

Chapter 18

Securities Arbitration Law

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Chapter 18

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18.1 Introduction

The continuing market downturn and related events fueled a sharp increase in the number of securities arbitrations filed in 2001. In the past year, NASD Dispute Resolution, Inc., the principal forum for securities arbitration, reported a 24% increase in claims filed with it – 6,915 cases filed in 2001 versus 5,558 in 2000. The New York Stock Exchange, which runs a distant second in terms of total cases filed, reported a 41% jump in new claim filings – from 553 new cases in 2000 to 780 last year. NASD Dispute Resolution and state regulators reported a sizeable increase in complaints and claims concerning the use of margin. The number of cases involving mutual funds also increased by more than 100%.

In addition to fueling a surge in the number of claims filed, the slumping markets – and the attendant losses suffered by investors – resulted in an increase in the total damages awarded by NASD arbitration panels last year. In 2001 NASD arbitrators awarded damages to complaining investors in approximately 53% of the 1,365 claims arbitrated, with a total recovery of almost \$100 million, including punitive damages, compared to \$76 million in 2000. The increase in total damages awarded in 2001 reflects a \$27 million increase in the amount of compensatory damages awarded by NASD panels (from \$55 million in 2000 to \$82 million in 2001) while the punitive damages awarded were less (from \$21 million in 2000 to \$15 million in 2001). The 53% “win” rate for investors in 2001 remained unchanged from the prior year.

While SRO arbitration continues to be the main forum for resolving complaints among investors, brokerage firms and their registered representatives, significant court decisions were handed down last year concerning issues pertinent to those complaints. Among those issues were the appropriateness of pre-hearing dispositive motions in arbitration, the arbitrability of claims, the finality of arbitration awards, and the liability of clearing firms. Additionally, a review of arbitration awards reveals a trend towards increased scrutiny and accountability of analysts’ recommendations and the advice of other market professionals.

18.2 Supreme Court Docket

As noted in Chapter 1 herein, the year’s most anticipated Supreme Court decision affecting arbitration was *Circuit City Stores, Inc. v. Saint Clair Adams*, 121 S. Ct. 1302 (2001). In that case, the Supreme Court reversed the Ninth Circuit’s holding that the Federal Arbitration Act (“FAA”) does not apply to labor and employment contracts. The Ninth Circuit had concluded that the employment contract was exempt under section 1 of the FAA that excludes from the Act’s coverage “contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.” In reversing the Ninth Circuit’s decision, the Supreme Court affirmed the majority view that the FAA does apply to employment contracts with the limited exception of employees engaged in the interstate or foreign transportation of goods. On remand, the Ninth Circuit recently held that although the FAA applied to the arbitration agreement in the case *sub judice*, the entire

agreement was an unconscionable contract of adhesion and, therefore, unenforceable under California state law. 2002 U.S. App. LEXIS 1686 (February 4, 2002). Applying the reasoning of the Supreme Court's decision in *Circuit City*, a district court in California held in *Eftekhari v. Peregrine Financials & Securities Inc.*, 2001 U.S. Dist. LEXIS 16087 (N.D. Cal. 2001), that a registered representative in the securities industry, by signing the NASD Form U-4, is compelled to arbitrate any Title VII employment discrimination claim as well as disputes concerning trading practices.

Now looming on the horizon is a noteworthy case that the Supreme Court recently accepted for review. *Howsam v. Dean Witter Reynolds*, 261 F.3d 956 (10th Cir. 2001), *cert. granted*, 2002 U.S. LEXIS 1183 (U.S. Feb. 25, 2002), involves an attempt by a brokerage firm to enjoin an investor from arbitrating a dispute with the firm on the ground that the dispute was time-barred under NASD's six-year eligibility rule (NASD Dispute Resolution Code of Arbitration Procedure, Rule 10304). The district court dismissed the suit, concluding that the parties had unequivocally agreed that *all* disputes between them, including questions concerning the arbitrability of those disputes, would be determined by an arbitrator rather than by the courts. The Tenth Circuit reversed, holding that the district court erred in finding that the parties had agreed to allow an arbitrator, rather than the courts, to decide whether specific disputes are arbitrable. The Supreme Court's decision in this case may finally resolve the conflicting decisions about who is to decide issues concerning arbitrability, a dispute that has raged for some time. See section 1.3.2, *infra*.

In another case that will likely have an effect upon attorneys practicing in the area of securities arbitration, the Supreme Court has granted certiorari in *Securities & Exchange Commission v. Zandford*, 99-1733 (2001). The issue before the Court will be whether the actions of a broker who sold and converted a security from a brokerage account (and was subsequently convicted of federal wire fraud charges) are sufficiently connected with a securities transaction to support a civil violation of the federal securities laws. Zandford, had been convicted of wire fraud for stealing from his clients' investment accounts. The SEC filed civil securities fraud charges against the broker and moved for summary judgment on the grounds that the defendant's criminal conviction for wire fraud established all the facts necessary to satisfy the elements of the civil securities fraud claims and that the doctrine of collateral estoppel prevented the defendant from contesting his civil liability under the federal securities laws. The district court agreed and entered summary judgment in the SEC's favor.

