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PIABA Bar Journal

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The Bar Journal of the Public Investors Arbitration Bar Association

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The PIABA Bar Journal is interested in receiving submissions from PIABA members and non-members, including experts, mediators, arbitrators and securities regulators. Manuscripts are reviewed prior to publication, and are accepted for publication based on, inter alia, quality, timeliness and the subject's importance to PIABA and the arbitration/investor-attorney community. Individuals interested in contributing in the future should contact Andrew Stoltmann, Robin Ringo or any member of the Board of Editors. Your comments and contributions are always welcome.

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President's Message

by J. Pat Sadler

As I sit down to write my final President's Message for the PIABA Bar Journal, feelings of pride, nostalgia and frustration swirl in my head - pride over the quality of this organization, nostalgia recalling the character and dedication of its membership, and frustration about the current political climate and the barriers to change.

No PIABA President can function without the support of the membership, and the support you have given me has been overwhelming. Knowing that it is always dangerous to name names because some will inevitably be left out, there are many who must be thanked. To long time PIABA members such as Bob Rex, Mark Raymond, Mark Tepper, Steven Miller, Jonathan Evans, Ted Eppenstein, David Robbins, Scott Ilgenfritz, Diane Nygaard, Bill Lapp, and Pearl Zuchlewski, your wisdom and support has meant so much to me. The opportunity to work with energetic young leaders like Chris Bebel, Jenice Malecki, and Andrew Stoltmann gives me comfort that the future of this organization is in good hands. Jim Keeney, you are amazing. Joanne Schultz, thanks for being a sounding board, calling it as you saw it.

To the fifteen board members and director emeritus Mark Maddox who continue to give so much, you are the finest group of people I could ever hope to work with. Chuck Austin has been my right hand, and he will be a great leader as the next President of PIABA. To the membership, give Chuck your support and PIABA will thrive.

I hope this year is only the beginning of a new standard in PIABA's commitment to educating its members in the art of securities arbitration. The first California mid-year meeting was of outstanding quality and planning for the second is already underway. The Chicago analyst meeting was well received and the October annual meeting will, as usual, be first rate. The list serve, bulletin board, and research data base and the *PIABA Bar Journal* round out the educational tools which make us better lawyers.

All is not well though. As I write this, arrogant members of Congress are attempting to pass a bill which would strip the states of much of the enforcement authority which they used to expose the analyst scandals and which for years has provided meaningful protection to public investors. Regardless of your politics, understand this fact: the Republican leadership is no friend of the public investor.

The fight must continue to improve the SRO arbitration process. The NASD must find a way to implement the second list for arbitrator selection. Causal challenges must be granted using an appearance of impropriety standard. Arbitrator training must de-bunk the notion that inapplicable defenses apply. Professor Long has spent a career on this issue. Don't give up, Joe.

We have the resources and the resolve. Progress has been made. All we need to do is continue the fight. Fortunately for us, we have the secret weapon in Robin Ringo, our incomparable Executive Director. Advisor, chief critic and friend, her contributions are endless. She has also molded Kerrie and Josh into first rate lieutenants. Together, they assure that PIABA will be a meaningful, well run bar association for years to come.

Finally, permit me a personal note – to Larry, Scot, Allan, Phil, Seth, Brian, Mike, Bill and the Marks, thanks for being my friends. You guys mean the world to me.

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ProfLipner's I Love New York Law Column – Phony As A $3 Bill: Attorney-Issued Discovery Subpoenas In Arbitration

By: Seth E. Lipner

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This article concerns a rarely written about, but important subject in arbitration law - third party discovery.[1] The article principally concerns a misunderstood and often-misused device - the attorney-issued subpoena addressed to a third party seeking documents as part of discovery.

As a general rule, parties seeking third party discovery in arbitration cannot do so by subpoena. Any attorney who believes he has the power to compel third parties to deliver documents to that attorney's office simply by signing a paper titled "Subpoena" is sorely mistaken. Even the arbitrators may not have the power to order third parties to submit to such discovery, although an otherwise proper subpoena to a third party to appear, with documents, before the arbitrators, is authorized by both New York law and the Federal Arbitration Act.

A. Subpoenas Generally

A subpoena is legal process whereby a witness is subjected to the jurisdiction of the court and required to give relevant information "under penalty" (which is what "subpoena" means). The penalty is "contempt" - for disobedience.

There are two types of subpoenas known to the law. The most common is to secure testimony from a witness. Its formal name is "subpoena ad testificandum", although it is sometimes simply called a "subpoena". The second is a "subpoena duces tecum", which seeks a paper or thing rather than testimony.[2] There is no legal impediment to combining the two, and referring to the combination document simply as a "subpoena", and include in it clauses for both testimony and documents.

The remedy for defying either type of subpoena is "contempt of court".[3] If the subpoena

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[1] The only articles which could be found on subpoenas were are Brecher, "The Use of Subpoenas In Arbitration," N.Y.L.J., July 18, 1996, at p.1, and Snider, "The Discovery Powers of Arbitrators and Federal Courts Under the Federal Arbitration Act," 34 Torts & Ins. L.J. 101 (1998). The *Brecher* article considers issues of attorney-issued subpoenas in arbitration, albeit not in the same depth as this article. The *Snider* article does not consider the matter. An earlier, less authoritative version of this article appeared in PLI: Securities Arbitration 2002.

[2] Siegel, **New York Practice**, Third Edition (1999), West Publishing Co., §382 Subpoenas; Issuance, page 619.

[3] *See, e.g.* FRCP 45(f); N.Y. CPLR 2308(a), which in addition to contempt, authorizes the court to issue a warrant directing the sheriff to bring the witness forcibly to court.

was not properly issued or properly served, then it is invalid, because the recipient is not subjected to the "penalty". If the recipient does not comply with an invalid subpoena, there are no legal consequences associated with that default. Conversely, however, the recipient of an invalid subpoena might be liable for a privacy law violation if production of highly personal information is made. One responding to a "valid" subpoena is immunized by law from such suits, but one responding to an invalid subpoena may be doing so at his peril.[4] And one trying to intimidate a third party into sending private documents in response to an improper subpoena may be liable for abuse for process.

Many states, including New York, give attorneys the power to issue subpoenas in litigation, obviating the need to bother the court and obtain a "judicial subpoena".[5] By contrast, the Federal Rules of Civil Procedure authorize only the clerk to issue subpoenas,[6] although the rule provides that the clerk shall issue the subpoena "in blank, to a party requesting it. . . ."[7] The Federal Rules, naturally, authorize both types of subpoenas - for the "attendance of witnesses"[8] and for the "production of documentary evidence."[9]

Subpoenas are used at distinct points in a legal proceeding. The most common use is at trial; the other is as part of the discovery process. This article will first consider (in Part B) the use of subpoenas at trial, or, in our case, at an arbitration hearing. The next part of the article (Part C) concerns subpoenas as part of the discovery process in litigation, followed by a discussion of subpoenas as part of discovery in arbitration (Part D).

B. Subpoenas in Arbitration

Section 7 of the Federal Arbitration Act ("F.A.A.") authorizes arbitrators to issue subpoenas.[10] It provides that:

> [T]he arbitrators selected . . . or a majority of them, may summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document, or paper which may be deemed material as evidence in the case. The fees for such attendance shall be the same as the fees of witnesses before masters of the United

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[4] Compare, e.g. 8 Vt.St.A.Ch. 55 (immunizing a financial institution from privacy violations when responding to a valid subpoena) with 8 Vt.St.Ann. §1021 (requiring that financial information be kept confidential).

[5] *See, e.g.* NY CPLR 2301 and 2302(a); Rules of the Supreme Court of Virginia 4:9(c)(2)

[6] FRCP 45(a).

[7] *Id.*

[8] FRCP 45(a) and (e). The old Latin terms have disappeared from the FRCP.

[9] FRCP 45(b). As will be seen in Part C, infra, there is provision in the FRCP for using subpoenas to compel third-party "discovery", but such subpoenas may only be issued upon proof, furnished to the clerk, of service of a deposition notice under FRCP 30(b) or 31(a). See FRCP 45(d)(1).

[10] 9 U.S.C. § 7.

States courts. Said summons shall issue in the name of the arbitrator or arbitrators, or a majority of them, and shall be signed by the arbitrators, or a majority of them, and shall be directed to the said person and shall be served in the same manner as subpoenas to appear and testify before the court; if any person or persons so summoned to testify shall refuse or neglect to obey said summons, upon petition the United States district court for the district in which such arbitrators, or a majority of them, are sitting may compel the attendance of such person or persons before said arbitrator or arbitrators, or punish said person or persons for contempt in the same manner provided by law for securing the attendance of witnesses or their punishment for neglect or refusal to attend in the courts of the United States.

