six years elapsed from the date of the investment at issue, and more that six years had elapsed from the date the registered representative who sold the investment had left Respondent's employ.

Triggering and Tolling: Application Of The FINRA Eligibility Rule From A Claimant's Perspective

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For as long as the NASD and now FINRA have had an Eligibility Rule,[1] there has been constant debate before arbitration panels and the courts about two critical elements: 1. When does the eligibility rule begin to run, the date of purchase or some later date? and 2. Can the eligibility rule be tolled? This article will explore the grounds upon which FINRA arbitration panels (over the protestation of Respondents) and courts have determined that

1. The "event or occurrence giving rise to the claim" can be some later date after the purchase of the securities at issue, including the date losses are incurred and/or discovered; and
2. The running of the Eligibility Rule can be tolled.

1. Background

In 2002, the U.S. Supreme Court in *Howsam v. Dean Witter Reynolds, Inc.,* 537 U.S. 79 (U.S. 2002), resolved the circuit split in holding that the issue of eligibility pursuant to NASD Rule 10304 (now FINRA Rule 12206) was for the arbitrators, not the courts, to decide. Following the Supreme Court's decision in *Howsam,* arbitrators have exclusive jurisdiction to decide Rule 12206 motions to dismiss. Prior to the *Howsam* decision, there was a split in the courts about how Rule 12206 should be applied and by whom the determination should be made. The Third, Sixth, Seventh, Tenth, and Eleventh Circuits held that the eligibility rule created a

[1] The Eligibility Rule is now FINRA Rule 12206, but was formerly covered under NASD §15.

substantive jurisdictional requirement for the court's determination.[2] The First, Second, Fourth, Fifth, Eighth, and Ninth Circuits found that the rule created a *procedural question* for the arbitrators to decide.[3]

The distinction between the two is significant because it served as the underlying foundation for the rationale of the courts in determining whether or not the court would applying tolling, discovery and the like. The resolution by the Supreme Court in favor of the view held by the "procedural question" circuits undermined the premise upon which the "substantive jurisdictional requirement" circuits' were founded.[4]

2. Arbitration Panels Have Great Flexibility To Interpret The "Event Or Occurrence" Language of FINRA Rule 12206

Arbitration is a creature of contract, which is subject to the rules and procedures set forth by the governing body – in this case, FINRA. The eligibility rule is not a statute of limitation, but rather falls within the arbitration contract. The eligibility rule is actually an incorporated term of the contract between the respective parties (including the contract between the registered entity or person and FINRA, providing the customer a right to sue in FINRA arbitration even in cases where there is no direct arbitration agreement between the customer and the registered party).

[2] *See* Aidikoff, et al., *FINRA Six-Year Eligibility Rule 12206: The Purchase Date is Often Not the Triggering "Occurrence or Event Giving Rise to a Claim,"* 20 PIABA B.J. 1 (2013) (citing *PaineWebber Inc. v. Hofmann*, 984 F.2d 1372, 1378-79 (3d Cir. 1993); *Roney & Co. v. Kassab*, 981 F.2d 894, 898-900 (6th Cir. 1992); *Dean Witter Reynolds, Inc. v. McCoy*, 995 F.2d 649, 650-51 (6th Cir. 1993); *Prudential Sec., Inc. v. Yingling*, 226 F.3d 668, 671-72 (6th Cir. 2000); *Edward D. Jones & Co. v. Sorrells*, 957 F.2d 509, 512-13 (7th Cir. 1992); *PaineWebber, Inc. v. Farnam*, 870 F.2d 1286, 1292 (7th Cir. 1989); *Cogswell v. Merrill Lynch*, 78 F.3d 474, 478-81 (10th Cir. 1996); and *Merrill Lynch v. Cohen*, 62 F.3d 381, 383-84 (11th Cir. 1995)).

