;

Punitive damages to Claimants in the amount of $17,000,000.00 pursuant to Pyle v. Securities, U.S.A., Inc., 758 F. Supp. 639 (D. Colo. 1991);

Attorneys' fees to Claimants in the amount of $3,000,000.00 pursuant to Colorado Revised Statutes Sec. § 11-51-604, see also Barrett v. Investment Management Consultants, Ltd., 190 P.3d 800 (Colo. App. 2008);

Expert witness fees to Claimants in the amount of $33,500.00;

Court reporter costs to Claimants in the amount of $13,168.29;

Filing fees to Claimants in the amount of $600.00; and

The Panel assessed all Hearing Session Fees ($26,100.00) against Respondent.

Claimants' Counsel: Philip M. Aidikoff, Esq., Robert A. Uhl, Esq., and Ryan K. Bakhtiari, Esq., Aidikoff, Uhl & Bakhtiari (Beverly Hills, California); Steven B. Caruso, Esq., Maddox Hargett & Caruso, P.C. (New York, New York)

Respondent's Counsel: H. Nicholas Berberian, Esq., Patrick G. King, Esq., and Tina L. Winer, Esq., Neal, Gerber & Eisenberg LLP (Chicago, Illinois)

Claimant's Expert: Craig McCann, Securities Litigation & Consulting Group (Fairfax, Virginia).

Respondent's Expert: Nat Singer, Swap Financial Group (South Orange, New Jersey); Ezra Zask, SFC Associates (New York, New York)

Arbitrators: Malcolm T. Cleland (Public Chairperson); Marc H. Schtul (Public); Patricia Mary Vondra (Non-Public)

This case is significant because Claimants submitted total net out of pocket damages of $26,893,945.00 and market adjusted damages of $34,058,948 at the arbitration hearing. The Panel's award represented 100% of the market adjusted damages, plus $17,000,000.00 in punitive damages, $3,000,000.00 in attorneys' fees, $33,500.00 in expert witness fees, and $13,168 in costs. Including the other relief, the award in this case represented more than 200% of NOPs. According to the Wall Street Journal, "the award by an industry arbitration panel is the largest ever levied against a major Wall Street brokerage in favor of individual investors, according to the Securities Arbitration Commentator Inc., a newsletter in Maplewood, N.J."

D Vollstedt & S Vollstedt TTEE, Steve or Deborah Vollstedt Trust U/A DTD 2/12/2004, Deborah Vollstedt and Steve A Vollstedt v. Charles Schwab & Co., Inc.

FINRA Case No. 09-06446

Claimant was an accountant and assistant controller for a major corporation. He was a wealthy self-directed investor who was not part of Schwab's private client group. Claimant was notified that he would be transferred to Australia for a two-year work assignment. Shortly thereafter, Claimants sold their home in Denver, Colorado. Following this sale, Claimants desire and intention was to invest the net sales proceeds in a safe investment for at least two years in anticipation that they would use these funds to purchase another home when they returned to the United States from Australia.

In early 2004, Claimants met with Respondent's broker at the broker's office to discuss the products that were available to invest their home sale proceeds. Claimants were considering investing these funds into either a certificate of deposit or a money market fund prior to the meeting. Claimants emphasized that they wished to keep their money safe for both emergency purposes and so that they could use the funds to purchase a home when they returned from Australia in two years.

The broker presented the Schwab YieldPlus Fund as an appropriate and suitable investment vehicle for the proceeds. He described the YieldPlus Fund as an ultra short-term bond fund whose share price had been stable for an extended period of time and whose stated objectives were to be a very safe investment with minimal changes to share price and a substitute for a money market fund. He also described the YieldPlus Fund as a good, safe alternative to a money market fund that provided a slightly higher yield. The broker also showed Claimants the YieldPlus Fund prospectus and some additional information about the fund on his computer screen.

Before deciding to purchase the fund, Claimants reviewed both the prospectus and the information about the YieldPlus Fund that was available on Respondent's website. In January 2004, Claimants purchased approximately $76,000.00 of shares of YieldPlus in three different accounts.