The Fourth Circuit reversed, holding that the federal securities laws do not reach every claim for the theft or conversion of a security from a brokerage account. The appeals court held that the defendant's fraudulent actions were not sufficiently connected with a securities transaction for collateral estoppel to bar him from contesting his civil liability for charges based on § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and the SEC's Rule 10b-5. *Securities & Exchange Commission v. Zandford*, 238 F. 3d 559 (4th Cir. 2001). The specific legal issue before the Court was whether the fraudulent scheme was sufficiently "in connection with" the purchase or sale of securities to amount to a federal securities laws violation. The Court noted that the broker's sales of the securities were incidental to the scheme to defraud; his fraud was in stealing the proceeds of the sale. Accordingly, the Fourth Circuit concluded that the "in connection with" requirement was not met and refused to hold that every fraud or conversion involving

securities encompassed a violation of the federal securities laws. The Supreme Court now takes up the case.

The Supreme Court declined to review two securities-related rulings – one concerning the waiver of an arbitration agreement, *Grumhaus v. Comerica Secs. Inc.*, 223 F.3d 648 (7th Cir. 2000), *cert. denied*, 149 L. Ed. 2d 467, 121 S. Ct. 1600 (2001), discussed *infra* at section 1.3.2. In the other, the Court declined to review the Second Circuit’s refusal to reinstate tort law and other claims by a former brokerage employee who objected to statements in the Form U-5 filed by his former employer. *Britton v. Securities and Exchange Commission*, 532 U.S. 971 (2001), *denying cert. to*, *Britton v. Chalsty*, 2000 U.S. App. Lexis 14122 (2d Cir. 2000) (unpublished opinion).

18.3 Judicial Interpretation of Arbitration Rules and Procedures

18.3.1 Pre-hearing Dispositive Motions

The Tenth Circuit in *Sheldon v. Vermonty*, 269 F.3d 1202 (10th Cir. 2001) held that, despite the absence of a specific rule granting such authority, NASD arbitration panels have the authority to entertain and grant a pre-hearing motion to dismiss claims with prejudice as long as no party is deprived of “fundamental fairness.” In that case, Claimant Sheldon filed an arbitration claim with the NASD seeking damages from several broker-dealers for alleged violations of federal and state securities laws, common law fraud, negligent misrepresentation, breach of fiduciary duty, unjust enrichment, and civil conspiracy in conjunction with promotion of an allegedly worthless stock. In response, the broker-dealers moved to dismiss for failure to state a claim. The Claimant also filed pre-hearing motions, opposing the motions to dismiss and moving for summary judgment. After hearing argument on the motions to dismiss during a telephonic pre-hearing conference, the arbitration panel granted the motions and dismissed all of Sheldon’s claims with prejudice. Subsequently, the district court entered an order confirming the arbitration award, and it also entered a separate judgment dismissing Sheldon’s claims. On appeal, Sheldon argued that the NASD’s Code of Arbitration Procedure does not contain any provision authorizing pre-hearing motions to dismiss and that the Code required the arbitration panel to permit discovery and hold an evidentiary hearing before dismissing his claims. According to Sheldon, the arbitration panel exceeded its authority in dismissing his claims with prejudice based solely on the allegations in his pleadings and the arguments of counsel at the telephonic hearing. Alternatively, Sheldon argued that, even if the arbitration panel had the authority to grant a motion to dismiss based solely on the pleadings, the panel erred in dismissing his claims because he adequately pled claims for relief against the broker-dealers under federal and state law. Thus, Sheldon claimed that he was denied a fundamentally fair hearing and that the district court erred in refusing to vacate the arbitration panel’s dismissal of his claims under § 10 of the FAA.

The Tenth Circuit noted that a district court has limited authority to vacate an arbitration panel award except under the criteria set forth in § 10 of the FAA and some judicially recognized reasons, including a violation of public policy and fundamental fairness. *See infra* at section 1.4 for a discussion of recent cases addressing a court’s

authority to vacate an arbitration award. The Tenth Circuit then stated that although the NASD's procedural rules do not specifically address whether an arbitration panel has the authority to dismiss facially deficient claims with prejudice based solely on the pleadings, there is no express prohibition against such a procedure. The Court observed that the NASD's procedural rules expressly provide that "the arbitrator(s) shall be empowered to award any relief that would be available in a court of law." NASD Manual, § 10214. The Court reasoned that this would logically include the authority to dismiss facially deficient claims with prejudice. Thus, the Court held that a NASD arbitration panel has full authority to grant a pre-hearing motion to dismiss with prejudice based solely on the parties' pleadings so long as the dismissal does not deny a party fundamental fairness. The Court then went on to find that each party in the case before it had the opportunity to fully brief their issues and argue the motions to dismiss.