The clear import of Section 7 of the F.A.A. is to provide, in arbitration, the power to subpoena non-parties, *i.e.* those who are not otherwise subject to the arbitrators' jurisdiction. Parties, of course, are already subject to sanction by the arbitrators by virtue of the agreement to arbitrate.[11] But since non-parties have not, by contract, subjected themselves to the jurisdiction of the arbitrators, they cannot be held in contempt by the arbitrators. Thus, the F.A.A. provides the mechanism for subjecting non-parties to the power of arbitrators by providing the legal basis for compelling attendance - the arbitrator-signed subpoena. The remedy for defying such an arbitrator-issued subpoena is also prescribed in the F.A.A. A contempt application may be made in the U.S. District Court.[12]

The (state) Uniform Arbitration Act ("U.A.A."), like the F.A.A., authorizes only the arbitrators to issue subpoenas.[13] In states which have enacted the U.A.A., attorneys have no statutory power to issue any sort of subpoena in arbitration, whether it be for attendance or documents, whether for hearing or pre-hearing discovery. That is not to say that attorneys don't issue and sign such documents (it happens). And it is not to say that addressees of such "subpoenas" don't comply (they often do). But such an attorney-issued "subpoena" in a U.A.A. state misrepresents itself as placing the addressee "under penalty" for non-compliance.[14]

In 2000, the National Conference of Commissioners on Uniform State Laws revised the Uniform Arbitration Act (hereinafter referred to as the R.U.A.A.). Section 17

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[11] In litigation, they are automatically subjected to "penalty", *i.e.* the power of the court, because they either appeared or were served with a summons (legal process).

[12] And, under state law, in state court as well.

[13] The U.A.A. is the law in 35 states: Alaska, Arizona, Arkansas, Colorado, Delaware, District of Columbia, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, and Wyoming.

[14] An issue is thus raised whether one who is victimized by such subpoenas (e.g. when they are used obtain highly-personal information) has a claim against the lawyer who, without legal authority, issued them. *See also* text accompanying n4, *supra*.

addresses subpoenas. Like its predecessor the U.A.A., the R.U.A.A. authorizes "an arbitrator" to issue subpoenas, but nowhere does it empower attorneys to do so[15]. And Section 17(d) makes clear that that grant of authority to the arbitrators (and not the lawyer) extends to compelling discovery (both testimonial and documentary) from third parties.[16] The R.U.A.A. is clear - only the arbitrators may subpoena. The R.U.A.A. has been adopted in a couple of states.

Neither the Federal Arbitration Act nor the Uniform Arbitration Act (or the R.U.A.A.) thus empower attorneys in an arbitration to issue subpoenas. In *National Broadcasting Co. v. Bear Stearns*, 165 F.3d 184 (2d Cir. 1999), the court explained that section 7 of the F.A.A. "explicitly confers authority only upon the *arbitrators*, by necessary implication, the *parties* to an arbitration may not employ this provision to subpoena documents or witnesses." (Italics in original).

That is not to say that a subpoena, issued and signed by a licensed attorney, has no use anywhere in arbitration. Some states (like New York)[17] permit attorneys to sign arbitration subpoenas, and, in those states, the attorney-issued subpoena can be used to compel attendance at the hearing or to produce documents at the hearing.[18] A non-party who defies this kind of attorney-issued subpoena faces a penalty in the state court - but not, under the F.A.A., in federal court.[19]

The most important difference between an F.A.A. arbitrator-issued subpoena and an attorney-issued state law subpoena is jurisdictional. The F.A.A. imposes a kind of national jurisdiction for arbitrator-issued subpoenas, *i.e.* such a subpoena can be

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[15] *See* R.U.A.A., at §17(a). Interestingly, the statute does authorize arbitrators to issue subpoenas to take the deposition of a third-party witness, a form of discovery not usually seen in arbitration, and one which, arguably, is not permitted.

[16] Indeed, the statute presumes that in arbitration there shall be no discovery whatsoever unless the arbitrator approves it. R.U.A.A. at §17(c), together Official Comment 4, thereto.

[17] California is an example of a non-U.A.A. state which nevertheless requires that the subpoenas be issued (as in federal court, in blank) by the "neutral [*i.e.*] arbitration association". Under the typical arbitration rules (see, e.g. AAA or JAMS), that means the arbitrators..

[18] CPLR 7505 states that "An arbitrator and any attorney of record in the arbitration proceeding has the power to issue subpoenas." The CPLR thus adopts the same rule to arbitration which it applies to a court proceeding, where attorney-issued subpoenas are acceptable because it obviates the need to bother the court for a "judicial subpoena". There are hybrid states, to be sure. Virginia, for example, follows the U.A.A. rule on subpoenas in arbitration (*i.e.* arbitrators only), but permits attorneys to sign subpoenas in court proceedings. Compare Va.Code §8.01-581.06 (the arbitration rule) with Rules of the Supreme Court of Virginia, Rule 4:9(c)(2)(the litigation rule).

[19] It is interesting to compare the verbiage in the various statutes concerning who among the arbitrators may issue subpoenas. Under the F.A.A., "the arbitrators, or a majority of them" may subpoena. Under the U.A.A., "the arbitrators" (plural) may subpoena. Nothing is said about a majority. Under New York law, "an arbitrator" (singular) may sign the subpoena.

issued, and served, across state lines.[20]

By contrast, subpoenas issued under state law cannot be served outside the territory of the state from which they were issued.[21] Put differently, there is no "long-arm" jurisdiction for subpoenas, the way there is for summonses and F.A.A. subpoenas.[22] As a result, the only enforceable attorney-issued subpoena are ones issued from the state where the arbitration will be heard to a non-party who is present in that state as well.[23] Anything other than these "local" subpoenas are unlikely to be enforceable against the subpoenaed party.[24]

The rules of many arbitration organizations do not change this basic lay of the land. For example, the Commercial Arbitration Rules of the American Arbitration Association state that an arbitrator "or other person authorized by law to subpoena witnesses or documents" may do so.[25] Similarly, both the NASD and the New York Stock Exchange provide that "[t]he

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[20] Even with this "national" service rule, venue issues sometimes arise in the context of the enforcement of these subpoenas. Can, for example, a witness be forced by an FAA subpoena to travel across state lines, or outside the judicial district in which he lives? When these situations arise, courts do not question the validity of the subpoenas (the F.A.A. is clear). But these travel and venue problems are just that, they can be dealt with creatively, although sometimes in a strange manner. *See e.g. Security Life Insurance Co. of America v. Duncanson & Holt*, Slip op., No. 99-3523 Oct. 2, 2000 (8th Cir.) and *Amgen Inc. v. Kidney Center of Delaware County, Ltd.*, 879 F.Supp. 878, 881-883 (N.D.Ill. 1995). This topic is beyond the scope of this article.

[21] *See, e.g. Siemens & Halshe, GmbH v. Gres*, 37 A.D.2d 736, 324 N.Y.S.2d 639 (1st Dept. 1971). As Prof. Siegel explains, "a New York subpoena may not be served outside the state regardless of the court involved." *Id*. at p.620. See also Ariz.Rev.Sta.Ann. Rule 45(b)(2)("A subpoena may be served anywhere *within* the state."(underscoring added)). See also R.U.A.A. §17(g), which tries to address this situation as a matter of comity, stating that states which follow the R.U.A.A. will endeavor to recognize and enforce arbitrator subpoenas from other states "upon conditions determined by the court so as to make the arbitration proceeding fair, expeditious and cost effective."

[22] Analytically, this rule is founded in due process. Long-arm jurisdiction (*i.e.* service of process across state lines) is justified constitutionally when (a) the party being served has had meaningful contact with the summoning state and (b) there is a nexus between that conduct, the claim and the forum. *See Washington v. International Shoe Co.*, 326 U.S. 310 (1945). Extra-state service of a subpoena on a non-party is, almost by definition, a violation of due process because the subpoenaed party has not necessarily directed his conduct toward the forum. Even if there is contact, there is no nexus. Thus, when dealing with a state subpoena, as with a summons, state lines must be considered and respected. *Cf. World-Wide Volkswagon v. Woodson*, 444 U.S. 286 (1980) (which emphasized the continuing importance of state lines when jurisdiction is at issue).

[23] Despite cases which speak generally about the preemptive effect of the F.A.A., state subpoena law (*i.e.* the power to compel attendance) is probably not "pre-empted" by the F.A.A. (*Cf.*) *Volt*, 489 U.S. 468 (1989) (holding that California's state arbitration procedures are not pre-empted by the F.A.A.)

[24] As a corollary to the rule described in n. 19, supra, no state will order one of its citizens to attend a proceeding in another state, because foreign process is not valid. Thus, to place a witness "under penalty" with a state (as contrasted with an F.A.A.) subpoena, the subpoena must be validly issued from the state where it is to be served, and it must be made returnable in that state as well.

arbitrators and any counsel of record to the proceeding shall have the power of the subpoena process as provided by law."[26]

The rules thus refer to the law, and they neither expand nor contract the subpoena power which the law provides. The arbitration rules actually state nothing but a truism - arbitration rules cannot *expand* on the subpoena power which the *law* provides. Since the point of the subpoena is to subject a non-party to a legal sanction, and since the third party has agreed to neither the arbitration rules nor the arbitrators' power to sanction, the law, not just the rules, must be complied with to see whether a sanction is appropriate.

Even though *expansion* is not permitted, arbitration rules can and sometimes do *limit* otherwise lawful subpoena powers. For example, the rules of JAMS (The Judicial Arbitration and Mediation Service) provide that only the arbitrator may subpoena.[27] Thus, in a JAMS arbitration, even one conducted under New York law, the parties' attorneys would not have the power to subpoena, despite the provisions of CPLR 7505, because the parties agreed to abide by the JAMS rules.

In summary, arbitrator-signed subpoenas under the F.A.A. are superior to attorney-signed subpoenas, which, in any event, are only available if state law *and* the arbitration rules permit. Validity is important to both enforceability (from the standpoint of the party issuing the subpoena), and to immunity for compliance (from the stand-point of the addressee of the subpoena, if that addressee then "voluntarily" provides private information). And finally, but importantly, attorney-signed subpoenas, when permitted by state law, present real jurisdiction and enforcement problems when served across state lines, problems which are obviated when arbitrator-signed subpoenas are involved.