While living in Australia, Claimants continued to add to their initial investments in the fund with the intent of accumulating most, if not all, of the funds needed to buy a home when they returned to America. They also elected to reinvest all dividends back into the fund. Claimants also considered their YieldPlus investments to be an "emergency" fund available to for unexpected contingencies. On at least two occasions while living in Australia, Claimants contacted the broker to discuss the appropriateness of the investments in Claimants' accounts as it pertained their anticipated home purchase and their retirement objective. The broker assured Claimant that the YieldPlus Fund continued to be a suitable investment vehicle.

From August 2007 through March 2007, the value of the YieldPlus Fund declined considerably. Claimants sold their positions in late March 2008 and incurred losses of principal equal to approximately $103,800.

Claimants asserted the following causes of action: (1) negligence; (2) negligent misrepresentation; (3) breach of fiduciary duty; (4) breach of contract; (5) fraud in the inducement; (6) common law fraud; and (7) violations of Colorado and New Mexico securities laws.

In the Statement of Claim, Claimants requested (1) Compensatory damage of at least $103,800; (2) Reimbursement of Claimants' FINRA filing fees of $1,425; (3) Reimbursement of all FINRA hearing session fees; (4) Pre-judgment interest at the Colorado or New Mexico statutory interest rate from the dates Claimants purchased their Schwab Yield Plus Fund securities in their accounts through the date of the arbitration award; (5) Post-award interest at the Colorado or New Mexico statutory interest rate from the date of the arbitration award through the date of the payment of the award; (6) Costs and attorneys' fees; (7) Punitive damages; (8) a disciplinary referral of this matter to FINRA regulatory authorities; and (9) Such other relief as this Panel may deem just and proper.

Respondents requested that the Panel: (1) Issue an award finding that Claimants are not entitled to recover damages from Schwab and that Claimants' claims be dismissed in their entirety with prejudice; (2) Award Schwab its costs; (3) Award Schwab all other relief as provided by law; and (4) Expungement from non-parties regulatory reports.

Prior to the arbitration hearing, the arbitration panel granted Respondent's Motion in Limine to Exclude Admission of or Reference to Regulatory Settlements & Filings and to preclude Claimants from introducing evidence of prior regulatory rulings against Schwab in unrelated customer cases. During the arbitration hearing, Respondent requested expungement of the claims with respect to non-party brokers. The panel determined that expungement was appropriate for one non-party based upon testimony of fact and expert witnesses (including Claimants), as well as arguments of counsel for all parties.

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimants as follows:

Compensatory damages in the sum of $151,715.00;

Pre-award interest on the sum of $151,715.00 at the New Mexico statutory rate of 8.0% from the date Claimants first purchased the Schwab Yield Plus Fund and continuing until payment of the award in full or any judgment entered on the award, whichever is later;

Attorneys' fees in the sum of $144,141.75 pursuant to New Mexico Code § 58-13B-40;

Claimants' costs in the sum of $27,264.82; and (5) Claimants' non-refundable filing fee of $300.00; and

The Panel also ordered Respondent to pay all Hearing Session Fees and all Administrative Costs relating to the arbitration, which totaled $13,500.

Claimants' Counsel: Timothy J. Dennin, Esq. (Northport, New York) and Thomas F. Shine, Esq. (Indialantic, Florida)

Respondent's Counsel: Stephen Young, Esq. and Cara L. Finan, Esq., Law Offices of Keesal, Young & Logan (Long Beach, California)

Claimant's Expert: Robert Lowry, RL Consulting Services, Inc. (Leesburg, Virginia) and Eric Sikowitz, Sikowitz Consulting Services (New York, New York)

Respondent's Expert: Greg Kyle, Bates Group, LLC (Lake Oswego, Oregon) and John Maine (Belvedere, California)

Arbitrators: Katherine M. Harmeyer (Public Chairperson); James J. Ashe (Public); James W. Warren (Public)

This case is significant because it represents an award of approximately 150% of NOPs, plus interest, costs, attorneys' fees (which were approximately 90% of the damages awarded), and hearing session fees. In fact, the total amount awarded exceeded 320% of the NOPs, plus interest at 8% from the date of purchase. The award also demonstrates the potential success individual investors can have in arbitration if they choose not to participate in a class action. Investors who were part of the YieldPlus class action settlement received less than $0.25 for every $1 lost. In addition, the award is significant because it represents full recovery of transaction losses.