The Tenth Circuit's word on pre-hearing dispositive motions in arbitration was not the first and certainly will not be the last. While the *Sheldon* decision appears to provide authority to arbitration panels to dismiss claims on pre-hearing motions, the authority of arbitration panels to do so is not undisputed and remains somewhat undefined. In *Sheldon*, the Tenth Circuit relied upon the broad grant of authority given to arbitration panels by § 10214 of the NASD Code of Arbitration Procedure Manual and the general concept of "fundamental fairness." These bases alone leave arbitrators with little guidance, procedures or standards, especially compared to the well-developed substantive and procedural law that governs motions for pre-hearing dispositions in civil actions. Moreover, there is a split of opinion on whether pre-hearing dispositions in arbitration are appropriate. *Cf. International Union, United Mine Workers of America v. Marrowbone Development Co.*, 232 F.3d 383 (4th Cir. 2000) (holding that by granting summary judgment following limited arguments and the presentation of a few exhibits, the arbitrator denied plaintiff a full and fair hearing, exceeded his authority and failed to follow the procedure described in the parties' agreement); *United Paperworkers Int'l v. Misco, Inc.*, 484 U.S. 29 (1987) (holding that under the "Arbitration Act," federal courts are empowered to set aside arbitral awards "[w]here the arbitrators were guilty of misconduct in refusing . . . to hear evidence pertinent and material to the controversy"); *Hoteles Condado Beach v. Union de Tronquistas*, 763 F.2d 34, 40 (1st Cir. 1985) (concluding that vacatur of an arbitration panel's finding is appropriate when the exclusion of relevant evidence "so affects the rights of the parties that it may be said that he was deprived of a fair hearing."); *with Warren v. Tacher*, 114 F. Supp. 600, 602-03 (W.D. Ky. 2000) (holding that motions to dismiss may be appropriate in NASD arbitrations prior to discovery and without an evidentiary hearing: "Plaintiffs cite no authority that they are automatically entitled to a full-blown evidentiary hearing following discovery, and the court is aware of none."); *Goldman Sachs & Co. v. Patel*, New York County Supreme Court, Sklar, J., N.Y.L.J. August 18, 1999, ("Contrary to respondent's assertion, the NASD panel has the power to decide a motion to dismiss a claim on legal grounds, without holding an evidentiary hearing").

Once court has been cited by Claimants' and industry counsel for opposite propositions. In *Prudential Securities v. Dalton*, 929 F. Supp. 1411, 1417 N.D. Okla. 1996), a former branch manager for Prudential Securities had filed an NASD arbitration claim against Prudential alleging that the firm had defamed him in erroneously reporting a customer complain on the manager's Form U-5. Prudential filed a pre-hearing motion to dismiss Dalton's claims, and in a 2 to 1 decision the arbitration panel granted the dismissal

motion. Dalton then moved in court to vacate the panel's decision, and Prudential cross-moved to confirm it. The court vacated the award on the ground that the panel had erred in refusing to hear pertinent and material evidence but also observed that NASD panels have authority to dismiss a claim that, on its face, does not state a claim entitling the claimants to relief.

18.3.1 Claims and Parties Subject to Arbitration

To Be Decided by Court or Arbitration Panel?

Generally circuits have differed on the issue of whether the court or arbitration panel determines which claims and parties are subject to arbitration. Nevertheless, as mentioned *supra* in section 1.2, the U.S. Supreme Court, by granting certiorari in *Dean Witter Reynolds, Inc. v. Howsam*, 261 F.3d 956 (10th Cir. 2001), *cert. granted*, 2002 U.S. LEXIS 1183 (U.S. Feb. 25, 2002), may give a final word on the issue. In *Howsam*, the Tenth Circuit recently observed that the majority view seems to be that absent a "clear and unmistakable" agreement between the parties to arbitrate the issue of arbitrability, the courts, not arbitrators, are to decide that issue.¹

In reaching its holding, the Tenth Circuit relied in large part on its former decision in *Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 78 F.3d 474 (10th Cir. 1996). The Court noted that while courts in other jurisdictions were "sharply divided" on the issue, the majority of courts had concluded that courts, and not arbitrators, should determine whether an action is time-barred by the NASD Code because that determination involves the scope of the arbitrator's "subject matter jurisdiction." After discussing the holdings of courts reaching a contrary conclusion, as well as the Supreme Court's recent decision in *First Options of Chicago v. Kaplan*, 514 U.S. 938 (1995), the *Cogswell* court adopted the majority view that the courts, and not arbitrators, should determine the arbitrability under NASD Code § 10304 of disputes submitted to arbitration, absent a "clear and unmistakable" agreement to the contrary.

Similar conclusions were reached in *Salomon Smith Barney, Inc. v. Harvey*, 260 F. 3d 1302 (8th Cir. 2001) and *John Hancock v. Wilson*, 254 F. 3d 48 (2d Cir. 2001). In *Harvey*, the Eighth Circuit concluded that since the record reflected no clear and unmistakable evidence of the parties' intent to arbitrate issues of arbitrability, the issue of statute of limitations, which it termed a "substantive eligibility requirement," was presumed to be determined by the courts, *citing Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen* 62 F. 3d 381, 384 (11th Cir. 1995). Likewise, in *Wilson*, the court looked to the "clear and unmistakable" agreement and found that one party's membership in the NASD, in the absence of a separate agreement between the parties, cannot alone constitute a "clear and unmistakable" intent to submit the issue of the arbitrability of their disputes to the arbitrators.

¹ In another interesting part of the decision in *Howsam*, the Tenth Circuit rejected Respondent's contention that the choice of law provision in the parties' 1992 agreement mandated that New York state law apply rather than federal law precedent. Relying in part upon *PaineWebber, Inc. v. Elahi*, 87 F.3d 589 (1st Cir. 1996), the Court found that the federal substantive law of arbitrability, rather than state law, must be applied when deciding whether the arbitration at issue was time-barred under the NASD Code.

In contrast, in *Bell v. Cedant Corporation*, 2001 U.S. Dist. LEXIS 5239 (S.D.N.Y. 2001) applying Connecticut law, the district court found the arbitrability issue should be decided by arbitrator. It based its finding on the language in the agreement that “any other matter or thing” should be settled by arbitration as a manifest intent to arbitrate the issue of arbitrability.