[3] *Id.* (citing *PaineWebber Inc. v. Elahi*, 87 F.3d 589, 598-99 (1st Cir. 1996); *PaineWebber, Inc. v. Bybyk*, 81 F.3d 1193, 1196, 1198-99 (2d Cir. 1996); *Conticommodity Servs. v. Philipp & Lion*, 613 F.2d 1222, 1224-26 (2d Cir. 1980); *Miller v. Prudential Bache Secs., Inc.*, 884 F.2d 128, 132 (4th Cir. 1989), cert. denied, 497 U.S. 1004 (1990); *Smith Barney Shearson, Inc. v. Boone*, 47 F.3d 750, 753-54 (5th Cir. 1995); *FSC Secs. Corp. v. Freel*, 14 F.3d 1310, 1312 (8th Cir. 1994)).

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FINRA has affirmatively chosen to use the eligibility rule over other options, including using applicable statutes of limitation. Unlike a statute of limitation, there is no hard and fast rule to determine accrual, although FINRA has adopted equitable tolling as will be discussed below. Current caselaw and FINRA guidance show that the clock does not necessarily even begin running at the same time as a similar statute of limitation would have accrued. Therefore, it is critical to note the language of Rule 12206(a), which states:

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

What has been included in the language of Rule 12206(a) is as significant as what has not been included. For example, the rule does not say that a claim must be brought within six years of the *purchase* of a security or when a representative *ceased registration* with a member. Notwithstanding, these are frequently presented to panels by counsel representing broker-dealers as if they are the mandatory triggering events or occurrences. They are not.

If either were intended, over the last few decades, the NASD and FINRA, the drafters of the rule, could have included either of these in the text of the rule itself, but have not done so. Instead, the NASD/FINRA have provided that a claim must be brought within six years of an "occurrence or event giving rise to the claim," giving arbitration panels (and formerly the courts) freedom to make a case-by-case determination on the issue of when the clock reasonably should began to run.

In fact, panels and courts have freedom to consider any number of "events or occurrences" as the moment that triggers the six-year clock, regardless of applicable statutes to limitation, as discussed below.

When reviewing how past panels have used this freedom to apply the eligibility rule as they saw appropriate, the lack of published decisions denying eligibility motions can be misleading. Rule 12206(b)(5) provides that the Panel only needs to render a reasoned award when granting a motion to dismiss, not when one is denied. When denying motions to dismiss, panels are not required to issue reasoned awards available for public review, nor is that a standard practice. Therefore, the overwhelming majority of reasoned decisions addressing Rule 12206 motions are in favor of the Respondent because reasoned awards almost always contain orders granting motions to dismiss. Yet, this is not indicative of anything more than a quirk in the rule.

A. <u>The Appropriate "Event Or Occurrence" Is When The Defrauded Investor Knows Their Investment Is Valueless</u>

One needs to look no further than the guidance provided by FINRA to arbitrators in FINRA's Arbitrator's Guide to understand FINRA's position:

> The arbitrators may find that there is a continuing occurrence or event giving rise to the dispute. For example, although a customer purchased stock 10 years ago, there are allegations of ongoing fraud starting with the purchase, but continuing to a date within six years of the date the claim was filed.

FINRA's Arbitrator's Guide, p. 45 (February 2014 ed.)

In many FINRA customer arbitrations, there are underlying elements of fraud and instances of an ensuing "cover up," or ongoing omissions in supervision and/or disclosure. In these cases, the triggering "event or occurrence" rightfully should be when the victim actually discovered that they had been harmed. Investors are frequently recommended unsuitable investment products, which the respective investor does not appreciate were unsuitable until the previously latent, hidden risks come to bear and manifest themselves to the investor in the form of significant losses or illiquidity.

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To hold that the six year clock does not begin to run until the customer becomes aware that they had been harmed is consistent with previous holdings going back as far as 20 years by the NASD's own Director of Arbitration. The FINRA Director of Arbitration has denied motions to dismiss in cases under the former eligibility rule (Section 15 of the NASD Code of Arbitration) on various occasions, holding that "[I]t has been determined that the purchase date is not the event of occurrence that gave rise to this dispute. Also, Section 15 does not refer specifically to the purchase date as the time that the six year limitation begins to run. Therefore, it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute." Order of Director of Arbitration (July 26, 1991).