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 Scott Shewan, scottshewan@att.net, Peter J. Mougey, pjm@levinlaw.com or Robin S. Ringo, rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *Release No. 34-64386/File No. SR-FINRA-2011-018; Proposed Rule Change and Amendment No. 1 to Adopt NASD Rule 2830 as FINRA Rule 2341 (Investment Company Securities) in the Conso* was submitted to the Securities and Exchange Commission by Peter J. Mougey on May 31, 2011.

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

Re: Proposed Addition to FINRA Code of Arbitration Procedure FINRA Regulatory Notice 2011-18 Exchange Act Release No. 34-64386

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I am pleased to comment on the above-referenced proposed adoption of NASD Rule 2830 (Investment Company Securities) as FINRA Rule 2341 (Investment Company Securities) in the consolidated FINRA rulebook with significant changes.

PIABA is a bar association comprised of attorneys who devote a significant portion of their practice to the representation of investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules that govern the arbitration process and/or touch upon investor protection.

I. The Proposed Change Should Be Approved Because It Will Incrementally Improve Disclosure Concerning Brokerage Firms' Financial Incentives To Recommend Certain Mutual Funds Over Other Investments

PIABA believes that the proposed FINRA Rule 2341 should be adopted. The proposed rule will incrementally improve disclosure concerning brokerage firms' financial incentives to recommend certain mutual funds over other investment company securities or other investments. Under the current NASD Rule 2830, the duty to disclose "special cash compensation" (compensation other than sales charges and service fees not made available on the same terms to all FINRA members who sell the fund's shares) rests with the investment company, which must disclose the compensation either in the prospectus or a fund's statements of additional information ("SAI").

The new FINRA Rule 2341 eliminates the investment company's duty to disclose special cash compensation in the prospectus or SAI and instead places the duty to disclose on the FINRA member. Under the proposal members would be required to disclose any additional cash compensation received in connection with the sale of mutual fund shares, and also disclose any "preferred" list of investment companies to be recommended to customers as a result of the member firm's receipt of special cash compensation. The proposal would also require FINRA member firms to establish a web site or toll-free telephone number to make this information readily available to customers.

PIABA believes that the proposed Rule 2341 will incrementally improve disclosure of built-in conflicts of interest that incentivize member firms and registered representatives to recommend certain investments based on special compensation that they receive from investment companies rather than on the merits of the investments. Under the proposal disclosure would be modestly improved because the information would be made readily available to customers and highlighted in a more accessible format than under the current rule. This highlighted and always-available disclosure would represent an improvement over the current rule, under which such disclosures are embedded in lengthy prospectuses that many customers discard. As such, the disclosure required under the proposed new rule represents a modest improvement over the current rule and should be adopted.

II. The Proposed Rule Change Should Go Further to Prohibit Special Cash Compensation That Is Not Made Available On The Same Terms to All FINRA Members Who Sell The Fund's Shares

The dynamic discussed above in which registered representatives, who frequently hold themselves out as trusted advisors rather than as commissioned salespeople, may have special financial incentives to recommend certain mutual fund shares over other investments, is simply inconsistent with FINRA's goal of investor protection. Public investors should not have to remain perpetually on guard lest their "financial advisors" disadvantage them by recommending mutual fund shares based on special financial incentives made available to some FINRA members but not others. Inevitably many investors will simply overlook disclosures concerning brokers' financial incentives and remain unaware that their "financial advisor" is making recommendations based on special financial incentives available from a given investment company.

Rather than modestly improving the disclosure rules, FINRA should limit financial incentives paid by investment companies to member firms to the sales charges and service fees disclosed in the prospectus fee tables and made available on the same terms to all member firms. FINRA should also require that the member firms disclose sales charges and service fees for all mutual funds in a prominent manner similar to what would be required by proposed FINRA Rule 2341. That way, compensation for sale of mutual fund shares would be made more uniform, simpler, and more transparent than under either the current NASD Rule 2830 or proposed FINRA Rule 2341.

Conclusion

For the above reasons, PIABA respectfully requests that FINRA approve the changes to the Code of Arbitration Procedure proposed in Regulatory Notice 2011-18. We further urge FINRA to consider further amendments that would limit financial incentives paid by investment companies to member firms to the sales charges and service fees disclosed in the prospectus fee tables and made available on the same terms to all member firms.