Contractual Right to Arbitrate and Waiver

Despite the strong federal policy favoring arbitration, the Fifth Circuit could not find a binding arbitration agreement between the parties in *PaineWebber, Inc. v. Chase Manhattan Private Bank*, 260 F.3d 453 (5th Cir. 2001). This civil procedure tangle involved third-party claims, district courts in New York and Texas, the NASD and NYSE. It made its way to the Fifth Circuit after PaineWebber filed an action in the Southern District of Texas alleging, among other matters, third-party claims against Chase Manhattan Private Bank Switzerland (“Chase-Switzerland”). Chase-Switzerland moved to dismiss the Texas action for lack of subject matter jurisdiction and, alternatively, to transfer the case to the Southern District of New York. The Texas district court ordered Chase-Switzerland to arbitrate the claims after concluding that it was within the court’s jurisdiction because it had agreed to arbitrate within the United States through the NYSE and the NYSE had previously granted PaineWebber’s request to hold the arbitration in Houston.

On appeal, the Fifth Circuit found that the relevant agreement between the parties, which simply stated, “any dispute between [Chase-Switzerland] and PaineWebber which cannot be resolved by good faith negotiations shall be submitted to the appropriate arbitrator or court in the United States,” did not constitute a binding agreement to arbitrate. 260 F. 3d at 462-63. Specifically, the Court looked at the provision in the agreement that identifies “court” and “arbitration” as equals, the lack of specificity regarding the geographic location or forum for any arbitration, and the absence of language requiring arbitration. The Court compared the dispute resolution clause in the applicable agreement to arbitration provisions in other agreements between the parties and other agreements in cases finding binding arbitration. In contrast, those agreements contained specific language requiring arbitration, and identifying the forum for the arbitration. It then found that the agreement “simply leaves too many critical elements unaddressed” to support PaineWebber’s contention that the agreement, standing alone, amounts to a binding arbitration agreement.

In *Creative Solutions Group, Inc. v. Pentzer Corporation*, 252 F. 3d 28 (1st Cir. 2001), the Court determined that the parties had not expressly agreed to arbitrate certain claims and then considered whether the defendant had waived its right to arbitrate other claims. In that case, the parties had agreed to arbitrate issues related to the Purchase Price Financials as of *March 31, 1999* in connection with the plaintiff’s capital stock purchase of defendant’s companies. The court first concluded that claims arising from overstatement of the *1998* earnings were not by the terms of the agreement subject to arbitration and that a party cannot be required to submit to arbitration any claim that it has not agreed to do so.

Additionally, the Court vacated the district court’s finding that the defendant had waived its right to arbitrate another claim that was arbitrable under the party’s agreement. In determining whether the plaintiff had been prejudiced and the defendant had waived its right to arbitrate, the Court looked to the following factors: “whether the party has actually participated in the lawsuit or has taken other action inconsistent with his right, . . . whether the litigation machinery has been substantially invoked and the parties were well in preparation of a lawsuit by the time an intention to arbitrate was communicated by the

defendant to the plaintiff, . . . whether there has been a long delay in seeking the stay or whether the enforcement of arbitration was brought up when trial was near at hand. . . .” quoting *Jones Motor Co., Inc. Chauffeurs, Teamsters, and Helpers Local Union No. 633*, 671 F. 2d 38, 44 (1st Cir. 1982) (citations omitted). In this case where defendant moved to dismiss, initiated no formal discovery and essentially no discovery was exchanged, the Court found that the “litigation machinery” had not been invoked. Moreover, it rejected the district court’s finding of prejudice to plaintiff based on defendant’s and their auditor’s failure to turn over requested documents, forcing plaintiff to incur legal expenses to compel and commence litigation to compel arbitration.

Concerning a plaintiff’s waiver, the Supreme Court refused to hear the plaintiffs’ contention that waiver had not occurred in *Grumhaus v. Comerica Secs., Inc.*, 223 F. 3d 648 (7th Cir. 2000), *cert. denied*, 121 S. Ct. 1600 (2001). The Seventh Circuit had found that the plaintiffs had waived their right to arbitrate after first suing in state court and then, six months after the case was dismissed, moving to compel arbitration. In finding that plaintiffs had waived their right to arbitrate, the Court first observed that by filing the initial action in court and willingly participating in that action, plaintiffs’ conduct was inconsistent with a desire to arbitrate. Moreover, the Court distinguished prior decisions in *Gingiss International v. Bormet*, 58 F.3d 328 (7th Cir. 1995) and *Doctor’s Associates, Inc. v. Distajo*, 107 F. 3d 126 (2d Cir. 1997) in which the rights and remedies sought to be arbitrated were distinct from those litigated. In this case, where the claims all stemmed from the same allegedly wrongful liquidation of certain stocks, plaintiffs could not escape the waiver by re-characterizing the legal claims and elements for arbitration.

In *PaineWebber, Inc. v. Cohen*, 2001 U.S. App. LEXIS 27196 (6th Cir. 2001), the Court while addressing the issue of whether a federal court had subject matter jurisdiction to hear the brokerage firm’s action to compel arbitration reinforced the federal policy favoring the enforcement of arbitration agreements. The client’s executor had filed a state court action against the firm and its branch manager. In response, the firm filed a federal action to compel arbitration and stay the state action. The firm’s action did not include the branch manager. The federal district court dismissed the action, accepting the defendant investor’s challenge to jurisdiction on the ground that the branch manager of the firm was an indispensable party under Fed. R. Civ. P. 19(b) and his presence would eliminate complete diversity, thereby depriving the federal court of subject matter jurisdiction. On appeal, the Sixth Circuit reversed. Even though the Court’s holding could result in parallel proceedings in federal and state court, with the possibility for inconsistent results, the Court, endorsing the federal policy favoring arbitration, did not find the harm to be so prejudicial to the client executor to require a finding that the manager was an indispensable party.

