BROKERAGE FIRM COUNTERCLAIMS: FIRMS' ATTEMPTS TO TURN LIABILITIES INTO ASSETS

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I list an important place for that prize statement of principle ... calling for the letting in of the light of day on issues of securities, foreign and domestic, which are offered for sale to the investing public. My friends, you and I as common-sense citizens know that it would help to protect the savings of the country from the dishonesty of crooks and from the lack of honor of some men in high financial places. Publicity is the enemy of crookedness.

President Franklin D. Roosevelt

INTRODUCTION

This article addresses what appears to be a growing problem and our experience in defending against it. Specifically, broker-dealers' attempts to apply indemnification clauses in private placement subscription agreements—intended to apply solely to the sponsor of the investment—to themselves. Firms are using the indemnification clauses in order to file counterclaims for attorney's fees and to intimidate clients who have sought redress in FINRA arbitration for losses in alternative investments sold by brokerage firms. Successful arguments against such tactics include:

- The indemnification clause does not apply to the broker-dealer because the broker-dealer is neither a party to the subscription agreement nor identified in the indemnification clause;
- The counterclaim is invalid as a matter of law;
- The indemnification clause does not apply to causes of action brought against the broker-dealer;
- As a matter of public policy, broker-dealers may not indemnify themselves against accountability for their own frauds and misrepresentations; and
- Industry regulators find the tactics unacceptable.

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THE INDEMNIFICATION CLAUSE DOES NOT APPLY TO THE BROKER-DEALER BECAUSE THE BROKER-DEALER IS NEITHER A PARTY TO THE SUBSCRIPTION AGREEMENT NOR IDENTIFIED IN THE INDEMNIFICATION CLAUSE

It appears this new wave of counterclaims being filed against investors in FINRA arbitrations are generally premised upon a sole cause of action, indemnification under the subscription agreement. In short, brokerage firms usually assert (1) that certain statements contained within documents signed by the investor amount to representations or warranties made by the investor, (2) that the indemnification clause in the subscription agreement applies to the broker-dealer, and (3) that the claims alleged in the statement of claim conflict with these alleged representations and warranties and therefore trigger the indemnification clause such that the investor should indemnify the broker-dealer for its costs, fees and expenses in defending against the lawsuit filed by the customer. An example indemnification clause reads as follows:

> 7. *Indemnification*. The undersigned recognizes that the acceptance of his Subscription will be based upon his representations and warranties set forth herein and in other instruments and documents relating to the participation of the undersigned in the Partnership, and the undersigned hereby agrees **to indemnify and defend the General Partner and the Partnership and to hold such firms and each officer, director, agent, attorney and/or Partner thereof harmless** from and against any and all loss, damage, liability or expense, including costs and reasonable attorneys' fees, to which they may be put or which they may incur by reason of, or in connection with, any misrepresentation made by the undersigned in this Subscription Agreement, the Questionnaire, or elsewhere, any breach by the undersigned of his warranties, and/or failure by him to fulfill any of his covenants or agreements set forth herein or elsewhere . . . .[2]

The crucial portion of the clause—often conveniently avoided altogether in most counterclaims—is the portion identifying to whom the indemnity would apply if triggered. The language usually, as in the example, states that the signatories agree to "indemnify and defend" the "General Partner and the Partnership" and to "hold … harmless" "such firms and each officer, director, agent, attorney and/or Partner thereof . . . ."

2. (Emphasis added).

A. The Broker-Dealer is Not the General Partner or the Partnership Contemplated by the Indemnification Clause

Hopefully this one should be obvious to your Panel. The "General Partner" is usually the private placement's sponsor or an entity associated with the sponsor. The "Partnership" refers to the private placement itself. Obviously, the broker-dealer is neither of these entities. There is generally no reference whatsoever to the broker-dealer in subscription agreements—neither in the indemnification clause nor in any other provision.

The broker-dealer is the seller of the offering. The only reason a broker-dealer would appear in any way in a subscription agreement is if the sponsor included a field asking for the soliciting broker-dealer's name. The broker-dealer's role in the transaction is precisely that, the soliciting broker-dealer. It is neither the General Partner nor the Partnership contemplated by the indemnification clause.