Thank you for your consideration.

Respectfully,
Peter J. Mougey
President
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

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The following PIABA Comment Letter regarding *Release No. 34-64260/File No. SR-FINRA-2011-016;Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Delay the Implementation date of FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability)* was submitted to the Securities and Exchange Commission by Peter J. Mougey on May 4, 2011.

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

Re: Release No. 34-64260; SR-FINRA-2011-016

Dear Ms. Murphy:

Thank you for the opportunity to comment Release No. 34-64260, which seeks to delay the implementation date for FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability), as approved in SR-FINRA-2010-039, to July 9, 2012. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") in opposition to the above-referenced rule proposal. The proposed rule would delay the implementation of critical investor protections for an unacceptable period of time. The current rule proposal seeks to delay the implementation of the revamped FINRA Rule 2090 to July 9, 2012, more than nine months after the originally set implementation date of October 7, 2011. PIABA respectfully asks the SEC to reject the proposed rule and consider keeping the implementation date of October 7, 2011.

PIABA does not support the proposed delay. As originally drafted, FINRA Rule 2090 and 2111 were to be fully implemented by October 7, 2011. The original order approving this rule change was filed on November 17, 2010 and thus, provided the industry almost an entire year to implement these new rules. Clearly, both FINRA and the SEC believed there was ample justification to implement the new rule in order to reset firms' suitability obligations. To allow the implementation of these new rules to be pushed out an additional nine months, means more time will elapse under an unsatisfactory rule system.

Firms seeking this delay argue that they need more time to properly adopt internal measures and policies to ensure compliance with the new rules. Under the original proposal, firms were provided ten months to comply with rules that are hardly significant alterations from prior existing rules and procedures. While, firms that were not both NYSE and NASD members prior to the consolidation into FINRA, may not have existing "know your customer" policies. This could probably be resolved with a special exemption for firms fitting into this category to allow sufficient time for compliance. Otherwise, firms that were both NYSE and NASD members should have no difficulty complying with new Rule 2090 by October 2011.

Moreover, the New Suitability Rule 2111 requires that brokers and dealers perform a three-fold suitability analysis: first, the reincorporation of Reasonable Basis Suitability; second, Customer-Specific Suitability; and third, Quantitative Suitability. There is nothing "new" about these standards. Each of these suitability requirements have been a part of the securities and investment advisory industries for decades. To the extent firms and brokers need time to create new documents to include some of the additional information requested under Rule 2111, they have ample time to create them. Furthermore, since SEC Rule 17a-3 already requires brokers and dealers to update customer information related to suitability every 36 months, existing customer accounts should already be undergoing this review. An additional nine months from October 2011 (a total of nineteen months from the original implementation) is an extraordinary delay in the implementation of crucial new investor protection rules and standards.

In sum, PIABA does not support the proposed delay and hopes that the SEC and FINRA will hold brokers and dealers to the original implementation date of October 7, 2011. These more specific rules so critical to increased investor protection should not be postponed until July 2012 for implementation and effective enforcement. I would like to thank you once again for the opportunity to comment on this rule proposal.

Sincerely,
Peter Mougey
President
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

The following PIABA Comment Letter regarding *Regulatory Notice 11-11; FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports* was submitted to the Financial Industry Regulatory Authority by Peter J. Mougey on April 25, 2011.

Marcia Asquith
Office of the Corporate Secretary .
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 11-11; Debt Research Reports

Dear Ms. Asquith:

Thank you for the opportunity to comment on Regulatory Notice 11-11, which proposes to apply safeguards and disclosure requirements to the publication and distribution of debt research reports. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA")[1] in general support to the abovereferenced proposal. The proposed rules would be a step in the right direction for something that has long been overdue.

Research reports have long been used for both debt and equity securities. Of course, without a regulatory requirement to do so, many firms failed to adhere to the "Guiding Principles" that were previously put in place. FINRA needs more definitive rule-making to help prevent more financial catastrophes like the one experienced in the last few years with the increasing use of complex, risky debt products (including mortgage backed securities, CDOs, auction rate securities, structured debt products, reverse convertibles, etc.). A framework is certainly needed to regulate the research surrounding these debt securities.