Who is a “customer” subject to NASD arbitration?

Two notable decisions addressed the scope of the term “customer” within the NASD arbitration rules. In *Fleet Boston Robertson Stephens, Inc. v. Adflex, Inc.*, 264 F.3d 770 (8th Cir. 2001), the Eighth Circuit found that Adflex, an entity that received banking and financial advice, as opposed to investment or brokerage services, from Fleet Boston, was not a “customer” of Fleet Boston within the scope of the NASD’s rule requiring that disputes between or among members or associated persons and “public customers” be subject to arbitration under NASD Code of Arbitration Rule 10101. Accordingly, the Court affirmed the district court’s denial of the Adflex’s motion to stay litigation and mandate arbitration. In reaching its conclusion, the Eighth Circuit, like the district court, determined that whether

Fleet Boston was compelled to arbitrate Adflex's dispute depended on the nature of the relationship between them. Since Adflex was not classified as a member or an associated person of a NASD member, the issue became whether it was a "customer" in its dealings with Fleet Boston. The Court noted that "customer" is not specifically defined by the NASD Arbitration Code. Nevertheless, it rejected as being overly broad and too inclusive Adflex's argument that "customer" was defined in NASD Manual General Provisions § 0120(g) as anyone not a broker or dealer. The district court had relied on a provision in the NASD Rules of Conduct – which outline the standards of conduct expected of NASD members when dealing with customers – that defines a "customer" as "any person who, in the regular course of such member's business, has cash or securities in the possession of such member." NASD Rules of Conduct § 2270. The Eighth Circuit looked further to numerous provisions in the NASD Rules of Conduct concerning the term "customer" and other judicial interpretations. Consistent with those interpretations, the Court declined to extend the definition where the business relationship did not include some brokerage or investment relationship between the parties.

However, the Second Circuit in *John Hancock Life Insurance Company v. Joseph A. Wilson*, 254 F.3d 48 (2nd Cir. 2001) construed the term "customer" in NASD Code of Arbitration Rule 10301 to mean either a customer of an associated person or a customer of the NASD member firm. In that case, claimants had purchased securities from an independent broker who was affiliated with John Hancock. The investors, however, were not customers of John Hancock and had no business dealings directly with the firm. Thus, John Hancock argued that the investors' claims against it were not arbitrable because they were not customers of the firm. The Second Circuit agreed with the district court's conclusion that Rule 10301(a) requires an NASD member firm to arbitrate claims brought by the customer of an "associated person" of the NASD member even if the claimant was not a customer of the NASD member firm.

The decision in *John Hancock* was followed in *BMA Financial Services, Inc.*, 164 F. Supp. 2d 813 (W.D. LA 2001), in which the court found investors could compel arbitration against NASD member firm even though the account was never maintained with the firm, the firm was not involved with disputed transactions and the representative who sold the investments at issue never told investors that he was affiliated with the firm. Nevertheless, the court found that because the representative had signed a Form U-4 with the firm, it was an associated person and thus under *John Hancock*, its customers (the investors) were allowed to arbitrate their claims against the firm.

In contrast, in *Investors Capital Corp v. Brown*, 145 F. Supp. 2d 1302 (M.D. Fla. 2001), the Court denied a motion to compel arbitration, finding a genuine issue of material fact existed as to whether the investor was a customer of the firm with which the broker had affiliated after the initial investment purchase.

18.3 Judicial Review of Arbitration Awards

The willingness of courts to vacate arbitration awards remains limited. Courts have generally refused to vacate awards absent clear proof that the arbitration panel violated limited

statutory standards, including the Federal Arbitration Act, 9 U.S.C. §10,² or the “controversial nonstatutory” standard of “manifest disregard.” *IDS Ins. Co. v. Royal Alliance Associates, Inc.*, 266 F. 3d 645 (7th Cir. 2001) (Judge Posner); see *UBS Warburg LLC v. Auerbach, Pollak & Richardson*, NYLJ 10/22/01 (Supreme Court, New York County) (applying New York law standard for vacatur).

In *Alex Montez, Jr. v. Prudential Securities, Inc.*, 260 F.3d 980 (2001), the Court considered the second provision of § 10 – “evident partiality . . . in the arbitrators.” While noting that different circuits have adopted different approaches, 260 F. 3d at 983 (citations omitted), the Court found in this case that the district court did not err in holding that there was no “evident partiality,” notwithstanding the fact that the law firm that represented the Respondent in the arbitration had previously worked with the arbitrator in his capacity as the former general counsel of WNS, Inc. The Court found no grounds for vacatur where the arbitrator had no financial interest in the law firm or WNS and his relationship with the law firm had ended five years before the arbitration. Additionally, the court noted that even if the arbitrator had failed to make a disclosure under NASD Rule 10312 that alone would not be a basis for nullifying the arbitration award.