B. The Broker-Dealer is Not an Officer, Director, Agent, Attorney, or Partner as Contemplated by the Indemnification Clause

It appears counterclaims brought by broker-dealers using the indemnification clause in the subscription agreement essentially rely upon a single assertion, that the broker-dealer was somehow an agent of the sponsor and that any contradictions in the representations and warranties by the investor constitutes a breach of the subscription agreement for which the investor must indemnify the broker-dealer as an agent of the sponsor.

Responding to this argument, it is important to point out to the arbitrators why a broker-dealer could not possibly be the agent of the sponsor, or any of the other entities listed in the indemnification clause. The Restatement of Agency (Third) § 1.01 defines agency as follows:

> Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that **the agent shall act on the principal's behalf and subject to the principal's control**, and the agent manifests assent or otherwise consents to so act.[3]

Here, the purported "principal" is the sponsor. The broker-dealer, however, neither acts on the sponsor's behalf nor subject to its control.

The sponsor and the broker-dealer enter into a selling agreement, a contract that sets forth the rights and responsibilities of each party to that

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3. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (emphasis added).

contract. The contract provides that the sponsor will pay the broker-dealer in the form of sales commissions, marketing fees, or due diligence fees for its sale of the private placement. To that extent, the broker-dealer does not operate on the sponsor's behalf; it operates on its own behalf and its own self-interest in earning the commissions and other fees for selling shares of the investment. Similarly, any responsibilities the broker-dealer undertakes would be set forth by separate contracts with the investors and these agreements would in no way indicate that the sponsor has the capacity to assert any control over the broker-dealer. Without these necessary elements, there can be no agency relationship. Consequently, any assertion that the broker-dealer is an agent of the sponsor is clearly erroneous.

Further, the relationship between these two entities cannot be interpreted as that of a principal and agent because a sponsor does not have the capacity to act as a principal. The Restatement of Agency (Third) § 3.04(1) states that a person only has the capacity to act as principal where that person could step in and perform the same act as the purported agent.[4] The broker-dealer is engaged in the sale of securities as a registered broker-dealer with FINRA. A sponsor, however, is typically not a registered broker-dealer with FINRA and could not therefore have performed these or any acts as a broker-dealer. Therefore a sponsor generally has no capacity to act as principal in an agency relationship with a broker-dealer.

By claiming to be a mere agent of a sponsor and thus covered by the indemnification clause, a broker-dealer is attempting to have its cake and eat it too. On the one hand it professes to be a distinct entity, a FINRA registered broker-dealer. On the other hand, it professes to be so beholden to and under the control of a sponsor as to be a mere agent. However, once registered as a broker-dealer, it exposed itself to all of the responsibilities owed by any broker-dealer to its clients. These duties are distinct and unrelated to the subscription agreement between the investor and the investment sponsor.

The broker-dealer is not a party to the subscription agreement. It is neither the General Partner nor the Partnership contemplated by the indemnification clause in the subscription agreement. Finally, it is not an officer, director, attorney, agent, or partner as contemplated by the indemnification clause. As such, the broker-dealer is not covered by the indemnification clause.

4. *Id.* § 3.04(1).

THE COUNTERCLAIM IS INVALID AS A MATTER OF LAW

Counterclaims brought by broker-dealers using the indemnification clause in subscription agreements are invalid as a matter of law and violate the securities laws and associated rules. Securities regulation exists primarily to reduce fraud in the sale of securities through disclosure of all material facts in a manner least disruptive to capital formation.[5] This is implemented through the disclosure, registration, and antifraud provisions of the Securities Act of 1933 (the "Securities Act"),[6] the Securities Exchange Act of 1934 (the "Exchange Act"),[7] and the rules and regulations promulgated by the U.S. Securities and Exchange Commission (the "SEC").[8] To enforce the Securities Act and the Exchange Act, Congress and the judiciary have created express and implied civil causes of action to penalize those who sell securities with materially false or misleading statements or omissions.[9]

Most securities offered to investors are required to be registered with the SEC under the Securities Act or with applicable state authorities under state laws; however, certain private offerings are exempt from registration under the Securities Act.[10] A securities offering is considered private and exempt from registration only if the offering is limited to investors who have no need for the protection provided by registration, which depends on the number of offerees, the sophistication of the offerees in light of their access to the type of information that would be included in the registration, and the manner of offering.[11]

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5. *See* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) ("To provide full and fair disclosure of the character of securities sold … and to prevent frauds in the sale thereof."); 1 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, THE GENESIS OF THE NEW DEAL, 1928-32, at 653 (1938).