However, the proposal should go further. For example, the proposal seems to exclude "municipal security" from the definition of "debt security." FINRA has not explained why municipal securities (and the research related to them) should be afforded any different treatment than other debt securities.

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1. PIABA is an international bar association, consisting of over 500 members, dedicated to the protection of investors' rights in securities arbitration proceedings. Public Investors Arbitration Bar Association

The potential for conflicts exists with municipal securities just as much as other debt products.

Moreover, PIABA feels that the exclusion of research related to sales to only institutional investors leaves a large loophole. While larger banks and investment firms may not need the same disclosures that an individual investor does, the definition of "institutional investor" here seems to be vague. Until FINRA can provide a better definition, it makes sense to not provide an exclusion for institutional sales. As such, PIABA suggests that no such exclusion should be made until FINRA can provide a better definition.

The proposal also requests comments for whether there should be an "optin" or "opt-out" provision, such as for fund managers. PIABA hopes that FINRA would not provide any such provisions. The fund managers hold duties to the shareholders of their funds, many of which are sold to retail investors. This "optin" or "opt-out" provision again would provide a loophole that creates the potential for conflict and fraud. The recent group oflarge bond-fund disasters (such as with the Regions Morgan Keegan Funds, the Schwab YieldPlus Fund, Citigroup' s MAT Three and MAT Five funds, and the Oppenheimer Champion Income Fund and Core Bond Fund), many of which resulted in FINRA investigations and/or fines, demonstrates that fund managers should not be given this discretion.

Conclusion

In sum, PIABA supports the new rule proposal but hopes that FINRA would provide a little more protection with regards to all debt securities. Moreover, the proposal should not create carve-outs for institutional investors, nor provide any "opt-in" or "opt-out" provisions. I would like to thank you once again for the opportunity to comment on this rule proposal.

Sincerely,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Peter J. Mougey
President

The following PIABA Comment Letter regarding *Regulatory Notice 11-08 Proposed Consolidated FINRA Rules Governing Markups, Commissions and Fees* was submitted to the Financial Industry Regulatory Authority by Peter J. Mougey on March 28, 2011.

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 11-08 Markups, Commissions and Fees

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 consolidated rules governing markups, commissions and fees. The proposal contemplates eliminating two key provisions currently contained in the rules: the "5% Policy" and the "Proceeds Provision". PIABA believes that these two provisions should not be eliminated, but rather, should be modified to address FINRA's concerns.

In the Regulatory Notice, FINRA explains that the "5% Policy" was based on data from a 1943 survey of market participants, which indicated that transactions were typically executed at a markup of 5% or less. FINRA proposes not transferring this policy to the consolidated rule because it is based on data that is over 70 years old. A current survey of costs indicates that average markups are now 2%, and average markdowns are 1.3%. Rather than eliminating the policy altogether, we believe the policy should be adjusted to reflect current data, i.e. a "2% Policy". While we appreciate that FINRA has stated that the elimination of the "5% Policy" does not invite members to raise markups/markdowns and commissions, having an accurate policy as a reference point for what is or has been historically a reasonable limit on markups/markdowns and commissions provides important protection to both honest industry practitioners and the investing public. Eliminating

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

the guideline entirely may invite abuse by unscrupulous industry practitioners and tempt even honest industry practitioners to raise their markups/markdowns and commissions to meet the never-ending demand to make profits.

PIABA does support the inclusion of factors which a firm must take into consideration in determining if a markup/markdown or commission is reasonable, which further clarifies that the inclusion of a "policy" is simply meant as a broad guideline and is not determinative of reasonableness. FINRA should be clear that the reasonableness of markups/markdowns and commissions should be reviewed on a case by case basis.

With regard to the "Proceeds Provision", FINRA proposes eliminating the provision because it is "confusing and raises concerns that it represents a standard that may not be susceptible to consistent application." However, rather than eliminate the provision entirely because it is confusing, we believe it would be more prudent to issue guidance regarding how the provision should be applied. FINRA may provide that transactions falling within a set period of time, such as a purchase occurring within the settlement period of a sale, should be subject to the provision. To address another concern that FINRA has raised, FINRA may also provide that sales and purchases occurring at different firms are not subject to the provision. Eliminating investor protection because it may be confusing may set a worrisome precedent for future rule proposals.