C. Subpoenas as Part of Discovery - in Litigation

The foregoing discussion concerned just the raw subpoena power, and it envisioned a subpoena to a non-party to either (a) attend and give testimony at the arbitration; or (b) bring with him to the arbitration certain documents necessary to the proceedings (*e.g*. originals, or other documents which are to become proofs in the case). This section considers a different use of subpoenas - as part of the discovery process. Before turning to arbitration, it is necessary to consider the role subpoenas play in discovery in litigation.

While a subpoena duces tecum is used to require a person to bring a document to trial or hearing, the procedure to obtain documents or testimony prior to a trial is "pre-trial discovery". Among the names given to the devices available in pre-trial discovery

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[25] *See* AAA Commercial Arbitration Rules (Sept. 2000), at R-33.

[26] *See* NASD Rule 10322(a); NYSE Rule 619(f).

[27] *See* JAMS Comprehensive Arbitration Rules, at Rule 19 ("The arbitrator may issue subpoenas for the attendance of witnesses or the production of documents.")

are a Notice of Examination[28] (*i.e.* to take a deposition) or a Notice for Production of Documents.[29] Both federal and state procedural rules regulate the issuance of such discovery devices in some way, although the rules differ from court to court.

Subpoenas also play a role in discovery, albeit a role different from that played by these "Notices". As was the case at the trial stage, subpoenas are used in discovery to subject to penalty for non-compliance any third party against whom discovery is properly sought. Thus, for example, it is customary (indeed necessary) to serve a subpoena on a third-party witness being called to a deposition. The subpoena was necessary to subject the addressee to penalty for non-attendance, but the discovery could not be initiated without the Notice of Examination.

Both documents - the discovery device and the subpoena – are thus needed when trying to take the pre-trial deposition of a third party. All applicable rules with respect to both papers should[30] be complied with for the discovery to go forward. Thus, for example, if the time to conduct the type of discovery has passed, or the particular discovery being sought is not available by law (for example, without court pre-approval), an attorney could not use a paper titled "subpoena" as a substitute device with which to conduct the discovery, or as a way around the rules requiring a court order. Under such circumstances, the subpoena would be subject to a motion to quash and a protective order would issue because the discovery sought is outside the scope of what is permitted.[31]

It is thus clear that a subpoena is not a substitute for a properly used discovery notice, and a subpoena, by itself, is not a discovery device. As the New York Court of Appeals wrote in 1993:

> Generally, a *subpoena duces tecum may not be used for the purpose of discovery* or to ascertain the existence of evidence [citation]. "Rather, its purpose is 'to compel the production of specific documents that are relevant and material to facts at issue in a pending judicial proceeding'" [citation]
>
> On this record, the inexorable conclusion is that the purpose of the subpoena duces tecum was to obtain otherwise unavailable discovery. Respondent, however, *cannot use the procedural mechanism of a subpoena duces tecum to expand the discovery available under existing law* [citation]. Yet in view of his motion papers it is evident that this is precisely what respondent sought to do. Thus, *Family Court abused its discretion in denying appellants' motion to quash.*[32]

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[28] FRCP 30(b), or in New York law, a Notice of Taking Oral Questions (CPLR 3107), often called an EBT (Examination Before Trial) Notice. See Siegel, at p.551.

[29] *See* FRCP 34(a); In New York Practice it's statutory title is the same (see CPLR 3120), but it is often referred to as a Notice for Discovery and Inspection. Siegel, at p.565.

[30] The rules, of course, say 'must', not 'should', but voluntary compliance is always possible.

[31] See FRCP 26(c); N.Y. CPLR 3103.

[32] *Matter of Terry D.*, 81 NY2d 1042, 601 NYS2d 452 (1993) (underscoring added).

D. Subpoenas as Part of Discovery - Arbitration

The basic discovery rules are a little different in arbitration. Typically, documentary discovery is permissible in arbitration, but testimonial discovery is not available.[33] Indeed, in *Integrity Insurance Co. v. American Centennial Insurance Co.,*[34] the court ruled that even arbitrators lack the power to subpoena third party witnesses to a deposition, because it unfairly drags the witness into a process in which he has not agreed to take part. The court contrasted arbitrator-issued subpoenas for documents as less invasive. The court also distinguished arbitrator subpoenas to give testimony at a hearing which, of course, are permitted. The court felt that there was more possibility of a witness being subjected to abuse or harassment at a deposition, where the arbitrator was likely not to be present.[35]

In *Comsat v. National Science Foundation,*[36] the 4th Circuit read §7 of the F.A.A. even more narrowly. The court held that the "attend before them" language of the statute made *ultra vires* any pre-hearing arbitration subpoenas to third parties whatsoever. The court wrote that parties to an arbitration necessarily forego certain procedural rights, and such parties cannot "reasonably expect to obtain full-blown discovery from the other or from third parties."[37]

New York law is the same. The New York Court Appeals has said:

> The availability of disclosure devices is a significant differentiating factor between judicial and arbitral proceedings. "It is contemplated that disclosure devices will be sparingly used in arbitration proceedings. If the parties wish the procedures available for their protection in a court of law, they ought not to provide for the arbitration of the dispute." (8 Weinstein-Korn-Miller, N.Y.Civ.Prac., para 7505.06, pp. 75-101). Under the CPLR, arbiters do not have the power to direct the parties to engage in disclosure proceedings.

De Sapio v. Kohlmeyer, 35 N.Y.2d 402, 405, 362 N.Y.S.2d 843, 846 (1974).

The Court of Appeals has also held:

> Generally, a subpoena duces tecum may not be used for the purpose of discovery or to ascertain the existence of evidence. [citation omitted]

Matter of Terry D., 81 N.Y.2d 1042, 601 N.Y.S.2d 452 (1993)

The Appellate Division, First Department, has stated unequivocally, that:

[33] *But see* JAMS Rule 15(c), permitting one (1) "party" deposition per side.

[34] 885 F.Supp. 69 (S.D.N.Y. 1995).

[35] *But see Amgen Inc. v. Kidney Center of Delaware County, Ltd.*, 879 F.Supp. 878 (N.D.Ill. 1995), where a different result was reached, albeit with logistical (form and venue) problems which needed to be solved.

[36] 190 F.3d 269 (4th Cir. 1999).

[37] The court, however, recognized that third party discovery in arbitration might under "unusual circumstances" be sought from (and compelled) by the district court "upon a showing of special need or hardship." Even though the court tries to justify its unique approach as promoting arbitral efficiency, the decision clearly creates the opposite result, and it's approach is unlikely to gain a following. *See, e.g. Security Life, supra.*

> The panel did, however, exceed its authority by directing pre-arbitration disclosure. "Under the CPLR, arbiters do not have the power to direct the parties to engage in disclosure proceedings." *DeSapio v. Kohlmeyer*, 35 N.Y.2d 402, 406, 362 N.Y.S.2d 843, 847, 321 N.E.2d 770, 773.

Matter of North American Foreign Trading Corp. [Rosen], 58 A.D.2d 527, 395 N.Y.S.2d 194 (1st Dept. 1977).

The Appellate Division Second Department has ruled:

> [I]t is firmly established that "under the CPLR, arbiters do not have the power to direct the parties to engage in disclosure proceedings. *De Sapio v. Kohlmeyer*, [citation omitted]; see *Sherrill v. Grayco Builders*, 64 N.Y.2d 261, 273-74, 486 N.Y.S.2d 159, *Matter of North American Foreign Trading Corp. [Rosen]*, 58 A.D.2d 527, 395 N.Y.S.2d 194, ...

Goldsborough v. New York State Dept. of Correctional Services, 217 A.D.2d 546, 628 N.Y.S.2d 813 (2d Dept. 1995).

Most recently, Nassau Supreme Court (Justice De Maro) held:

> Generally, a subpoena duces tecum may not be used for discovery; its purpose is to compel the production of specific documents in a pending judicial proceeding. *Matter of Terry D.*, 81 N.Y.2d 1042, 1044 [other citations omitted]. Furthermore, under the CPLR, arbiters do not have the power to direct discovery. *De Sapio v. Kohlmeyer*. . . . Respondent's reliance upon Rule 619 of the NYSE Constitution and Arbitration Rules is misplaced because that rule grants arbitrators and counsel of record "the power of subpoena as provided by law", and New York law as set forth above, grants neither arbitrators or counsel of record the power to issue a subpoena duces tecum for purposes of discovery in arbitration.

Bach v. Fahnestock, No.13227/02, Nassau County Supreme Court, September 11, 2002.

* * *

These courts are not the only authorities lined up against third-party discovery in arbitration. In addition to Weinstein-Korn-Miller (cited in *De Sapio*, above), Prof. David Siegel, the unquestioned authority on New York procedural law, explains in his Practice Commentary to CPLR 2302 (the statute upon which our adversaries rely):

> The Advisory Committee further notes that this provision is not intended to authorize the use of the disclosure devices (now in Article 31 of the CPLR) by any nonjudicial body; that [this section] confers the subpoena power only for the hearing before such body and not, by implication, for the steps preparatory to the hearing. See 1st Rep Leg. Doc (1957), at p.162

D. Siegel, **Practice Commentaries**, C2302:1, McKinney's, p.248.

Vincent Alexander is in accord in his commentary to CPLR 7505:

> The subpoena power conferred by CPLR 7505 is limited to the procuring of evidence for the hearing or trial of the dispute. Depositions and other forms of pretrial disclosure are ordinarily not contemplated in arbitration proceedings.