6. Securities Act §§ 5-8, 10-12, 15, 17, 15 U.S.C. §§ 77e-77h, 77g, 77k, 77l, 77o, 77q (2014).

7. Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2014).

8. 17 C.F.R. § 240.10b-5 (2014) ("SEC Rule 10b-5").

9. Securities Act §§ 11-12, 15 U.S.C. § 77k-l; Exchange Act § 10(b), 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

10. Securities Act §§ 4-5, 15 U.S.C. §§ 77d-77e; Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959).

11. Securities Act § 4, 15 U.S.C. § 77d; U.S. v. Arutunoff, 1 F.3d 1112 (10th Cir. 1997).

The SEC promulgated Rules 500 through 508, known as Regulation D, to facilitate exempt transactions under the Securities Act.[12] Regulation D governs the limited offers and sales of securities without registration in transactions known as private placements. SEC Rule 506 is a safe harbor[13] that permits issuers to raise an unlimited amount of capital through the offers and sales of securities that do not involve any public offerings.[14] SEC Rule 506 requires that "[t]here are no more than or the issuer reasonably believes that there are no more than 35" non-accredited[15] purchasers. SEC Rule 506 also requires that any non-accredited investors "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchase comes within this description." Private offerings that are exempt from registration under the Securities Act ***are not exempt from the antifraud provisions***.[16]

Further, the "rules are available only to the issuer of the securities and not to any affiliate of that issuer or to any other person for resales of the issuer's securities. The rules provide an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves."[17] Thus, because the selling broker-dealer is not the issuer of the security and because the exemption applies only to the transaction and not the security, the exemption under Regulation D is not available to the selling broker-dealer.

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12. 17 C.F.R. §§ 230.500-508 (2014) ("SEC Regulation D").

13. "Safe harbor" is defined as "[a] provision (as in a statute or regulation) that affords protection from liability or penalty. BLACK'S LAW DICTIONARY 665 (9th ed. 2009) ("SEC regulations, for example, provide a safe harbor for an issuer's business forecasts that are made in good faith.").

14. 17 C.F.R. § 230.506 (2014) ("SEC Rule 506").

15. SEC Rule 501 defines what qualifies an investor as accredited. 17 C.F.R. § 230.501 (2014) ("SEC Rule 501").

16. Securities Act § 4(a), 15 U.S.C. § 77d; SEC Rule 506. SEC Regulation D – Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, Preliminary Note 1, 17 C.F.R. § 230 (2014).

17. SEC Regulation D – Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, Preliminary Note 4, 17 C.F.R. § 230.

The issuer of an exempt private offering has a duty to make a reasonable inquiry into a purchaser's background before accepting the purchaser.[18] The acceptance of a purchaser, known as a subscriber, is generally based upon completion of a subscription agreement and associated questionnaire. In addition to suitability questions, subscription agreements generally contain an indemnification clause. The indemnification clause is designed to discourage unaccredited investors from making false statements in subscription agreements and suitability questionnaires in order to be permitted to invest in private placements where such investments could potentially destroy the exemption from registration upon which the issuer and its principals and underwriters rely.[19]

Indemnification clauses are not designed—and should not be used—to protect broker-dealers that sell unsuitable investments to their customers based on false representations. While a properly executed private placement is exempt from the registration provision of the Securities Act, transactions—and the disclosures made or a lack thereof—***are subject to the anti-fraud provisions of the Securities Act***.[20] Federal securities laws and SEC rules all ***prohibit any condition, stipulation, or provisions that waive compliance with federal securities laws or that waive any cause of action available under their anti-fraud provisions***.[21] Further, oral misrepresentations as to risk may effectively nullify any warnings in a subscription agreement by discounting its general significance and its relevance to the customer's particular situation.[22]

