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April 10, 2008

Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: File No. SR-FINRA-2007-021

Dear Ms. Morris:

I write to comment on the proposed amendment to Rule 12504 relating to motions to dismiss, and to respond to a comment submitted on April 7, 2008 by the Securities Industry and Financial Markets Association ("SIFMA"). I have been an NASD/FINRA arbitrator since 1990, have served for four years on the National Arbitration and Mediation Committee, am a past president of the Public Investors Arbitration Bar Association, a past chair of the Oregon State Bar Securities Regulation Section, and have represented investors (and occasionally registered representatives) in securities arbitration for many years.

I generally support the proposed rule because it is an improvement over the current situation, which is truly unworkable. The proposed amendments to Rule 12504 would bring some standards to the process, and are definitely an improvement. However, the proposal could be improved with two minor changes, which I discuss below.

The Problems With The Current Practice.

It has become routine for respondents to file self-styled "motion to dismiss" in answering statements of claim. The problem is that there are no standards in the Code from which to judge the motions. Filing those motions in court is one thing. There, the civil procedure rules and substantive law create an integrated system that is fair to all the parties. The motion to dismiss rule in Rule 12(b) of the Federal Rules of Civil Procedure is linked with a pleading standard (FRCP 8), and a body of substantive law establishing requirements for pleading various legal and equitable claims. A review standard requires that all well-pleaded allegations be taken as true. And, court rules provide for a general right to re-plead (FRCP 15), often with a right to take discovery before doing so (FRCP 26 - 37) to ensure that no one is denied a day in court by elevating form over substance. Those corollaries are an essential part of the law governing motions to dismiss.

The only one of those corollaries that exists in FINRA arbitration is a "pleading" standard, but it is different from FRCP 8. Code Section 12302(a) merely requires a "statement of claim specifying the relevant facts and remedies requested." That standard is consistent with the statement of FINRA's Linda Feinberg, who explained that the Code does not require a claimant to plead legal causes of action. She stated:

> In SRO/NASD arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law; it can be cognizable under NASD rules.. . . The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law.

Speech of Linda D. Fienberg, July 20, 2004, presented to North American Securities Administrators Association (NAASA) Arbitration Forum. The Code requirement of simply describing facts supporting a grievance, and the lack of any requirement to plead a "claim for relief," is incompatible with the concept of motions to dismiss, which are designed to test whether pleaded allegations meet the legal standards for stating cognizable claims. Many arbitrators do not understand this incongruity. Nor can they be expected to, since there are no rules setting forth the standards for dispositive motions.

The other standards critical to true motion to dismiss jurisprudence – that well pleaded allegations be taken as true and that rights to re-plead be freely granted – simply do not exit in the Code. Arbitrators are free to weigh the competing written descriptions of facts, or assume that one side or the other is wrong, and all without ever hearing any testimony and without reviewing the evidence. So, not only do motions to dismiss not fit well in the context of arbitration, but there is nothing to judge them by. Until now, there has been no attempt by FINRA either to prohibit dispositive motions, or to set any standards for deciding them.

FINRA is correct in realizing that there is a big problem here. And, its stated purpose in proposing the amendments, "to ensure that parties will have their claims heard in arbitration, by significantly limiting motions to dismiss," is a step in the right direction. Given the choice of no rule changes or what FINRA has proposed, I would much prefer the new rules. However, there is room for improvement if the Commission is inclined to consider minor amendments.

Proposed Rule 12504(a)

By limiting the circumstances in which dispositive motions can be filed to those enumerated in subparagraph (a)(6), the proposed rule will remove pre-hearing dispositive motions in most cases. However, there remains a problem with subparagraph (a)(6)(B). That section provides that pre-hearing dismissal motions are appropriate where the moving party was not "*associated with the account(s), security(ies) or conduct at issue.*" The provision is subject to misinterpretation and abuse. There are many types of claims that exist against persons or

entities who are not directly associated with the transactions, but who nonetheless are liable under the law.