V. Alexander, **Practices Commentaries**, CPLR 7505, McKinney's, at p.682.

* * *

The law is thus crystal clear – attorneys do not have the power to issue discovery subpoenas in arbitration. No

other conclusion can possibly be drawn. Even arbitrators may lack that power.

None of this is meant to suggest or assert that attorneys lack the power to issue subpoenas to compel attendance "at a hearing before the arbitrators."[38] But a subpoena returnable in a lawyer's office is certainly invalid, regardless who signed it.

E. Motions to Quash: Where to Bring Them

When a party serves an improper subpoena, what action should the attorney take? Obviously, the first action should be to put the opposing attorney on notice of the impropriety and demand that the subpoena be withdrawn. In addition, the subpoenaed party should be advised that, in the opinion of the victim, the subpoena is not proper and that any disclosure of personal or private information in response to it will not be protected. One must take care not to "instruct" the subpoenaed party to not comply.

The victim should them move to quash. The best place to move to quash is in court, because that is the only place where the victim can obtain preliminary injunctive relief. Even if arbitrators have been appointed, the system is often not sufficiently responsive to put a stop to potential damage. Of course, one must consider the cost of going to court to quash a subpoena, and one would certainly be influenced by the subpoenaed party's response to the letter described in the last paragraph.

Once in court, the issue may arise as to whether the arbitrators have exclusive jurisdiction to quash the subpoenas. That argument, if made by the subpoenaing party, should fail. For example, in New York, CPLR Article 23, which is always cited in support of attorney-issued discovery subpoenas, also contains CPLR 2304 (Motion to Quash, etc.), which addresses both subpoenas returnable in court and those "not returnable in court." The statute states: "If the subpoena is not returnable in a court, . . . a. motion to quash . . . may thereafter be made in the supreme court." Jurisdiction is thus expressly conferred by the CPLR. Additionally, observe that NASD and NYSE rules expressly permit only subpoenas "as provided by law." The use of the terms "as provided" and "law" implies the existence of a judicial remedy (and perhaps served as the basis for the NYSE's long-standing policy, now apparently abrogated, of declining to submit such motions to the panel).

The assertion that the arbitrators have exclusive jurisdiction to rule on a motion to quash cannot be correct, however. Since under New York law (and every other places law), even arbitrators lack the power to compel third-party disclosure by subpoena, how can the arbitrators, then, authorize a party to issue such subpoenas? How can the arbitrators lawfully authorize a party to do that which the law prohibits even the arbitrators from doing?

F. Subpoenas in Aid of Arbitration

New York law provides that third-party discovery in arbitration is limited to that which is judicially approved:

CPLR Sec. 3102 (Method

[38] For examples of cases in which subpoenas were enforced by courts, *see e.g. Henegan Const. Co. Inc. v. Bettinger & Leech, Inc.*, 196 A.D.2d 763, 764 (1st Dept. 1993); *Stanton v. Paine Webber Jackson & Curtis, Inc.*, 685 F.Supp. 1241 (S.D.Fla. 1998) and *Meadows Indemnity Co. Ltd. v. Nutmeg Insurance Co.*, 157 F.R.D. 42 (M.D.Tenn. 1994).

> of Obtaining Disclosure)
> (c) Before Action Commenced; . . . Before an action is commenced, disclosure to aid in bringing an action, t preserve information, or to aid in arbitration, may be obtained, but only court order.

Prof. Siegel explains, and the cases make clear, that such disclosure is not favored by the courts, and a showing of "extraordinary circumstances" must be made.[39] Discretion is lodged in the courts, which don't always require such a strict showing. For example, in *Hendler & Murray, P.C. v. Lambert* 127 A.D.2d 820, 511 N.Y.S.2d 941(2d Dept 1987), the court wrote:

> Generally, courts may not order discovery in aid of arbitration unless the movant has demonstrated "'extraordinary circumstances"' *(De Sapio v. Kohlmeyer*, 35 NY2d 402, 406, quoting from *Matter of Katz [Burkin]*, 3 AD2d 238, 239). It has been stated that "[t]he test is necessity rather than convenience" *(Matter of State Farm Mut. Auto. Ins. Co. v. Wernick*, 90 AD2d 519). At bar, the respondent has requested the production of the petitioners' books and records. Under the circumstances of this case, the court did not abuse its discretion in granting the discovery requested in aid of arbitration, because the respondent has demonstrated that the documents are required "to present a proper case to the arbitrator" *(Matter of Moock v. Emanuel*, 99 AD2d 1003, 1004).

Both *Hendler & Murray and Moock*[40] were partnership dissolution cases seeking partnership records. These cases thus do not seem to present true third-party issues, since the subpoena party is related to the arbitration parties. Thus, the "extraordinary circumstances" language may be applied with greater rigor when the subpoena is directed to an unaffiliated third party; in any event, before approaching a court with an application, one should have a good sense the discovery sought is really needed.

CONCLUSION

Third party discovery in arbitration is, and ought to be, a rarity. Arbitration rules do not provide for it, and neither does the law, except in the most special of circumstances. As the New York Court of Appeals explained in DeSapio, the benefits of arbitration, especially that of efficient and expeditious dispute resolution, is best fulfilled when discovery is narrow.

Lawyers representing clients must know the difference, not only when they are involved in an arbitration proceeding itself, but when they suggest, demand or agree to arbitration in the contracts they draft and negotiate for clients.

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[39] *See* D. Siegel, Practice Commentary C3102:5 (1991). *See also DeSpaio v. Kohlmeyer, supra.*

[40] Notably, while document discovery was permitted in *Moock*, a request for depositions was denied.

The Practitioner's Corner – Unauthorized Trading: How to Prove a Negative

The Practitioner's Corner – Unauthorized Trading: How to Prove a Negative

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Introduction to "How To" Series

With this issue of the *PIABA Bar Quarterly*, The Practitioner's Corner begins a "How To" series on causes of action. Knowing the elements of common securities arbitration causes of action allows practitioners to improve their ability to evaluate the chance of success; draft Statements of Claim; respond to motions to dismiss; know the documents to ask for in discovery; and, be in a stronger position to argue the case in mediation or simplify the issues for arbitrators.

While most securities arbitration cases – like life – are not limited to a single issue, each usually has a predominant allegation of wrongdoing. In the first of this series, the focus is on unauthorized trading. Subsequent articles will examine unsuitability, excessive trading, misrepresentations and omissions, selling away, breach of fiduciary duty and failure to supervise.

The Basics

Unauthorized trading occurred when trades were executed in a customer's account without obtaining approval beforehand, either orally or by written discretionary authority granted to the broker or to a third-party. One of the challenges for customer attorneys in proving that unauthorized trading took place is posed by the customer's receipt of confirmations and monthly account statements. The ratification defense will be raised by defense counsel and the customer's attorney will have to explain why his client did not promptly complain to the broker or firm after receiving those documents. In that instance, the customer's sophistication and his or her reliance on the broker's representations may be determinative of success.[1]

Use of Confirmations to Thwart Unauthorized-Trading Claims

In *Smith Barney, Harris, Upham & Co. v. Amirarjomana,* 201 N.Y.L.J. 55, at 24, col. 2

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[1] This article examines the elements of an unauthorized trading cause of action and does not deal in any detail with the ratification defense. For a discussion of that defense in securities arbitration cases, see §5-12 of *Securities Arbitration Procedure Manual* (Matthew Bender 2002).

(N.Y. Sup. Ct., IA Part 16, J. Fingerhood, March 23, 1989) , the brokerage firm was granted summary judgment by the court against a customer who incurred a debit balance after the October 1987 stock market crash. The customer had alleged that unauthorized trading took place in his account. Based on the receipt of a trade confirmation for the allegedly unauthorized stock purchase – which, in small print on the reverse side, required the customer to object within ten days if he disputed the trade - the court stated:

> A contract for the sale of securities is enforceable if it meets the requirements of UCC 8-319(c), which provides:
>
> (c) within a reasonable time a writing in confirmation of the sale or purchase and sufficient against the sender under paragraph (a) has been received by the party against whom enforcement is sought and he has failed to send written objection to its contents within 10 days after its receipt.

Under New York law, a confirmation of sale which has been sent in the regular course of business is presumed to have been received.

Since ratification, waiver and estoppel are equitable defenses, customer attorneys are quick to remind arbitrators that those who *seek* equity (i.e., the brokerage firm respondent) must *do* equity. That is, the broker or firm which assert the defenses of ratification, estoppel or waiver must *not* have "unclean hands" themselves. Proof of a broker's fraudulent conduct tends to vitiate the ratification defense in arbitration cases, especially if the so-called ratification was not a clear indication that the customer intended to adopt the broker's actions.

Case Law on Unauthorized Trading Cases

Section 10(b) of the Securities Exchange Act prohibits a person, in connection with the purchase or sale of a security, to use or employ any manipulative or deceptive devise in contravention of the rules and regulations of the Securities and Exchange Commission (12 U.S.C. §78j(b)). Rule 10b-5, promulgated as a result of that section, makes it unlawful for any person, in connection with the purchase or sale of any security, to use any means of interstate commerce, the mails or any national securities exchange, to: employ any device, scheme or artifice to defraud; to make any untrue statement of material fact; or, to engage in any act which operates or would operate as a fraud or deceit on any person (17 C.F.R. §240.10b-5).