In applying the judicially created standard of “manifest disregard,” the D.C. Circuit in *LaPrade v. Kidder, Peabody & Co.*, 246 F. 3d 702 (D.C. Cir. 2001), rejected the claim that the arbitration panel had acted in manifest disregard of the law. The panel had required the Claimant/employee to pay a portion of the forum fees for an arbitration involving both statutory and non-statutory claims against the Respondent/former employer. The Court held that the employee failed to carry her burden of showing that the panel had refused to apply or ignored case law³ holding that when federal statutory claims are subject to arbitration because of an agreement required to be signed as a condition of employment, an employee cannot be required to pay arbitration related costs. Similarly, in *Rosenbaum v. Imperial Capital, LLC*, 169 F. Supp. 2d 40 (Md. 2001), the court noted that “manifest disregard” requires more than a showing that the arbitrators applied the law incorrectly. See also *Koruga v. Fiserv Correspondent Services, Inc.*, 2001 U.S. Dist. Lexis 2417 (E.D. Or. 2001) and *McDaniel v. Bear Stearns & Co. Inc. and Bear Stearns Securities Corp.*, 2002 U.S. Dist. LEXIS 762 (S.D. NY 2002), discussed *infra* at section 1.5.

² Under this provision an arbitration award may be vacated:

- (a) Where the award was procured by corruption, fraud, or undue means; (b) Where there was evident partiality or corruption in the arbitrators, or either of them; (c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final and definite award upon the subject matter submitted was not made.

9 U.S. C. § 10 (1994).

³ *Cole v. Burns International Security Services*, 105 F. 3d 1465 (D.C. Cir. 1997).

Applying the New York law criteria for vacatur, a New York Supreme Court judge relieved a clearing firm of liability by vacating a \$5.7 million arbitration award against the firm, UBS Warburg. *UBS Warburg LLC v. Auerbach, Pollak & Richardson*, NYLJ 10/22/01 (Supreme Court, New York County). The arbitration was brought by the broker, Auerbach, Pollak & Richardson, Inc. (“APR”) based on alleged wrongdoing arising out of their relationship. The Court found that the arbitration panel’s “irrational refusal” to consider and apply the applicable law of the net capital rule was a manifest disregard of public policy that warranted vacatur.

The Court in *Calabria v. Franklin Templeton Services, Inc.*, 2001 U.S. Dist. LEXIS 16113 (N.D. Cal. 2001), considered the impact of a generic choice of law provision in determining whether an arbitration award was final. In that case, the choice of law provision contained in the arbitration agreement did not incorporate the Florida state law provision concerning the time limit for filing a motion to modify, correct or otherwise confirm an arbitration award. Citing *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995) and *Wolsey, Ltd v. Foodmaker, Inc.*, 144 F. 3d 1205 (9th Cir. 1998), the Court observed that a generic choice of law clause does not incorporate procedural state law that affect the “balance of power between arbitral and judicial tribunals.” Here the Court found that the application of a more lenient state limitations period would undermine the finality of the arbitrator’s decision where the FAA provision would not and, accordingly, found the FAA’s time limit to govern the dispute.

18.4 Clearing Firm Liability

A pair of recent court decisions concerning clearing firm liability are noteworthy in two respects: the length of the underlying arbitration awards and the arbitration panels’ awards against the respondent clearing firms. These arbitration awards and in particular their lengthy opinions, while not legally of precedential value, may suggest a trend toward expanding clearing firm accountability, at least where there is evidence that the clearing firm was aware of, and ignored, misconduct by one of its introducing firms. In affirming the panels’ awards, both courts endorsed the arbitration panels’ conclusions that if a clearing firm’s actions go beyond ministerial or routine clearing functions it may be liable in connection with the misconduct of an introducing firm.

In *Koruga v. Fiserv Correspondent Services, Inc.*, 2001 U.S. Dist. Lexis 2417 (2001), the U.S. District Court for the Eastern District of Oregon refused to vacate a \$1.8 million arbitration award against a clearing firm, Fiserv Correspondent Services (“Fiserv”), in favor of six customers of introducing firm Duke & Co., which cleared through Fiserv (and its predecessor firm Hanifen Imhoff Clearing Corp). The arbitration panel found that the clearing firm had known about and had materially assisted unlawful activities by the introducing firm and was therefore jointly liable under the Washington and California Securities Acts for the full amount of the damages, plus costs, interest and fees.

Unlike most arbitration awards, which are typically brief and often do not contain any explanation for how the panel’s decision was reached, the award in this case ran to 39 pages and included Findings of Fact, Conclusions of Law and an Explanation of the Award with evidentiary and legal support. The panel specifically found that Duke was a “boiler room” (the firm and several of its principals were indicted on criminal charges in New York) and

that the clearing firm “had substantial reasons to suspect that Duke was highly likely to engage in micro-cap stock fraud” and was aware of “Duke’s systematic violations” of Washington and California securities laws. (Award, page 10.) The panel even criticized the 7th Circuit’s opinion in *Carlson v. Bear, Stearns & Co. Inc.*, 906 F.2d 315 (7th Cir. 1990), another clearing firm case.

The clearing firm moved to vacate the award, and the investors moved to confirm it. Applying the “manifest disregard” standard of review, the district court rejected Fiserve’s contention that the panel had improperly disregarded the Seventh Circuit’s *Carlson* decision, since the panel had discussed and distinguished that case. While chiding the panel for its “unnecessarily caustic” treatment of *Carlson*, the court found that the arbitrators did not even need to consider the Seventh Circuit opinion, because it did not interpret the Washington and California statutes applicable in this case and the facts of *Carlson* were quite distinguishable. Unlike in *Carlson* in which the clearing firm was found to have performed only ministerial duties, in this case, the panel had made specific factual findings that Fiserve was directly involved and materially participated in the wrongful conduct. Accordingly, the Court found that the panel’s award was not contrary to any applicable law and thus it could not find a manifest disregard of the law.