PIABA therefore requests that FINRA review the proposal with regard to the elimination of the "5% Policy" and the "Proceeds Provision", and rather than eliminate these two provisions, modify them accordingly. I would like to thank you once again for the opportunity to comment on this rule proposal.

Respectfully submitted,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Peter J. Mougey
President

The following PIABA Comment Letter regarding *Release No. 33-9177/File No. S7-04-11 New Worth Standard For Accredited Investors* was submitted to the Securities and Exchange Commission by Peter J. Mougey on March 15, 2011.

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

Re: File No. S7-04-11, New Worth Standard For Accredited Investors

Dear Ms. Murphy:

Thank you for the opportunity to comment on the proposed amendments to the accredited investor standards, which seek to change the definition of an "accredited investor." I write on behalf of the Public Investors Arbitration Bar Association ("PIABA")[1] in general support to the above-referenced rule proposal. The proposed rule would be a step in the right direction to increase the net worth required for an individual to become an "accredited investor." PIABA respectfully asks the Commission to adopt the proposed rule for a number of reasons but hopes that additional changes are made to this proposal.

PIABA supports the proposed change to the definition of "accredited investor." Currently, an "accredited investor" is required to have a net worth of $1 million to invest in private offerings or other limited offerings. The proposal seeks to change the definition of an accredited investor by specifying that an accredited investor must have a net worth (individually or jointly with their spouse) of "more than $1,000,000…excluding the primary residence of such natural person."

The purpose of providing exemptions from registration under Rules 504, 505, and 506 of Regulation D (17 CFR § 230.501 et seq.) is to allow smaller, private companies to raise capital without incurring the considerable expense and time of complete registration of the offering with the Commission. In similar regards, the Commission does not require complete registration of

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

these offerings with the understanding that these private placements are only being offered to institutional and certain individual investors. One way risk is mitigated is by ensuring that the individual investors have a minimum net worth for them to be allowed to invest in private placements, which may provide some indication that they may have the financial means to withstand the risks inherent in these securities. However, as more people become millionaires as the value of the dollar decreases with inflation, there are more people who are qualified to be "accredited investors," yet many of these people do not have the sophistication to understand the risks associated with private placements to protect themselves sufficiently, nor the financial means to withstand the risk of loss of the investment. As a result, the Commission needs to raise the net worth threshold for accredited investors to protect the investing public better.

PIABA welcomes the proposed change to the definition that would eliminate the value of an investor's home from their net worth. Many investors are being solicited to invest in private placements or limited offerings when their total net worth is $1 million. However, for a large number of these investors, their primary residence constitutes a considerable portion of their net worth (and sometimes a majority of their net worth). Most private placements and limited offerings are substantially more illiquid than a publicly traded security, and these private placements often carry with them the risk of total loss of investor funds.

These investors should not be eligible to invest in private placements because they often do not have sufficient financial resources and reasonably cannot bear to lose their entire investment in private placements.

Moreover, there have been a recent string of private placements that have turned out to be purported Ponzi schemes. Examples include Medical Capital, Provident/Shale Royalties, and DBSI. Many clients who were solicited to invest in these products lost their entire investment in these products, and many could not afford to take on those substantial losses in these purported investment products.

The change in the definition of an accredited investor would limit the number of investors that would be eligible to invest in these products and will help protect them from these speculative and illiquid products.

In particular, the Commission is considering excluding excess debt on a principal residence from the net worth calculation. The "value" to be excluded from net worth under the proposed rule is the "Fair market value of the primary residence less the amount of debt secured by the property up to Fair market value."

More simply put, the rule proposal seeks to ensure that an investor's equity in a primary residence is excluded from the calculation but that additional indebtedness in excess of equity is realized. The Commission's reasoning for ensuring that debt in excess of equity is accounted for is sound.

The Seattle-based real estate market information company Zillow recently released a statement provided to Bloomberg News and other news publications stating that as of the 4th quarter in 2010, upwards of 27 percent of mortgages in the United States were "underwater" – over 15 million mortgages [2]. Under the proposed rule, this debt in excess of home equity would also be accounted for in the net-worth calculation. Since the basis for the accredited investor standard is to provide some indication of an investor's ability to withstand the risk of loss associated with such investments, ensuring that this excess debt is accounted for is critical. If an investor is upside-down on his mortgage, the investor is in a worse financial condition than if he had equity in excess of debt. Thus, in order to paint a complete picture of "net worth" for purposes of this rule, a potential private placement investor's debt in excess of home equity must be taken into account.