When does unauthorized trading amount to a violation of Rule 10b-5?

The federal courts have held that unauthorized trading is not actionable without an accompanying misrepresentation or non-disclosure. *Rowe v. Morgan Stanley Dean Witter,* 191 F.R.D. 398 (D.C.N.J. 1999); *Arioli v. Prudential-Bache Sec., Inc.,* 792 F. Supp. 1050, at 1062 (E.D.Mi. 1992), *Pross v. Baird*, *Patrick & Co., Inc.*, 585 F.Supp. 1456 (S.D.N.Y. 1984); *Bischoff v. G.K. Scott & Co., Inc.,* 687 F.Supp. 746 (E.D.N.Y. 1986). How the courts go about finding that accompanying wrongdoing – misrepresentation or

omission – sometimes appears to stretch the law to fit the facts and right a perceived wrong.

In *Cruse v. Equitable Securities of New York, Inc.*, 678 F. Supp. 1023 (S.D.N.Y. 1987), this author represented William T. Cruse in a securities fraud litigation in which we alleged unsuitable, excessive and unauthorized trading. Mr. Cruse sought damages for violations of the federal securities laws, the Racketeer Influenced and Corrupt Organization Act ("RICO"), common law fraud and breach of fiduciary duty. Defendants, a small NASD firm and its 22 year old broker, moved for an Order dismissing the complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure to state a claim upon which relief could be granted. The court ruled that affirmative misrepresentations did not have to be alleged in an unauthorized trading case; it was sufficient that the customer alleged material omissions: that the broker traded in the account without first obtaining the customer's authority, without telling him beforehand – thereby omitting that material fact.

In *Rivera v. Clark Melvin Securities Corp.*, 59 F.Supp.2d 280 (D. Puerto Rico 1999), the court came to the same conclusion: "A broker's failure to inform an investor of transactions made on his or her account is itself a material omission, and, in fact, 'no omission could be more material than that'", citing *Village of Arlington Heights v. Poder*, 712 F.Supp. 680, 683 (N.D. Ill. 1989).

Rule 10b-5 cases also require proof of detrimental reliance by the customer. How is that element met in unauthorized trading cases? In *Cruise,* with respect to the requirement that a plaintiff must have relied on the misrepresentation or omission to his or her detriment, the court quoted *Affiliated UTE Citizens v. United States*, 406 U.S.128, at153-154, 92 S.Ct. 1456, at 1472 (1972), where the U.S. Supreme Court stated that:

> Positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in making the decision... This obligation to disclose and this withholding of material fact establish the requisite element of *causation in fact*.

Mr. Cruse's case proceeded to trial, resulting in a substantial jury verdict on all of his causes of action. For other cases that cite *Cruse*, see *Rowe v. Morgan Stanley Dean Witter*, 191 F.R.D. 398 (D.C.N.J. 1999) and *Caiola v. Citibank, N.A., New York*, 295 F.2d 312 (2d Cir. 2002).

Rule 10b-5 also requires a plaintiff to prove facts showing an intent on the part of the broker to defraud the customer or a willful and reckless disregard of the customer's best interests, otherwise referred to as "scienter." Interestingly enough, even when unauthorized trading took place, such misconduct may not rise to a 10b-5 violation when a broker can prove that he made the trades "in order to protect an account from extreme losses." *Rivera v. Clark Melvin Securities Corp.,* 59 F. Supp.2d 280 (1999).

In *Messer v. E.F. Hutton & Co.,* 847 F.2d 673, at 679 (11th Cir. 1998), the court ruled that the broker's acts

involved a "reasonable decision well within the bounds of accepted industry practice." The *Rivera* court, citing *Brophy v. Redivo*, 725 F.2d 1218, at 1221, also noted that all of the elements of 10b-5 have not been met "when the investor did not specifically prohibit a trade, there were no misrepresentations by the broker, and the trades resulted in a profit to the investor."

Broker's Obligation to Advise Customer of Trade

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng,* 901 F.2d 1124 (Ct. App. D.C. 1990), the Court of Appeals for the District of Columbia Circuit concluded that a broker's duty to a customer - under the basic principles of agency law, as recognized by the District of Columbia - encompasses the duty to inform the customer of the right to *reject* unauthorized trades, and that the failure to do so, as a matter of law, constitutes a breach of that duty. Since the customers in this case were not informed of their right to disavow the unauthorized trades, said the Court of Appeals, "there could not have been ratification" of such trades. "Ratification occurs only," said the court, "when the customer, with full knowledge of the facts, manifests his intention to adopt the unauthorized transaction."

A Guideline

In *Patterns of Supervision,* published by the New York Stock Exchange, Inc., there is proposed "an effective system for receiving and recording orders." It is a five-step procedure that the NYSE recommends a broker should follow when taking an order. Counsel would be well-advised to use this "effective system" as a guide in the questioning of a broker at a hearing - to either support the broker's actions or to challenge them.

1. The broker should record the order on an order pad or order ticket while taking the order from the client, retaining a duplicate copy.

2. The broker should read the written ticket back to the client before entering the ticket, making sure all the information is correct and understood. "Repeat to the client whether the order is 'buy' or `sell,' the quantity, name of the security, price and any limitation such as an 'open order' or 'good thru week' order." [2]

3. Upon the broker's receipt of an execution report, he or she is to match that report with the duplicate copy of the order ticket to be certain that the essentials of the executed order are the same as those of the entered order.

4. The broker is then to

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[2] In "When is an Order an Order? Unauthorized Trading by Securities Brokers" (PLI's *Securities Arbitration 1994*), Douglas J. Schulz noted that the order ticket itself provides a guideline for a valid order: (1) the type of trade, such as a buy, sell, short sell; (2) the specific security to be purchased; (3) exactly how many shares/units are to be purchased; (4) the exact price at which the order is to be entered (unless it is a market order); (5) the current price at which the security is trading; and, (6) any special instructions (e.g., limit orders, stop loss, fill or kill, all or nothing, all or none, immediate or cancel).

contact the client to report the executed order, making sure to relate the quantity, the name of the security and the price of the security. "If there is any misunderstanding or mistake, it should come to light at this stage and may be resolved quickly."

5. On the day following the trade, the broker is to match-up the order report with the confirmation to make sure that the information contained is correct and that it contains the same information as was reported to the client.

The NYSE further recommends, in its *Patterns of Supervision*, "Even with thorough training and effective procedures, order errors can occur. Good practice suggests that all order errors promptly be reported to the manager for handling in accordance with the organization's procedures. As an aid to managers, some organizations employ at least one qualified individual in the main office order room whose major responsibility is to correct order errors."

The Prohibition and the Exception to the Rule

New York Stock Exchange Rule 408(a) – (c) provide that:

> (a) No member, allied member or employee of a member organization shall exercise any discretionary power in any customer's account or accept orders for an account from a person other than the customer without first obtaining written authorization of the customer.
>
> (b) No member, allied member or employee of a member organization shall exercise any discretionary power in a customer's account, without first notifying and obtaining the approval of another person delegated under Rule 342(b)(1)[related to supervision] without authority to approve the handling of such accounts. Every order entered on a discretionary basis by a member, allied member or employee of a member organization must be identified as discretionary on the order at the time of entry. Such discretionary account shall receive frequent appropriate supervisory review by a person delegated such responsibility under Rule 342(b)(1), who is not exercising discretionary authority. A written statement of the supervisory procedures governing such accounts must be maintained.
>
> (c) No member, allied member or employee of a member organization exercising discretionary power in any customer's account shall (and no member organization shall permit any member, allied member, or employee thereof exercising discretionary power in any customer's account to) effect purchases or sales of securities which are excessive in size or frequency in view of the financial resources of such customer.

Rule 408(d) sets forth an important exception to the rule requiring written trading authorization for discretionary trading. It states that:

> The provisions of this rule shall not apply to

discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed.

Many brokers extend unreasonably the exception to the discretionary trading rule, asserting that they were given "time and price discretion" when, in actuality, they engaged in unauthorized trading or discretionary trading without written authorization. "The time and price exception is often misused," said Mr. Schulz in PLI's *Securities Arbitration 1994,* "not only in the practical world of brokerage transactions, but in arbitration where it has become a favorite defense to unauthorized trading claims. ... The NYSE measures time and price discretion in hours or days, not in weeks. Therefore, a[n alleged] time and price discretion that lasts more than a day or two is questionable and most likely [is] a violation. If a broker wishes to take longer to enter a trade for his client, he has two other options - call the client back or use a Good Till Cancelled (GTC) order ticket."

How to Prove an Unauthorized Trading Case

The primary difficulty in these cases is being able to prove a negative - that a conversation did not take place in which the particular trade was authorized. Proving an unauthorized trading case requires counsel to carefully recreate events through the testimony of the customer and the presentation of the following documents:

(1) **Account Documents** – Trade confirmations and monthly account statements. Why? They could show how quickly the customer sold any alleged unauthorized purchases or repurchased any unauthorized sales.

(2) **Telephone records** of conversations between the broker and the customer. Why? They could show that there was no contact between the customer and the broker at the time of the trades. Cell phones billing statements provide excellent records in these cases since they track local as well as long distance calls.

(3) **Broker Records** - The broker's diary, calendar or other logs. Why?

Like phone records, these documents will show that there was no contact at the time of the trades.

(4) **Travel** - Airline tickets, hotel accommodations, restaurant receipts, passports. Why? They could show that the customer was traveling and, therefore, was physically unable – because of inaccessibility - to authorize the alleged unauthorized trades on particular days.