Likewise in *McDaniel v. Bear Stearns & Co. Inc. and Bear Stearns Securities Corp.*, 2002 U.S. Dist. LEXIS 762 (2002), the U.S. District Court for the Southern District of New York denied the defendant clearing firm’s motion to vacate the arbitration award against it based on claims of wrongful conduct by the introducing broker-dealer, A.R. Baron (“Baron”). As was the case with the Duke firm in the *Koruga* case, the introducing firm in this case had been charged with criminal fraud in New York. In confirming the award and denying the clearing firm’s motion to vacate, the Court first set out the legal standard for vacatur, including the “severely limited” standard of “manifest disregard,” citing *Greenberg v. Bear Stearns & Co.*, 220 F. 3d 22 (2d Cir. 2000). It then reviewed the New York law on aiding and abetting and clearing firm liability, emphasizing that liability requires more than ministerial acts by the clearing firm. In rejecting Bear Stearns’ contention that the arbitration panel did not properly apply the legal standard in finding that its conduct went beyond ordinary clearing functions, the Court looked to nine key factors relied upon by the panel to find active and direct involvement by Bear Stearns. The panel had found that Bear Stearns (1) failed to report commissions and markups, which aided the broker in concealing its unlawful conduct; (2) processed trades that Bear Stearns knew or should have known were unauthorized; (3) made loans above and beyond normal clearing debt; (4) continued clearing for Baron after knowledge of brokers’ unlawful and fraudulent conduct; (5) intervened on behalf of Baron with the NASD and assisted Baron’s NASD net capital acquisition and approval process; (6) monitored, supervised and restricted trading by the broker; (7) became actively involved in the broker’s operations by placing Bear Stearns employees on the broker’s premises; (8) was aware of, communicated with Baron about, and attempted to monitor customer complaints, and (9) collaborated closely with Baron regarding Baron’s affairs.

Arbitration panels in the last year have also imposed liability on clearing firms where there was evidence that the clearing firm participated in the wrongful conduct or knew or should have known of the wrongful conduct of the introducing firm. In early 2001, a NASD arbitration panel in Michigan ordered Bear Stearns Securities Corp, the clearing firm, to pay its former client, Mohammad Hamzeh, \$127,000 for breach of fiduciary duties for knowingly

participating in the manipulation of Kensington Wells “house” stocks for the purposes of personal gain. Similarly, a NASD arbitration panel in Indiana awarded damages against the clearing firm, MultiSource Services, Inc. that had serviced the now defunct brokerage firm (Sauceda & Granville Securities) that had sold the securities to the complaining investors, Dean and Joan Kopp. The arbitration panel found that MultiSource “was or should have been aware of the various red flags” in its dealing with the brokerage firm.

18.5 Arbitration Awards, Settlement and Other Regulatory Decisions

While arbitration awards are not legal precedent, a number of arbitrations and settlements of claims resulted in noteworthy developments in the securities arbitration arena that may project future trends.

18.5.1 Wall Street Analysts Come Under Scrutiny

In the first-high profile claim in which a major Wall-Street firm has compensated an investor for his losses related to the an analyst’s recommendations, Merrill Lynch paid \$400,000 to settle the arbitration claim of Debasis Kanjilal, a New York pediatrician. Dr. Kanjilal complained that he lost \$500,000 of his daughter’s college savings by following the bullish advice of Merrill Lynch’s Internet analyst, Henry Blodget, to purchase InfoSpace stock. Similar claims targeting other analysts and their firms have been filed.

Congress, too, is looking into the issue, and in June 2001 the House Financial Services Committee’s subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises held hearings on the issue of potential conflicts of interest on the part of analysts. The action follows the adoption of Regulation FD, requiring more disclosure between analysts and their firms, and voluntary efforts by firms to no longer permit analysts to trade in the same stocks they cover. The recent collapse of Enron and the significant losses suffered by individual investors who followed some Wall Street analysts’ bullish views on the company will undoubtedly add fuel to the fire. As this article goes to press, analysts from four major investment houses are testifying before Congressional committees about their strong and sustained “buy” positions on Enron. Congress is looking into whether the firms’ investment banking relationships with Enron may have influenced the analysts’ recommendations.

18.5.2 Firm Ordered to Pay Award, Pending Appeal, or Face Suspension

In April 2001, in a California case, a NASD hearing officer ruled that the brokerage firm, InterFirst, had to pay the investors the damages awarded by the arbitration panel, pending its appeal, or face suspension. The firm had been ordered by the arbitration panel to pay \$50,000 in damages to three elderly investors. The firm protested the arbitration award to the U.S. District Court for the Central District of California, claiming among other defenses, statute of limitations. InterFirst lost in the district court and then appealed to the Ninth Circuit. Meanwhile, the NASD hearing officer ruled that under NASD rules, InterFirst had

to pay the award or be suspended. Under its rules, the NASD may suspend a firm for non-payment of an arbitration award when a motion to vacate an award has been made and denied. Here, the NASD hearing officer determined that the loss in the district court was in essence the denial, and thus the firm was subject to suspension for non-payment even if it was appealing the district court decision. Following this ruling, in September 2001 the NASD sent a position paper to its members, informing them that monetary awards had to be paid on a timely basis or the firm would be subject to suspension.