The Northern District of Illinois agreed in *Pacific Brokerage Servs. v. National Fin. Servs. Corp.*, 864 F. Supp. 61 (N.D. Ill. 1994) holding:

> Here, [respondent]'s allegedly wrongful acts occurred only after the transaction was settled; absent a crystal ball, [investor] could not have known that [respondent] would subsequently breach its obligations to [investor]. Because no "occurrence or event giving rise to . . . [a] claim" took place at the time of the sale of the PLD stock, we conclude that August 27, 1987 is not the relevant starting date for Section 15's six year time period. *Id.* at 63-64 (emphasis added).

While applicable to more traditional investments such as stocks, as well as non-traditional investments in Real Estate Investment Trusts, Tenants In Common, and the like, investments in loan instruments highlight the flaws in using the date of purchase as the "event or occurrence" for the purposes of triggering the six year clock under Rule 12206. In the case of loan instruments, the appropriate "event or occurrence" should be when the victim knew their investments were valueless, since it is not until the default of a loan instrument that the creditor knows of the harm. When a loan investment purchased is to come due at some time in the

future, and the investor had not yet exercised any available right of repayment prior to maturity, it would not and could not have been known to the investor that the investments were valueless prior to default upon maturity. To hold otherwise would make an arbitration claim on a six year or ten year note virtually impossible, since on the day the note matures (and a claimant finds out that they cannot get their money back), it would already be untimely. This is why such an argument is fatally flawed.

In 2012, the District Court for the Northern District of California agreed with this notion and highlighted the significance of the fact that the investments at issue were loan instruments in upoholding the finding of a FINRA arbitration panel that the "triggering event [that began the running of the six year eligibility rule] was a 2006 board meeting 'in which the claimants were informed that their loans and monetary investments into the company weren't worth anything.'" *Oshidary v. Purpura-Andriola*, 2012 U.S. Dist. LEXIS 81367, 2012 WL 2135375 (N.D. Cal. June 12, 2012). The very fact that the investments were loans "provides support for the Panel's decision to not choose the purchase date as the triggering event." *Id* at 5. The court elaborated on the significance of this stating: "Unlike other types of investments, loans have an agreed-upon return on a date certain. The investor likely will not know whether repayment will occur until that date arrives." *Id.*

B. A Renewal of an Investment May Be the Triggering "Event or Occurrence"

Where an investor has the option to renew an investment or roll it over, whether upon maturity or when the minimum investment commitment period has expired, that rollover or renewal date can be the "event or occurrence" for the purposes of calculating eligibility. When an investment is rolled over, this can be construed as an independent recommendation by the broker. See *Getty v. Harmon*, 53 F. Supp. 2d 1053, 1056 (WD Wa. 1999) ("the class members

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had the option of rejecting the renewals. Therefore, each renewal, whether accompanied by new representations or not, was based upon a new decision, and each constituted a new investment…").

In *Pollack v. Laidlaw Holdings, Inc.*, No. 90-CV-5788, 1995 WL 261518 (S.D.N.Y. May 3,. 1995), the plaintiffs, upon occurrence of rollover of their investments, were judged to have made new investments where they believed they had the choice to extend or renew such investment or not. In *SEC v. SBM Inv. Certificates, Inc.,* Case No. DKC-2006-0866, 2007 U.S. Dist. LEXIS 12685, *29 (D. Md. Feb. 27, 2007), the Court cited *Pollack* affirmatively for this same proposition that a new investment occurs when an investor makes a decision of "whether or not to exercise their right of immediate repayment."