(5) **Other Firms** - The customer's monthly account statements from other brokerage firms. Why? To show that, for example, a particular stock or bond had never been purchased before in any other account.

(6) **Correspondence** between the customer and the broker, including e-mails. Why? They might reference the broker's use of "time and price discretion."

(7) **Polygraph examination** of the customer. Why? Arbitrators may allow it into evidence and, even if they sustain an objection to its admission, they will probably infer (being human) that the side which sought to introduce it passed the examination (otherwise that party would not have tried to offer it into evidence).

The NASD's Discovery Guide and Unauthorized Trading

NASD Notice to Members 99-90 states that arbitrators and parties should consider the documents described in Document Production Lists 1 and 2 as presumptively discoverable in *all* cases and should also consider discoverable the additional documents described in Lists 3 through 14 for cases alleging specific causes of action. Lists 11 and 12 are for cases in which unauthorized trading is alleged by the customer.

Arbitrators are advised, in the Guide, that the following documents are presumptively discoverable from brokerage firms and associated persons (brokers) in cases involving allegations of unauthorized trading:

1. Order tickets for the customer's transactions at issue.

2. Copies of all telephone records, including telephone logs, evidencing telephone contact between the customer and the firm/Associated Person(s).

3. All documents relied upon by the firm/Associated Person(s) to establish that the customer authorized the transactions at issue.

Likewise, the Guide provides that customers who allege that unauthorized trading took place in their account should expect to have to produce to the brokerage firm respondent:

1. Copies of all telephone records, including telephone logs, evidencing telephone contact between the customer and the firm/Associated Person(s).

2. All documents relied upon by the customer to show that the transactions at issue were made without his/her knowledge or consent.

Simplifying Unauthorized Trading Cases

Arbitrators consider the following factors more than any other in their deliberations on unauthorized trading cases. As such, to simplify your presentation – be it on behalf of customers or brokers – focus on these questions:

1. **Precedent** - Did the customer ever purchase that stock before? If not, the customer is more likely to be believed when he/she alleges that unauthorized trading took place in this "new" security.

2. **Complain** - How soon after the customer learned of the alleged unauthorized trade did he/she complain? The sooner the better for the customer's chance of prevailing.

3. **Mitigate** - How soon after the customer complained did he/she sell the unauthorized purchase or repurchase the unauthorized sale? The sooner the customer mitigated

damages, the more likely the arbitrators will conclude that the trade was unauthorized.

4. **Pattern** - Have other customers made similar allegations against the broker involving the same stock(s)? Since brokers who engage in such conduct are often recidivists, if this is the only complaint of this nature, the broker is more likely to be believed.

5. **Accessibility** - Where was the customer at the time of the transactions? The more inaccessible the customer, the more likely arbitrators will conclude that the trade was unauthorized. However, in this time of instant accessibility, it is more difficult for customers to prove that they could not have been reached.

And Now, The Other Side of the Story

When a customer alleges that a broker engaged in unauthorized trading, that customer has raised the bar of proof in the minds of the arbitrators, for he or she is not asserting that the broker engaged in negligent or even reckless misconduct. The customer is alleging that the broker deliberately, and without permission, took the customer's funds, made a purchase and received a commission. The customer is alleging fraud.

Even if it is clear that unauthorized trading took place, the broker still has an opportunity to testify in his/her defense. And that is when "the other side of the story" could torpedo the customer's case. The broker may explain that he knew the trade (a purchase or a sale) was just what his client *would have wanted* but that the client was inaccessible, and told the broker (beforehand) that he would be inaccessible. The broker may very well testify that there was a prior conversation in which the customer gave the broker permission to make the purchase or sale if the broker could not reach the customer, as long as the broker believed it to be in the customer's best interests.

Therefore, even if telephone records and prior trading history support a claim of unauthorized trading, the customer is not home free. There may be another aspect to the trade that the customer did not share with his attorney. That is the job of defense counsel to bring out, in which case a claim of unauthorized trading may suddenly become one of discretionary trading without receiving written trading authorization. Such misconduct is only a violation of self-regulatory rules and is of greater significance to NASD or NYSE disciplinary hearing officers than to arbitration panels.

Conclusion

The goal of a customer's attorney in unauthorized trading cases is to prove a negative, while the broker's goal is to prove a positive. The customer must prove that he did not know or should not have known of the trade. The broker must prove – yes, in the real world of securities arbitration, the respondent usually is expected to meet a burden of proof – that either the trading was specifically approved beforehand or that he was given time and price discretion by the customer to enter that order. In either instance, proving or defending an unauthorized trading case is a test of logic and a great deal of preparation.

View from The West - Things Every Arbitrator Should Know

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
Mark Twain

By Scot Bernstein

We hear too often about an arbitration award that seems to depart dramatically from the correct outcome of a case. You could call it an "anomalous" award, but these things happen too frequently to be considered anomalies. [1]

Notwithstanding our ability to model arbitration outcomes statistically – to say, for example, that customers win 57% of the time -- arbitration awards are not random events. Arbitrators make their decisions deliberately. Some wrong outcomes are inevitable, bred of bias or the hard reality that the wrong witness sometimes will be believed.

But some wrong awards are avoidable. Some wrong awards are the result of an arbitrator's misunderstanding of fundamental legal concepts. Appropriate education has a chance of preventing those incorrect outcomes.

But exactly what education is needed? What don't the arbitrators know?

Maybe arbitrators know that securities markets are not ruled by *caveat emptor* or "let the buyer beware." Certainly most know that. But some undoubtedly do not. Out of thousands of arbitrators, there inevitably will be some who are under the misimpression that the investor bears all risk of loss in an account. That is disturbing because it raises the very real possibility that an investor with a valid claim will be denied recovery unfairly.

Sometimes the gaps or errors in an arbitrator's knowledge will result from simple mistakes about the law – mistakes about matters so fundamental that we as lawyers cannot imagine anyone making them. Other times, the arbitrator's misunderstanding may be more subtle or sophisticated. Either way, if we do not correct the error, we run the risk that an investor who should recover will be sent away empty-handed while a broker-dealer or associated person is left to profit from illegal acts.

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[1] My thanks to Tom Mason for his invaluable thoughts and insights regarding the issues addressed by this article. Thanks as well to Andrew Stoltmann for his excellent ideas regarding areas of arbitrator misunderstanding of the law. And many thanks to aeronautical engineer Charles A. Lindley, Ph.D., for confirming that my quarter-century-old memories from my aerodynamics class would not make a Machery of the article.

Worse still, incorrect outcomes are a societal problem. A free, self-governing people have a right to see their laws carried out. If any dispute resolution forum routinely ignores those laws -- including laws meant to protect people from predation -- the result is an erosion of democracy and self-governance and is cause for serious concern.

All of this is a greater problem in an arbitral forum than in a judicial one. Arbitrators are far more likely than judges to harbor misconceptions about fundamental legal principles. More importantly, arbitrators' decisions almost always are final and nonreviewable.

Whatever their source, incorrect preconceived notions that may lead to incorrect outcomes need to be rooted out and eliminated through education. The first step in that process is to identify them. In this article, I will attempt to spotlight a few of the more obvious misconceptions.

Before I begin, however, let me note that this article is not intended as a formal legal treatment of the issues that follow. That would detract from the intended brevity of each point. Moreover, a formal treatment would be impractical for at least some of those issues because of variations in state laws.

Rather, the thrust of this article will be to spotlight the problem areas briefly, to give a sense of the general direction of the law, and to address the underlying logic of the law's position on an issue. In other words, the discussion will focus more on the ***why*** of the law than the ***what.*** My hope is that this article will be approachable for lawyers and nonlawyers alike.

One more thing: this article is not complete. Readers undoubtedly will think of arbitrator misconceptions that I have not addressed here. I encourage those who do to let me know about them. This article is intended as a work in progress.

1. Investments are not *caveat emptor*. "Buyer beware" is not the law.

Brokers have duties to their clients. It is true that nearly any investment can result in a loss. But that fact, taken alone and emphasized beyond its significance, can lead to wrong results. The reality is that there is some predictability to the different risks of different investments. Brokers, who hold themselves out as having expertise in the area, are required to make their recommendations with those risks solidly in mind.

Thus, an investor who needs safety can be given safety – or not. When a broker who knows or should be presumed to know about the relative risks of various investments sells a risky investment to a person who knows less than the broker and is looking to the broker for advice, and/or cannot afford to lose money, the broker should be required to make good the loss. Any other rule takes away the broker's incentive to do his or her job correctly. Any other rule teaches the public that fiduciaries cannot be trusted and that financial services are one area where the nation's economy will not be permitted to enjoy the benefits of specialization.

Occasionally you will hear someone – generally someone not educated in these matters or someone who has a romantic longing for the simple *laissez faire* of the 1800s – suggest that

people know investments go up and down and therefore cannot complain when that happens.

It is a position that is patently ridiculous. One may as well suggest that people know driving is dangerous and therefore cannot complain when a drunk driver causes them harm. Our society has been intelligent enough to impose on the parties in the best position to avoid wrongdoing or prevent harm the cost of any harm that their conduct or neglect inflicts on others. That principle is not limited to motorists. It applies to everyone, including stockbrokers.

The only difference between stockbrokers and the others is that fewer people are aware of stockbrokers' liability for their wrongdoing. Perhaps that is because investments generally and the rules surrounding them are less familiar than automobiles and the rules of the road.