One example is found in claims based on Section 509(g) of the Uniform Securities Act of 2002,[1] which has been adopted in some variation in many states. It provides for liability for

[1](g) Joint and several liability. The following persons are liable jointly and severally with and to the same extent as persons liable under subsections (b) through (f):

> (1) a person that directly or indirectly controls a person liable under subsections (b) through (f), unless the controlling person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;
>
> (2) an individual who is a managing partner, executive officer, or director of a person liable under subsections (b) through (f), including an individual having a similar status or performing similar functions, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;
>
> (3) an individual who is an employee of or associated with a person liable under subsections (b) through (f) and who materially aids the conduct giving rise to the liability, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist; and
>
> (4) a person that is a broker-dealer, agent, investment adviser, or investment adviser representative that materially aids the conduct giving rise to the liability under subsections (b) through (f), unless the person sustains the burden of

persons who directly or indirectly control someone liable, managing partners, officers and directors, and employees and broker-dealers who materially aid a transaction, even if they were not directly involved. Under the proposal as drafted, respondents will undoubtedly file pre-hearing motions to dismiss for claims brought against persons who are claimed to be liable under that section.

Other examples include selling away cases, in which a FINRA member firm can be liable when its representative sells an unauthorized product without the firm's knowledge. The issues in those cases focus on the extent to which the firm has met its supervisory obligations under NASD Rule 3010. Firms could abuse the proposed rule and move to dismiss the claims on grounds that they were not involved in the "accounts, conduct or securities at issue," especially where dishonest representatives fail to create bone fide accounts. NASD has issued numerous Notices to Members addressing the requirements of supervising small satellite offices, where these claims oftentimes arise. *See, e.g.*, NASD Notices to Members 85-65, 98-38. And, the Commission itself has recognized the serious supervisory rule violations that member firms can commit when their representatives engage in selling away. *See: Royal Alliance Associates*, Exchange Act Rel No. 38,174 (Jan. 15, 1997). Cases brought against firms on facts similar to the *Royal Alliance* case certainly deserve to go to hearing, but under the language of the proposed rule, they may be subject to motions to dismiss.

Finally, there is the issue of the misapplication of the subparagraph to clearing firms, which I discuss in more detail below.

I believe that this problem can be fixed by the insertion of a sentence in FINRA's Official Statement of Purpose stating that "Nothing in subparagraph (a)(6)(B) is meant to limit claims that would be recognized in court."

Proposed Rule 12504(b)

The section provides that "A motion to dismiss made after the party's case in chief is not subject to the procedures set forth in subparagraph (a)." I am concerned that the rule will encourage such a motion at the conclusion of the claimant's case. The practical effect of the subparagraph will be simply to postpone the motion to dismiss practice from pre-hearing to mid-hearing. But now, when the motion is accompanied by a lengthy brief and numerous citation, the claimant will be deprived of an opportunity to review the authorities before responding.

> proof that the person did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which liability is alleged to exist.

In addition to the fact that subparagraph (b) adds an element of surprise and merely postpones the problem, it will also have the effect of lengthening hearings, and giving more work for the arbitrators, who are not even compensated to read legal memoranda. In one case that I had, after respondent submitted a brief in support of a motion to dismiss mid-hearing, the panel recessed the hearing for the rest of the day so that they could read the papers. The motion was eventually denied but the motion did extend the length of the hearing. Of course, if the motion is granted, the hearing time could be reduced (though the average respondents' case is probably less than 2 days) somewhat. But, assuming that most panels will want to hear the entire case, and will deny the majority of the motions anyway, the net effect of the proposal is to make hearings more time consuming with no change in the ultimate outcome.

The provision creates more problems that it solves, and I would recommend that subparagraph 12504(b) be deleted from the rule.

SIFMA's Suggestion That Clearing Firms Should Be Exempt From The Proposed Rule

In its comment letter of April 7, 2008 to the proposed rules, SIFMA suggests that clearing firms should be exempt from the proposed rule. In support of its argument, SIFMA, and the chair of its clearing firms committee (as a signatory on the comment letter), represent to the Commission that a clearing firm "does not owe . . . a legal duty to the claimants; that "clearing firms cannot be held liable for the wrongful acts of the correspondent," and that there is "well settled law that clearing firms are not liable for the conduct of introducing firms under the federal securities laws or under SEC and SRO rules." SIFMA Comment at 2 -3.