18.5.3 Brokers' Claims Against Employer Firms

While many employees' claims against their former brokerage firms result in no or a minimal award of damages, there were a few noteworthy dispositions in 2001. A NASD arbitration panel ordered Waddell & Reed Financial, Inc. to pay Stephen Sawtelle, a former employee, \$27 million in damages for allegedly stealing his clients and discrediting his reputation after dismissing him from the firm. Likewise, Jay Johnston won a \$3 million award against his former employer, Deutsche Bank Securities, who fired Johnston allegedly for violating securities-trading rules. After an over-year long battle, Johnson was awarded one of the largest awards to date to a broker against a former employer.

Another broker, Berkley, was awarded \$250,000 in compensatory and \$300,000 in punitive damages against his former employer, UBS PaineWebber Inc., based upon his claim that he was fired after informing the firm that he suffered from depression. In ruling in favor of the former broker, the arbitration panel recognized the applicability of the American Disabilities Act to brokers.

Conversely, in early 2001, after an over two-year dispute, Thomas Weisel Partners agreed to pay Banc of America Securities more than \$20 million involving claims that Weisel (previously Montgomery Securities) purloined client information from its former firm.

18.5.4 Party to Pay Damages for Discovery Abuse in Arbitration

The NASD arbitration panel that in early 2001 ordered the clearing firm Bear Stearns to pay \$127,000 in damages in *Hamzeh v. Bear Stearns et al.*, also ordered the firm to pay an additional \$50,000 for failing to comply with discovery deadlines by withholding documents during the pre-hearing phase of the case. Reportedly, two weeks before the hearing and weeks after being ordered to produce the account documents, Bear Stearns turned over 11,000 pages of information.

18.5.5 Largest Award of Damages

In the largest award ever given to a group of investors who were not part of a class action, an NYSE arbitration panel awarded \$429 million to investors against a stockbroker, Enrique Perusquia. According to the NYSE, the panel found that the broker "committed acts of fraud, forgery, breach of fiduciary duty, embezzlement, self-dealing and other heinous acts." The broker declined to testify at the hearing, asserting his Fifth Amendment privilege against self-incrimination. He was charged criminally shortly thereafter.

18.6 Proposed Rule Changes

In January 2001, the NASD proposed letting customers of defunct brokerage firms pursue claims in court rather than through arbitration. The NASD proposal would prevent firms that have gone out of business or have been expelled or suspended from the securities industry from requiring customers to arbitrate financial disputes in an NASD forum instead of going to court.

The proposed change to the NASD Code of Arbitration Procedure, which must be approved by the SEC, comes in response to findings by congressional investigators that investors who win arbitration disputes with brokerage firms often are unable to collect their awards because the firm is out of business or bankrupt. According to Linda Fienberg, President of NASD Dispute Resolution, the proposed rule change is intended to give investors greater flexibility to seek remedies against defunct firms. For instance, by going to court, investors can obtain a preliminary injunction such as an immediate asset freeze, which is not available in arbitration. The proposal would apply only to customers of firms that no longer have NASD membership status and only to disputes slated to be arbitrated in the NASD forum.

The NASD has also proposed a set of rules and policies intended to make it more difficult for brokers to have customer complaints expunged from the CRD records. Currently, the NASD is reviewing comments to its proposal.

In October 2001, the SEC formally sought comment on NASD Dispute Resolution's proposal to amend Rules 10335 and 10205(h) of the NASD Code of Arbitration Procedure. Notice of Filing of Amendments to Proposed Rule Change Amending Code of Arbitration Rules 10335 and 10205(h) Relating to Injunctive Relief, Exchange Act Release No. 42606 (October 21, 2001). According to NASD Dispute Resolution, the proposed rule changes are intended to simplify and clarify the procedures for obtaining injunctive relief in certain disputes subject to arbitration.

18.7 Other NASD Actions

In the summer of 2001 the NASD Dispute Resolution began to make arbitration results available free of charge on line at the NASD Dispute Resolution Web site.

With an increase in online trading and increased claims against online brokers, in April 2001, the NASD sent a policy statement to its member brokerage firms detailing standards for "online suitability." *Online Suitability, Suitability Rule and Online Communications*, NASD Notice to Members 01-23, Apr. 2001. The document delineates what type of investment information posted on the Internet could fall within the definition of a "recommendation" for purposes of the suitability rule.

18.8 Mediation

Although NASD Dispute Resolution's statistics failed to show any increase in the number of cases mediated in 2001, the media and attorneys have noticed an increasing willingness of certain firms to mediate claims. See Lisa Burden, *Online Firms Seen Swapping Arbitration for Mediation*, FINANCIAL NET NEWS, Mar. 21, 2001, p. 1.

18.9 Conclusion

The activity and issues concerning securities arbitration that emerged in 2001 are poised to intensify in 2002. The volume of securities arbitrations in the coming year will likely increase due in part to the continued uncertainty in the financial markets leading to investor and brokerage firm concerns, and greater scrutiny of analysts, their firms and other financial professionals. Additionally, many of the issues that surfaced in 2001, such as pre-hearing dispositive motions, clearing firm liability and deference to arbitration agreements are still somewhat unsettled and thus ripe for additional arbitration and litigation.

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