The federal securities laws prohibit indemnification clauses that waive compliance with federal securities laws or that waive any cause of action available under their anti-fraud provisions. The Opinion of the General Counsel Relating to the Use of 'Hedge Clauses' by Brokers, Dealers, Investment Advisers, and Others (the "Opinion"), states that "[a]ll the

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18. Securities Act § 4, 15 U.S.C. § 77d; Mark v. FSC Securities Corp., 870 F.2d 331 (6th Cir. 1989).

19. Layman v. Combs, 994 F.2d 1344 (9th Cir. 1992).

20. Opinion of General Counsel Roger S. Forster Relating to the Use of 'Hedge Clauses' by Brokers, Dealers, Investment Advisers and Others, Investment Advisers Act Release No. 58, 1951 WL 1363 (Apr. 10, 1951) ("SEC Release No. 58"); 15 U.S.C. § 77n (2014).

21. SEC Release No. 58; 15 U.S.C. § 77n.

22. *See* Kelley v. Carr, 442 F. Supp. 346, 353-354 (W.D. Mich. 1944); Clayton Brokerage Co. of St. Louis, Inc. v. Commodity Futures Trading Commission, 794 F.2d 573 (11th Cir. 1986).

statutes administered by the Commission provide that any condition, stipulation or provision which binds any person to waive compliance with their requirements shall be void."[23] The Opinion goes on to state that "[in] my opinion, the anti-fraud provisions of the SEC statutes are violated by the employment of any legend, hedge clause or other provision which is likely to lead an investor to believe that he has in any way waived any right of action he may have."[24] In FINRA Regulatory Notice 10-22, FINRA reminded broker-dealers that Regulation D transactions "are not exempt from the antifraud provisions of the federal securities laws."[25]

Any security offered under Regulation D that a broker-dealer recommends to its customers must meet the suitability requirements.[26] A broker-dealer must have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.[27] The analysis has two principal components: "First, the 'reasonable basis' suitability analysis requires the [broker-dealer] to have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. Second, the 'customer specific suitability' analysis requires that the [broker-dealer] determine whether the security is suitable for the customer to whom it would be recommended."[28] The notice goes on to state that "[t]he fact that an investor meets the net worth or income test for being an accredited investor is only one factor to be considered in the course of a complete suitability analysis . . . . A [broker-dealer] also must be satisfied that the customer 'fully understands the risks involved and is [able] to take those risks.'"[29] The notice continues:

> The Securities and Exchange Commission (SEC) and federal courts have long held that a [broker-dealer] that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it. This duty emanates from the [broker-dealer]'s "special relationship" to the customer, and

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23. SEC Release No. 58; 15 U.S.C. § 77n.

24. SEC Release No. 58.

25. FINRA Regulatory Notice 10-22.

26. FINRA Rule 2310.

27. FINRA Rule 2310.

28. FINRA Regulatory Notice 10-22; *see also* FINRA Notice to Members 03-71.

29. FINRA Regulatory Notice 10-22.

> from the fact that in recommending the security, the broker-dealer represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation." Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws and, particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 thereunder. It also can constitute a violation of FINRA Rule 2010, requiring adherence to just and equitable principles of trade, and FINRA Rule 2020, prohibiting manipulative and fraudulent devices.[30]

Notwithstanding this well settled law, some broker-dealers are still attempting to expand the scope of indemnification clauses in the subscribing documents of private placements to cover any fraud or other misconduct they commit in conjunction with their sales of these investments. Two federal appellate courts addressed this specific issue.[31] In both cases the court refused the soliciting broker-dealers petitions to enforce the indemnification clauses in actions brought against them by investors.