C. The Clock Cannot Start to Run Until Damages Have Been Suffered

It is black letter law that a necessary element for almost any claim is damages, meaning that a claim cannot accrue until damages have been suffered. In the securities arbitration context, damages suffered are overwhelming monetary losses (frequently the result of a default upon a loan or drop in value of an equity investment) and more recently illiquidity. Therefore, it stands to reason that a claim cannot be brought before a potential claimant discovers that the loan is defaulted upon, the equity investment drops, or the market for an asset freezes causing illiquidity.

In *Kidder Peabody & Co., Inc. v. Brandt,* 131 F.3d 1001, 1004 (11th Cir. Fla. 1997), the 11th Circuit Court of Appeals recognized that the clock on the six year eligibility rule cannot start actually ticking until the claimant not only is deceived, but suffers damages:

> We hold that the "occurrence or event" which "gives rise to the . . . claim" is the last occurrence necessary to make the claim viable. A claim is viable when all the elements of that claim can be established such that it could withstand a motion to dismiss for

> failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6). Of course, the last "occurrence or event" necessary to make a claim viable depends on the nature of a particular claim. . . . For example, an action for negligence based on the defective design of a product is not viable until an injury is caused by that product.

The Court astutely noted the similarities between a products liability case and a case of liability in the unlawful sale of a financial product to an unsuspecting, unsophisticated customer and explained the flaws in Kidder Peabody's position.

> Although the duty and breach elements of such a claim are established by the company's act of marketing the product, that act does not establish the causation and injury elements of the claim. The incident in which the product causes injury, not the company's act of marketing a defective product, is the "occurrence or event which gives rise to the . . . claim" within the meaning of § 15 [now FINRA Rule 12206]. Hypothesizing some dates for the occurrences or events in this example reveals the flaw in Kidder's position. Suppose that the company marketed the defectively designed product in year one and that, as a result of that defective design, the product caused injury in year eight. Under Kidder's theory, even if a claimant filed an arbitration complaint the moment after his or her claim arose-the moment after he or she was injured-the claim would be ineligible for arbitration. We decline to adopt an interpretation of [the eligibility rule] that would render some claims ineligible for arbitration before they even come into existence. *Id.*

Like the 11th Circuit did in *Kidder*, the Sixth Circuit Court of Appeals also plainly rejected the same argument as the one advanced by Kidder Peabody for its inequity and illogic:

> Accepting [the Respondent's] proposed approach would create situations in which certain claims would be barred before they even arose. Needless to say, we refuse to interpret the "occurrence or event" language, which does not otherwise suggest that the purchase date always triggers the running of the six-year period, in this manner.

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3. An Arbitration Panel Has Discretion to Apply Tolling Principles to the Eligibility Rule

FINRA Rule 12206 creates a question for the arbitrators more akin to a statute of limitation. Arbitrators are free to interpret the rule as they saw fit, including adding in tolling provisions. Despite not being a statute of limitation, the current caselaw and FINRA guidance have shown that the eligibility rule is still subject to tolling.

Following the decision in *Howsam*, courts have interpreted the holding to allow arbitrators discretion to apply tolls and discovery rules. For instance, a Nevada Federal District Court denied a FINRA member's application to vacate an arbitration award based on the eligibility rule in *Mid-Ohio Sec. Corp. v. Estate of Burns*, holding that:

> [Claimant] first discovered the fraud at Cumberland, and hence the possible failure of *Mid-Ohio* to conduct due diligence, in 2005. If the arbitrators adopted tolling or discovery principles and used the 2005 date as the triggering event, that would be within the six-year period in Rule 12206. The FINRA panel had comparatively more expertise about the meaning of its own rule, and it therefore could weigh the propriety of tolling or the discovery rule in any particular case.

The *Mid-Ohio* Court acknowledged that in resolving the circuit split over the application of the eligibility rule:

> *Howsam* undermined the basic premise which courts relied upon to determine eligibility rules like Rule 12206 were not subject to tolling ... *Howsam* eviscerated that premise, finding that the eligibility time limit was not a question of arbitrability, but a gateway procedural matter for the arbitrator. Thus, the entire line of cases that suggest Rule 12206 is not subject to tolling is undermined.