This important interpretation in the operation of the proposed rule ensures that it makes logical sense, which the market will surely recognize. The current rule proposal specifically outlines what is to be excluded from the net-worth calculation – the fair market value of the primary residence less any debt on the residence up to the fair market value. Thus, the rule does not exclude debt in excess of equity and should state so clearly. PIABA believes it is in the interest of all public investors that the definition of net-worth in the proposed rule both exclude equity in the primary residence and explicitly include, on the debt side of the ledger, debt in excess of equity so as to prevent any confusion or abuse of this standard.

While PIABA does support the rule change, PIABA believes that the proposed rule could go further. PIABA believes that the threshold to be considered an "accredited investor" should be raised from $1 million to at least $2 million. It also would make sense to change the rule to provide an increasing threshold over time based on an index, such as the Consumer Price Index. A larger percentage of investors could be considered "accredited" 10 or 20 years down the road, but considering the rate of inflation this $1 million threshold may be misleading and an inappropriate standard in 10 or 20 years. In light of this, PIABA supports the rule to the extent that the Commission is required to re-examine the threshold every four years.

In sum, PIABA supports the proposed rule but hopes that FINRA and the

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2. See http://www.nuwireinvestor.com/articles/obama-wants-reform-ingovernment-backed-mortgage-giants-in-midst-of-56941.aspx (last viewed February 23, 2011).

Commission would make some additional changes in order to protect the investing public better. I would like to thank you once again for the opportunity to comment on this rule proposal.

Respectfully submitted,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Peter J. Mougey
President

The following PIABA Comment Letter regarding *Definition of the term"Fiduciary"* was submitted to the Department of Labor, Employee Benefits Security Administration by Peter J. Mougey on February 3, 2011.

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: Definition of the Term "Fiduciary," RIN 1210-AB32

Dear Mr. Wong:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"), I thank you for the opportunity to comment on the Department of Labor's proposed broadened definition of the term "fiduciary" under the Employee Retirement Income Security Act. This expansion of the term "fiduciary" specifically seeks to protect beneficiaries of pension plans and individual retirement accounts by including those individuals, who give advice to either an employee benefit plan or to such a plan's participants, in said definition and responsible to the resulting regulations.

PIABA is a national, not-for-profit bar association comprised of attorneys, including law school professors and regulators, both former and current, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. As a result, PIABA and its members take great interest in any action that seeks to alter investor protection.

PIABA generally supports the proposed regulation to the extent that it broadly defines who would be considered a fiduciary under ERISA. Specifically, we support the expansive definition of investment advice that will ensure that persons providing advice to both plan participants and beneficiaries are subject to the standards of fiduciary conduct.

Despite the aforementioned holistic support, PIABA would seek to revise certain particular exclusions still within the proposed expanded term "fiduciary." The Department has requested specific comment on the following maintained position. Under the current definition of fiduciary status, as a general matter, a recommendation to a plan participant to take an otherwise permissible plan distribution does not constitute investment advice within the meaning of the current regulation, even when that advice is combined with a recommendation as to how the distribution should be invested. PIABA believes that the regulation should include this advice as investment advice. There is no reason to exempt this specific type of advice from the protections of the regulation. Notwithstanding the fact that this advice may be covered by other rules or regulations, retirement funds provide for the care of our aging population, and all available means should be employed to protect those funds. This type of advice is fraught with potential for abuse. Specifically in this situation, the individual offering the advice may be recommending that the plan participant take a distribution and inappropriately invest the money. This is precisely the type of advice the regulation should protect against.

As a whole, the adoption of the proposed amendment will increase investor protection through its broadened scope of fiduciaries and the resulting standards to which the affected advisors shall be held. Accordingly, PIABA requests that the Department adopt the proposed amendment; however, in the adoption process, PIABA maintains that additional amendments that would protect the investing public in the interest of the current regulation should be considered. We thank you for the opportunity to comment on this proposal.

Respectfully submitted,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Peter J. Mougey
President