Capital markets are the life-blood of the economy. Horrible dislocations and economic harm have been visited on the nation and its people when those markets have failed. The Great Depression is a prominent example.

Thus, the laws governing securities issuers and broker-dealers and their associated persons are particularly stringent. Part of that body of regulation is the right of investors to recover their losses when those laws have been violated. Without that essential component of the enforcement mechanism, the laws are toothless.

The United States Supreme Court explained the importance of this body of law – the importance of ***not*** allowing *laissez faire* or *caveat emptor* to govern capital markets – in *Silver v. New York Stock Exchange*, 373 U.S. 341, 83 S.Ct. 1246, 10 L.Ed.2d 389:

> **"The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's.** It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1940. **A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry. As we recently said in a related context, 'It requires but little appreciation ... of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry."**

373 U.S. at 366, 83 S.Ct. at 1262 [footnotes omitted, emphasis added.]

2. There is no "comparative fault" or "percentage fault" in a breach of fiduciary duty case or a fraud case or a breach of contract case or a claim for violating securities statutes or regulations.

Arbitration awards sometimes have the appearance of "splitting the baby."

In a pure negligence case, percentage apportionment of fault might be appropriate. In an automobile accident in which a party is thirty percent at fault, for example, that party will receive only the remaining seventy percent of his or her damages. The name of the legal doctrine under which that percentage reduction of damages occurs is "comparative negligence." The doctrine of comparative negligence replaced the older and less sensible doctrine of contributory negligence, under which a person who had the slightest fault, even if it was less than one percent of the total, would recover nothing by way of damages.

But apportionment of fault and the resulting reduction in the investor's recovery are not appropriate with many kinds of claims. Examples include breach of fiduciary duty, fraud, breach of contract, and violations of securities or "blue sky" laws.

Claims involving breach of fiduciary duty are an ideal illustration. In a breach of fiduciary duty claim, a brokerage firm may be held liable because it held the client's trust and did not act in manner worthy of that trust. The client's claim is not supposed to be reduced in proportion to the client's fault because the client has no fault. ***Rather, the client is allowed to trust the broker***. The client under those circumstances is not the one with the obligation to prevent losses. Instead, it is incumbent upon the broker to shoulder the entire task of handling the account appropriately. The broker who fails to do that should pay in full for the harm it has done.

One way of looking at this is to focus on the parties' degrees of culpability. Negligence is a relatively innocent level of error. It is a mistake. One is liable for the results of one's own negligence – making a mistake and causing an accident while changing lanes in traffic, for example – and comparable fault by the injured party can be offset against the defendant's fault in determining the plaintiff's recovery.

But breach of fiduciary duty and fraud are much more serious forms of wrongdoing. Our society decided long ago to require those who invite trust to behave in a manner worthy of that trust and to protect those who trust. People who defraud others or who breach others' trust do not deserve the subsidy of comparative fault. They are not allowed to profit by blaming their victims. Society does not offset the faithless fiduciary's greater transgressions with the victim's relatively innocent mistakes. Imposing a duty of care on the fiduciary's client would defeat the law's purpose of permitting clients to trust fiduciaries and to concentrate their efforts on other things.

The analysis of liability under state securities law or "blue sky law" claims is even simpler. With blue sky law claims, there is no apportionment for the investor's contributing fault for a very simple reason: the statute does not provide for it. That is part of the stringent regulation discussed in item 1 above. It reflects a self-governing people's collective wisdom about the importance of having laws that promote and protect trust, particularly where investments and the nation's capital markets are concerned.

Similarly, claims for breach of contract have no comparative fault provision because fault is not even an issue. Breach is the issue. If a contract has been breached, the non-breaching party is entitled to the benefit of its bargain. If a brokerage firm has a contractual obligation to follow securities industry rules and it fails to do so, its client is entitled to be put into the position that the client would be in if the firm had lived up to its contractual obligations.

The bottom line in all of these cases is the same: if there has been wrongdoing more serious than mere negligence, the customer must be compensated in full for the harm the wr ongdoing has brought about. Arbitrators must steel themselves to bringing about that result, even if the numbers are large enough to appear intimidating and even if the broker seems cordial and nice in the hearing room. Anything less is dereliction of the arbitrators' responsibility.

3. Brokers often have fiduciary duties to their clients. In some states, including California [2], a fiduciary relationship is presumed. In others it must be proven, and what must be shown to establish a fiduciary relationship will be a matter of state law. In general, however, proof that a client or customer reposed trust and confidence in a broker may be all that is needed establish the existence of a fiduciary relationship.

This is as it should be. An economy based on specialization will work only if people are free to trust the honesty and competence of those who specialize. Any other rule, taken to its extreme, drags us all the way back to subsistence.

A fiduciary relationship is significant because it imposes on the fiduciary the highest duty known to the law. ***A fiduciary has the duties of a trustee***:

> "An agent is a fiduciary. His obligation of diligent and faithful service is the same as that imposed upon a trustee." "The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal."

Twomey v. Mitchum, Jones & Templeton Inc. (1968) 262 C.A. 2d 690, 708

Once a fiduciary relationship is established, the relationship no longer is a business relationship at arm's length. This is so despite brokerage firms' and other fiduciaries' attempts to pretend otherwise. The fiduciary must put the client's interest first and foremost – ahead of the fiduciary's own interests. Fiduciaries have a duty of absolute honesty and fidelity to their clients. If they breach that duty, they must pay for the damages caused by their breach.

The law imposes that higher duty on fiduciaries for the same reason it imposes a higher duty on common carriers. There are some people and entities whose activities are so important and whose

[2] *Twomey v. Mitchum, Jones & Templeton Inc.* (1968) 262 C.A. 2d 690; *Duffy v. Cavalier* (1989) 215 Cal.App. 3d 1517; *Hobbs v. Bateman Eichler, Hill Richards, Inc.* (1985) 164 Cal.App.3d 174, 210 Cal.Rptr. 387.

errors are so potentially harmful that the law imposes a heightened duty of utmost care and diligence upon them. Society and the economy suffer if consumers cannot trust those people and entities implicitly and go about their affairs free of the weight of the corresponding worries.

That applies to those who transport our things and our selves. And it applies as well to those whom we agree to trust with our money. Widespread fear of self-dealing and incompetence on the part of common carriers could immobilize people and property and grind the economy to a halt. Widespread fear of fiduciary defalcation could have the same effect on the flow of capital, the economy's life-blood.

Breach of fiduciary duty entitles the person to whom the duty is owed to receive ***all*** damages caused by the breach. If that result seems harsh, it is because the law has little tolerance for those who invite trust and then abuse it. A modern economy depends upon trust in more ways than any of us can name. Abusing that trust victimizes the economy as a whole.

Thus, treating a breach of fiduciary duty claim like an ordinary arm's-length business squabble is a misapplication of the law. Doing so is a disservice both to the aggrieved party and to the society whose laws are being ignored. It harms us all.

4. Mere negligence is enough. Brokers are obligated to be competent.

Broker-dealers often attempt to create in the hearing room an atmosphere that suggests that a customer who doesn't show actual, deliberate fraud doesn't have a case. Often, their approach is to show that the broker purchased the disputed investment for his or her own account or for the account of a close relative. But that whole approach often is a defense against a claim that was not even asserted, a verbal sleight of hand.

If the arbitrators are not paying attention, the brokerage firm's ploy might work. But if they are alert, they will realize the obvious: that the customer need not prove an un-made and unnecessary claim in order to be entitled to recover.

If a taxicab crashes into the rear end of an automobile stopped at a red light, the motorist whose car was struck will be entitled to recover for any resulting personal injury or property damage. The injured motorist is not required to prove that the accident was a deliberate ramming. Indeed, counsel defending a negligence case in court would be unlikely to insult a judge's or jury's intelligence by asserting that the defendant did not collide with the other vehicle deliberately and therefore should not pay for the harm caused. That lack of intent is presumed and is not a defense to a negligence claim.

People understand that collisions happen and that deliberate rammings generally are not the cause. Negligence or carelessness – the failure to act as a reasonably prudent person would act under the circumstances – is the basis of a negligence claim. Attempts to defend by pretending that the plaintiff must prove more than that will not be well-received.

Similarly, it is no defense for the broker to show that he was duped. The broker is one with the purported

expertise. A customer who paid for that expertise – especially from a full-service broker – is entitled to recover if the broker, even with good intentions, made a mistake and fell below the standard of care. The broker is the one who is being hired to handle money competently. The broker has a duty of reasonable care and, failing that, must pay the damages caused by the failure.

5. The broker-dealer is liable for the stockbroker's wrongdoing. The law makes employers liable for the harm caused by their employees acting in the course and scope of their employment. Thus, if a stockbroker's misconduct causes harm in an account, the employing brokerage firm is liable side-by-side with the stockbroker.

The legal principle that imposes liability on employers for losses caused by their employees is ancient enough to be known primarily by a Latin name: "*respondeat superior."* The principle makes sense for two reasons. First, it recognizes the reality that the employer, who controls the purse strings and otherwise has the ability to exercise control over the employee's conduct, is in the best position to prevent the employee from causing harm. The employer clearly is in a better position to prevent harm than is the customer or an uninvolved third party, for example.

Second, *respondeat superior* is consistent with the ancient and widespread legal principle that, as section 3521 of the California Civil Code puts it, "he who takes the benefit must bear the burden." Employers benefit a great deal by being able to hire employees. By accepting that benefit, they take on the obligation to pay for the harm their employees cause in the course and scope of employment.