Those are misleading statements of the law. The SEC itself has ruled in *In The Matter of Bear Stearns Securities Corporation*, 1999 Lexis 1551, that a major wall street firm's status as a clearing broker does not immunize it from liability. The Commission specifically held in that case and in its subsequent press release that when a clearing firm "enables" an introducing firm to defraud customers, the clearing firm will be fully responsible for its actions.

Several significant court cases, including the Ninth Circuit and the U.S. District Court for the Southern District of New York, have reached similar conclusions. They hold that clearing firms are not immune from liability, and can be liable for the fraudulent acts of their introducing firms, just as any other participant in a fraudulent scheme under blue sky laws and at common law. *See, e.g., Koruga v. Fiserv Correspondent Services, Inc.*,183 F.Supp.2d 1245 (D. Or. 2001), *aff'd* 2002 U.S. App. LEXIS 6439 (9th Cir. 2002)(affirming NASD award of more than $1.2 million against a clearing firm on grounds that clearing firm did not establish its affirmative defense under Washington and California securities laws[2] that it "did not know and could not reasonably have discovered" the introducing firm's fraudulent conduct); *McDaniel v. Bear*

[2] Cal. Corp. Code § 25504 and Wash. Rev. Stat. 21.20.430(3).

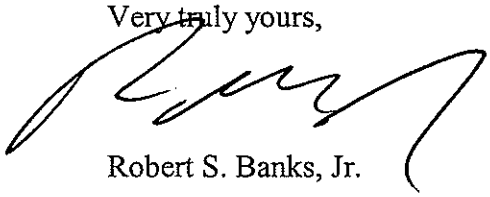
Stearns, 196 F.Supp. 2d. 343 (SDNY 2002)(affirming arbitration award against clearing firm on grounds that it aided and abetting fraud of introducing firm); *Hirata v. J.B. Oxford & Co.*, 193 F.R.D. 589, 600 (S.D. Ind. 2000)(denying clearing firm's motion to dismiss where plaintiff alleged that clearing firm had materially aided unlawful conduct); *RPR Clearing v. Shy Glass*, 1997 WL 460717 (S.D.N.Y. July 28, 1997), (upholding an NASD award against RPR Clearing and rejecting argument that the arbitrators "ignored the legal principal that [clearing firms] owe no duty to investors"). See *generally* R. Banks, *Clearing Firms, The Uniform Securities Act and Koruga v. Fiserv Correspondent Services, Inc, Securities Arbitration* 565 (Practicing Law Institute 2001).

And, there are many arbitration awards that have held clearing firms liable for their participation in the conduct of their introducing brokers. A small sampling, in addition to *Koruga* and *McDaniel*, includes *Martin v. Bear Stearns*, NASD No. 97-01093; *Rhodes v. SW Securities*, NASD No. 99-02825; *Ammann v. M. Rimson & Co., Inc.*, 1997 WL 633284 (NASD September 30, 1997); and *Kostoff vs. Yankee Financial, et al.* NASD 04-04259.

The SIFMA comment letter exemplifies the problem with dispositive motions in arbitration. SIFMA is undoubtedly correct that its clearing firm members have been successful in having many cases dismissed prior to a hearing. Those dismissals occur because the respondent firm makes broad, misleading statements about the law, much as SIFMA has done to the Commission here.[3] When those dismissals are granted in favor of any respondent, a claimant is denied his only opportunity to present evidence on a case that may well have merit in a court venue, and almost always deserves an evidentiary hearing in arbitration. In the several clearing firm cases that I have brought on behalf of my clients, a pre-hearing motion to dismiss has been filed in every one. Clearing firms are probably unique among broker-dealers in that they file motions to dismiss nearly 100% of the time. They are statistically among the most frequent abusers of the process, and should not be given an exemption from the proposed rule.

Thank you for your consideration.

Very truly yours,



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[3]This is not the first time that SIFMA (or its predecessor, the Securities Industry Association) has sought to change the rules on clearing firm liability through unorthodox channels. *See* R. Banks, *Clearing Firms and the 2002 Uniform Securities Act: What You Didn't Know Could Have Hurt You*, 2 Securities Arbitration 253 (Practicing Law Institute 2003)(describing SIAs' role in the Official Comments to Section 509(g) of the 2002 Uniform Securities Act).