Id. at 1271.

An arbitration panel that applies equitable tolling principles would be in accord with over a century of United States jurisprudence along with the basic underlying principle that arbitration

is a forum of equity. For more than one hundred years, courts in the United States have recognized the importance of equitable tolling. As stated in successive U.S. Supreme Court decisions, equitable tolling is a long-standing principle that should be applied when equity dictates.[5] "[W]here a plaintiff has been injured by fraud and 'remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered.'" *Holmberg v. Armbrecht*, 327 U.S. 392 (U.S. 1946) (citing *Bailey v. Glover*, 88 U.S. 342 (U.S. 1875). The courts have also recognized that the equitable tolling principle is applicable in securities cases. The United States Court of Appeals has held "[s]ecurities fraud claimants properly avail themselves of the equitable tolling doctrine by alleging the defendant's fraudulent concealment." *Tomera v. Galt*, 511 F.2d 504 (7th Cir. Ill. 1975) (citing *Schaefer v. First Nat'l Bank*, 509 F.2d 1287 (7th Cir. Ill. 1975)). Panels may choose to apply this in a number of situations, including in instances of continued omission(s) despite an affirmative duty on the part of the broker or broker-dealer to inform a client of material information about their investment(s).

C. Pre-*Howsam* Cases from the "Losing" Circuits Can Be a Trap and Should Not Be Relied Upon

In practice, broker-dealers frequently rely upon cases from the "losing" side of the split that *Howsam* resolved, such as *Salomon Smith Barney v. Harvey*, 260 F.3d 1302 (11th Cir. Fla. 2001) for the arguments that the eligibility rule cannot be tolled and the "occurrence or event"

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[5] As stated on page 9 of the 2014 Arbitrator's Manual:

> "Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail."
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triggering the eligibility rule is the date of purchase. However, such arguments should be made with due caution. Though most of the cases in this line have not been directly addressed by the Supreme Court of the United States, *Harvey* was reviewed, vacated and remanded.

Specifically, the Supreme Court vacated the 11th Circuit's decision in *Harvey* and "remanded [it] to the 11th Circuit Court of Appeals for further consideration in light of *Howsam v. Dean Witter Reynolds*." *Harvey v. Salomon Smith Barney*, 537 U.S. 1085 (U.S. 2002). Upon further consideration in light of Howsam, the 11th Circuit "vacate[d] the district court's judgment and remand[ed] this case with directions to the lower court to vacate its injunction and require[d] Salomon Smith Barney to arbitrate." *Salomon Smith Barney v. Harvey*, 331 F.3d 1286, (11th Cir. Fla 2003).

D. New York Courts Have Recognized Tolling In Securities Cases

Even prior to the *Howsam* decision, the New York State courts sagely noted that it would be erroneous to apply the date of purchase for purposes of determining eligibility in a case where the broker was sued for making a series of misrepresentations concerning the suitability of high-risk investments. See *Goldberg v. Parker*, 1995 N.Y. Misc. LEXIS 745, 1995 WL 396568 (NY Sup. Ct. Apr. 12, 1995), aff'd, 221 A.D.2d 267, 634 N.Y.S.2d 81 (1995). The *Goldberg* Court correctly reasoned that "[t]he effect of … [the broker-dealer's] interpretation in fraud cases is to reward the unscrupulous broker-dealer and to penalize the unsophisticated investor who does not discover the fraud for more than six years after the investment was purchased," and that the First Department had never held that the only date for triggering the eligibility rule is the purchase date. Id. at 3 (emphasis added).

3. Conclusion

Arbitrators have been afforded great discretion by both the courts and the drafters of Rule 12206 to apply the principles of discovery and tolling in the pursuit of equity and justice in the arbitral forum. This liberty comes with the responsibility to use it appropriately to ensure that wrongdoers do not evade justice on an exploited technicality.