The first case involved a plaintiff who brought suit under federal securities laws, alleging, among other things, that he had relied on certain oral misrepresentations.[32] Zissu had warranted in his subscription agreement that no oral representations had been made to him.[33] Under the indemnification clause in *Zissu*, the investors agreed to indemnify and hold harmless the sellers "against any and all loss, damage or liability due to or arising out of a breach of any representation or warranty" that he had made in the subscription agreement.[34] The court found that

> [t]his appeal raises a troubling question involving an apparent inherent contrariety between a "no representations have been made" clause and an "indemnity" clause protecting sponsors from losses arising from the breach of warranty clause contained in the same agreement. Yet, we need not reach or determine this issue because we hold that the indemnity clause in the subject agreement is not

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30. *Id*.

31. Layman v. Combs, 994 F.2d 1344 (9th Cir. 1992); Zissu v. Bear, Stearns & Co., 805 F.2d 75 (2d Cir. 1986).

32. *Zissu*, 805 F.2d at 76.

33. *Id.* at 77.

34. *Id.*

> specific enough to hold plaintiff liable for defendants' defense costs. Consequently, we hold that defendants are not entitled to relief on their counterclaim.[35]

The court explained that the

> "any and all damages" clause of the subscription agreement did not meet the requisite level of specificity necessary to hold Zissu liable to reimburse [defendants for] defense costs in their successful defense against Zissu's securities claims. The clause Zissu signed did not put him on notice that he would be responsible for defendants' legal fees incurred in the security fraud suit . . . . Instead, the warranties in question were necessary to exempt the limited partnership from the requirements of the 1933 Act and are so understood by investors. That being the case, the parties had little reason to expect that such warranties might also be the basis for the counterclaim made in the present case … [and although] courts have held that contractual indemnity provisions for attorneys' fees will be enforced, and broad indemnification provisions like the one here should be read to extend to such fees, a higher level of specificity is required when attorneys' fees are being assessed against a plaintiff suing for securities fraud.[36]

In the second case, the Ninth Circuit addressed a substantially similar indemnification clause.[37] The court held that "the indemnification required by the clause ... does not extend to fees or damages incurred in defending claims brought by the subscribing indemnitor."[38] The court stated:

> A person who contracts to pay an opponent's attorneys' fees if she sues unsuccessfully is agreeing to a departure from the standard American rule that a party prevailing in a lawsuit is not entitled to recover fees from the loser. It is not too much to ask that a clause effectuating such a deviation from the norm be explicit.[39]

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35. *Id.* at 76.

36. *Id.* at 79 (citing Lavorato v. Bethlehem Steel Corp., 91 A.D.2d 1184, 459 N.Y.S.2d 170 (N.Y. Sup. Ct. 1983); Colon v. Automatic Retailers Ass'n Service, Inc., 74 Misc. 2d 478, 343 N.Y.S.2d 874, 877-79 (N.Y. Civ. Ct. 1972); Jackson v. Oppenheim, 533 F.2d 826, 831 (2d Cir. 1976)).

37. *Layman*, 994 F.2d 1344.

38. *Id.* at 1353.

39. *Id.* at 1352.

The court noted the indemnification clause did not provide that the investor must pay the defendants' fees if the investor breached a warranty by suing the sellers.[40] The court found the "literal terms [of the indemnification agreement] would require the plaintiffs to pay the defendants' judgment and attorneys' fees even if the plaintiff prevailed!"[41]

The *Layman* court found that "the language indicates that the focus of the indemnification was on ensuring, first, that the suitability standards were met, so that the sellers could retain their private placement registration, and, second, that, if the registration were lost and damages resulted, the investor who caused the loss would be liable."[42] The court concluded that

> the unambiguous expressed intent of the clause is that any investor whose breach of a representation causes the sellers to lose their private placement exemption is obligated to reimburse the sellers for their losses. In our view, a reasonable investor who read the PPM and the subscription agreement would so interpret the indemnification clause.[43]

The same court found that "the crucial element of an indemnification is that it put potential investors on notice that the indemnification is not limited, and instead applies to fees and damages incurred in defending a claim brought by the subscribing indemnitor herself."[44] The court continued, stating that

> [t]he defendants' position is that the expressed intent of the parties, as literally set forth in the indemnification clause, was to force the investors to reimburse the sellers for *all* costs and liability resulting from *any* breach of the representations and warranties. The language thus encompasses this case, they argue. But if the indemnify clause is so interpreted to apply to the plaintiffs' lawsuit for oral misrepresentations, its literal terms would require the plaintiffs to pay the defendants' judgment and attorneys' fees even if plaintiffs prevailed! In our view, the absurdity of such a result—an investor would have a meaningless right to sue, because she would have to pay the judgment and fees of the losing sellers—undermines the

40. *Id.*

41. *Id.*

42. *Id.* at 1351.

43. *Id.*

44. *Id.*

> reasonableness of the defendants' interpretation of the indemnification.[45]

THE INDEMNIFICATION CLAUSE DOES NOT APPLY TO CAUSES OF ACTION BROUGHT AGAINST THE BROKER-DEALER

Counterclaims brought by broker-dealers using the indemnification clause in subscription agreements also do not apply to causes of action brought based on their duties owed to investors. The example indemnification clause above calls for the indemnification of the sponsor only for those costs "they may incur by reason of, or in connection with, **any misrepresentation made**" by the investor. Any costs incurred by a broker-dealer are not contemplated by the indemnification clause because the clause does not apply to the broker-dealer. However, even if a panel were to conclude that the clause does apply to the broker-dealer, its costs are not related to any misrepresentation made by the investor. The investor's claims neither arise from, nor are they connected with, the subscription agreement between the sponsor and the investor. Rather, they relate to the ***duties owed to the investor by the broker-dealer as a FINRA registered broker-dealer***, as set forth by the federal securities laws and FINRA regulations, to handle the investor's accounts appropriately.

Suppose an investor's statement of claim sets forth causes of action against a broker-dealer for: (1) Violation of the Common Law of Fraud; (2) Breach of Fiduciary Duty; (3) Negligent Failure to Supervise; and (4) Negligence, and that the broker-dealer is responsible for the investor' losses, due to its failure to perform adequate due diligence and its recommendation of unsuitable investments for the investor, as required pursuant to FINRA rules. The broker-dealer's costs and attorney's fees associated with defending itself against these allegations relate to its role in dealing with the investor as a ***broker-dealer*** and are wholly distinct and unrelated to the matter of the representations and warranties set forth between the investor and the sponsor.

Moreover, the indemnification clause does not pertain to any of these matters. Alleging otherwise is attempting to call into effect an indemnification clause entirely unrelated to the claims at issue. It would have to specifically contemplate these issues if it was intended to apply to them. For instance, Florida law clearly states that "an indemnity agreement

45. *Id.*

which indemnifies against the indemnitee's own negligence must state this in 'clear and unequivocal' language."[46]

The indemnification clauses we have seen make no reference to negligence or any of the other allegations generally alleged by investors in claims against brokerage firms. If a Panel were to stretch the scope as broker-dealers would like them to, this would essentially hold the investor accountable for the broker-dealer's misconduct. Thus, a negligence claim alone would preclude a broker-dealer from indemnification for its costs and fees because the indemnification clause likely fails to clearly and unequivocally state that it indemnifies the broker-dealer from negligence.

Similarly, the indemnification clause makes no reference otherwise to having investors indemnify anyone, the sponsor or otherwise, from their own misconduct. Broker-dealers have various responsibilities that are wholly unrelated to the indemnification clause. Guidance on a broker-dealer's duties to investors when selling alternative investments can be gleaned from FINRA Notice to Members 03-71 ("NTM 03-71"), in which FINRA "reminds members of their sales conduct obligations" regarding non-conventional investments. In NTM 03-71, FINRA reminded broker-dealers of their obligations, including:

> (1) conduct appropriate due diligence with respect to these products, (2) perform a reasonable-basis suitability analysis, (3) perform customer-specific suitability analysis for recommended transactions, (4) ensure that promotional materials used by the member are fair, accurate, and balanced, (5) implement appropriate internal controls, and (6) provide appropriate training to registered representatives that sell these products.[47]

Given the complex and, at times, difficult-to-understand nature of non-conventional investments, NTM 03-71 goes on to state that members should "take particular care to assure that they are fulfilling these obligations."[48] Further, NTM 03-71 cautions that in the performance of the customer-specific suitability analysis owed each client, the broker-dealer should not rely "too heavily upon a customer's financial status as the basis for recommending" these products because "a customer's net worth alone is not

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46. *See* Univ. Plaza Shopping Ctr. v. Stewart, 272 So. 2d 507, 511 (Fla. 1973); *see also* Maxus Exploration Co. v. Moran Bros., Inc., 817 S.W.2d 50, 56 (Tex. 1991) (holding that Texas law requires that an agreement to indemnify another for his own negligence must be "express").

47. FINRA Notice to Members 03-71.

48. *Id.*

necessarily determinative of whether a particular product is suitable for that investor."[49] As such, whether investors had the minimum requisite net worth to invest in these investments is only a part of the broker-dealer's suitability obligation in determining whether the investments were appropriate.

Finally, NTM 03-71 clarifies that a broker-dealer may not, in presenting an investment to an investor, disregard the risks when presenting the potential benefits of the investment to the investor to induce him to purchase the product. Any sales materials or oral presentations made by the broker-dealer "must present a fair and balanced picture regarding both the risks and benefits of investing in these products . . . . Moreover … it is critical that members balance their promotional materials with disclosures of the corresponding risks and limitations of the product . . . ."[50]

Issues arising between an investor and a broker-dealer that pertain solely to the broker-dealer's failures with regard to the manner in which it offered a non-conventional product to the investor have nothing to do with the subscription agreement entered into between the investor and the sponsor. The precise conduct for which the indemnification clause calls for the indemnification of the sponsor is ***entirely distinct*** from the conduct at issue in disputes between an investor and a broker-dealer.

AS A MATTER OF PUBLIC POLICY, BROKER-DEALERS MAY NOT INDEMNIFY THEMSELVES AGAINST ACCOUNTABILITY FOR THEIR OWN FRAUDS AND MISREPRESENTATIONS

The very existence of causes of action against broker-dealers under federal and state securities laws, as well as under FINRA rules and regulations, affirms that there exists a public policy to hold broker-dealers accountable for their actions and to ensure the protection of persons when investing in securities. To permit a broker-dealer to shield itself against accountability for its own frauds and misrepresentations in selling securities to investors would contravene this policy.[51]

49. *Id.*

50. *Id.*

51. Florida Bar Opinion Committee, *Report on Standards for Opinions of Florida Counsel of the Special Committee on Opinion Standards of the Florida Bar Business Law Section*, 46 BUS. LAW. 1407, 1435-36 (1991) ("[V]arious types of indemnification contracts sometimes are held to be invalid because they are contrary to public policy").

This is a common sense argument that can be made to a Panel if a broker-dealer files a counterclaim against a Claimant. The reality is, if such indemnification clauses were permissible, ***every*** broker-dealer would immediately insert such clauses in their contracts and FINRA arbitration would cease to exist. Pointing out that most firms would never try such an argument should cause arbitrators to realize that such an argument is against public policy.

INDUSTRY REGULATORS FIND THE TACTICS UNACCEPTABLE

The tide already appears to be shifting and as regulators have become aware of these counterclaims, they have voiced their objection. For example, Michelle Ong, a FINRA spokeswoman, is quoted in an article published in the New York Times stating that "indemnification clauses do not shield firms from their legal and regulatory obligations to comply with federal securities laws and FINRA rules" and "[t]he use of any clause or tactic designed to intimidate or keep a customer from exercising his/her right to proceed in arbitration would violate FINRA conduct rules and we may investigate the use accordingly."[52]

CONCLUSION

It is hoped that regulators will step in and sanction the firms that have tried this abusive tactic, thereby causing other firms not to attempt the argument. However, if even one panel is convinced of the validity of this convoluted argument, other firms that sold or still sell these products will follow. Keep fighting the good fight!

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52. Susan Antilla, *Brokers Countersue to Thwart Suits by Unhappy Investors*, N.Y. TIMES, Sept. 18, 2014, at B8, *available at* http://dealbook.nytimes.com/2014/09/17/brokers-countersue-to-thwart-suits-by-unhappy-investors/?_php=true&_type=blogs&_r=0 (last visited Jan. 28, 2015).