Respondeat superior liability is important because the employee who harms a customer or third party seldom has sufficient assets to compensate the victim for the loss. Without an employer (or an employer's insurance policy) to pay for the loss, the loss goes uncompensated and the misconduct that caused it goes undeterred. Neither result is desirable in a civilized society.

Classic defenses to *respondeat superior* liability include attempts to define everything the employee did to cause the loss as being "outside the scope of employment." But attempts to define "getting into an accident" as being outside the scope of a truck driver's employment seldom fool the courts, and analogous arguments about stockbrokers should not fool arbitrators. Allowing arguments like that to prevail would write *respondeat superior* out of the law and would disable the law as an effective tool for deterring socially undesirable conduct.

Brokerage firms attempting to avoid their responsibility for a stockbroker's misconduct often will attempt to sidetrack the arbitrators with arguments about "controlling person" liability. Under state and federal securities laws,

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[3] See, for example, section 15 of the Securities Act of 1933, 15 U.S.C. section 77o; section 20 of the Securities Exchange Act of 1934, 15 U.S.C. section 78t. And compare the broader vicarious liability provision of section 25504 of the California Corporations Code.

persons who control an entity that is liable for violating those laws can be liable themselves to the same extent as the offending entity. But the standards for imposing controlling person liability are different from and in some respects more stringent than the very broad standards applicable to common law *respondeat superior*. It follows that a defense to controlling person liability is not a defense to *respondeat superior* liability, and arbitrators should not be fooled by a firm's attempt to equate or confuse the two.

In securities arbitration, we occasionally read awards that are not "joint and several" -- *i.e.*, awards that hold the stockbroker and the brokerage firm liable for different sums, indicating that the arbitrators ignored the age-old principle of "*respondeat superior*." That is something that never should happen. When it does, a brokerage firm that is liable is a matter of law is permitted to retain money belonging to a customer who has been harmed by the firm's business operations. No arbitrator with a conscience and a sense of duty should be willing to countenance that miscarriage of justice. If a stockbroker did something that results in liability, the employing firm is liable with the stockbroker and in the same amount.

6. An investor who wants a hearing is entitled to a hearing. No "motion to dismiss" or "motion for summary judgment" is possible without the investor's consent.

Ten years ago, pre-hearing "dismissal motions" were seldom if ever seen in securities arbitration proceedings. That has changed. In the mid-1990s, securities industry respondents began filing "motions to dismiss" under section 15 (now known as Rule 10304) with increasing frequency. Next came motions asserting that statutes of limitation barred recovery. Now we are seeing motions to dismiss asserting every imaginable theory. While arbitrators almost never grant one of these "motions," they frequently waste the parties' time and their own by entertaining them. That should not happen.

The absurdity of all of this is that there is no such thing as a "motion to dismiss" under the Code of Arbitration Procedure. The Code contains no procedure for pre-hearing dispositive motion practice. Indeed, granting a pre-hearing "motion to dismiss" would violate the public customer's right to a hearing. That right is contained in NASD Rule 10303(a), which provides as follows:

> **Any dispute, claim or controversy** except as provided in Rule 10203 (Simplified Industry Arbitration) or Rule 10302 (Simplified Arbitration), **shall require a hearing** unless all parties waive such hearing in writing and request that the matter be resolved solely upon the pleadings and documentary evidence. [Emphasis added.]

The New York Stock Exchange and the Pacific Exchange have identical rules. See NYSE Rule 602 and Pacific Exchange Rule 12.3.

The rules establishing the right to a hearing set forth the lone exception to that right: a situation in which ***all parties*** have waived the hearing in writing and requested that the matter be resolved upon the pleadings and documents. Without that consent, there

can be no "motion to dismiss." An investor who wants a hearing gets a hearing.

The rules providing for a hearing in each case where an investor wants one make sense. In arbitration, unlike court, pre-hearing discovery is limited in several ways. First and most importantly, there are no depositions or interrogatories. Second, document discovery proceeds without the enforcement powers of the court and, as a result, the process frequently is flouted by securities industry respondents. As a result, the evidentiary record that could form the basis for summary judgment motion practice in court is wholly lacking in arbitration. Deciding a case in an evidentiary vacuum -- throwing a case out before the investor has had an opportunity to put on any evidence -- may be the kind of “justice” that would pass muster in a third-world dictatorship, but it should not be accepted here.

Parties making "motions to dismiss" and other dispositive motions, when confronted with the illegitimacy of those motions, invariably make a variety of facially invalid arguments to try to legitimize them. Usually, when the arguments are not just plain arm-waving, they center on case law that allows dispositive motions in court. Those arguments are invalid for a variety of reasons including the most obvious: arbitration is not court. The codes of civil procedure that apply in court do not apply in arbitration. The codes of arbitration procedure that apply in NASD, NYSE and Pacific Exchange arbitration, in turn, do not apply in court. The Code of Arbitration Procedure provides a hearing for any investor who wants one. That is the beginning and end of the matter.

7. Statutes of limitation are not always simple calculations beginning on the transaction date. Time limitations often do not start running until the claimant discovers the wrongdoing. Securities industry respondents are fond of arguing that cases must be dismissed on statute of limitations grounds because they were filed more than the specified number of years – the length of the statute of limitations -- after the purchase of the disputed securities. But that does not follow.

For many kinds of claims, the statute of limitations, by its own terms, does not even ***start*** running until the aggrieved party learns of the wrongdoing or should have known about it with the exercise of reasonable diligence. Statutes of limitation for fraud uniformly work that way. In California, for example, the statute of limitations for fraud is three years from the discovery of the wrongdoing. See California Code of Civil Procedure section 338. A date three years after the transaction itself is a meaningless point in time.

There is an excellent reason for this rule: any other rule would reward wrongdoers for "lulling" their victims and keeping them in the dark. The law avoids setting up incentives to engage in continuing fraud.

The rule is a bit more complex in breach of fiduciary duty cases. Where a fiduciary relationship exists, the investor's duty of inquiry is relaxed. Thus, the things that would be expected to put an investor on notice of misconduct in an arm's-length relationship do not put an investor on notice if the broker is a fiduciary. This rule is consistent with

other rules described above. Like those rules, this one allows people to place their faith in fiduciaries; it does not permit itself to be twisted into a tool for faithless fiduciaries to get away with the fruits of their wrongs.

Thus, in most investor/broker disputes, determining when statutes of limitation run out depends upon a determination of when they started. That, in turn, requires an inquiry into when the investor learned of the wrongdoing, when the investor should have learned of the wrongdoing with the exercise of reasonable diligence, the nature of the relationship between the investor and the broker and its impact upon the degree of diligence required of the investor, and other factors.

Far from being the simple, bright-line calendar calculations advocated by respondents, therefore, statutes of limitation require intensely factual inquiries before they can cause a claim to be barred as untimely. Statute of limitations questions often are inextricably intertwined with the merits of the underlying controversy. As a point of cross-reference, the complexity of disputes about time limitations precludes their being resolved without resort to the relevant evidence. That does not stop respondents from asserting their supposed simplicity and arguing for pre-hearing dismissals, of course. But the complexity of these matters would make dismissal motions inappropriate and unfair even if a hearing were not guaranteed under the Code of Arbitration Procedure.

7a. Rule 10304 -- the NASD's "six-year rule" -- does not start automatically on the transaction date. Like statutes of limitation, Rule 10304 can present complex factual issues. This is because numerous cases have held that Rule 10304 begins running when the cause of action "accrues" -- *i.e.*, when a case first can be brought. That date often differs from the transaction date.

Limited partnership cases presented the classic example of a deviation between transaction date and the date of accrual of a cause of action. Many limited partnerships were doomed from the start, a fact obvious to the firms that sold them. Nonetheless, investors were lulled into a state of complacency by brokerage statements that carried the limited partnership interests at their original purchase price. That practice of keeping investors ignorant turned the partnership interests into the financial equivalent of unexploded ordnance.

Thus, it was obvious that it would be patently unfair to start the various time limitations before the limited partnership interests had exploded in their owners' portfolios, putting the investors on notice of the wrong that had been done.

Federal appellate decisions from circuits that regarded the interpretation of Rule 10304 to be a matter for the courts (as opposed to a matter for the arbitrators) are consistent with this interpretation. Those circuits have adopted the view that **it is the *accrual* of a cause of action that starts the six-year period with respect to that cause of action. In other words, purchase date is not dispositive.** *PaineWebber, Inc. v. Hofmann* 984 F.2d 1372 (3d Cir. 1993); *Osler v. Ware* 114 F.3d 91 (6th Cir. 1997); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer* 49 F.3d 393 (7th

Cir. 1995); *J.E. Liss & Co. v. Levin*, 201 F.3d 848 (7th Cir. 2000); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cogswell* 78 F.3d 474 (10th Cir. 1996); and, most recently, *Kidder Peabody v. Brandt* 131 F.3d 1001 (11th Cir. 1997).

In *Kidder Peabody v. Brandt,* the court stated as follows:

> Therefore, we reject Kidder's interpretation of the "occurrence or event giving rise to the ... claim" language of Section 15 [now known as "Rule 10304"]. **Instead, we hold that under Section 15 the "occurrence or event" which "gives rise to the ... claim" is the last occurrence or event necessary to make the claim viable.**

8. There often is a contract between the customer and the firm. In more cases than I can count, respondents have asserted that a breach of contract claim is without basis because there is no contract between the customer and the firm. Often, the defense is just plain false.

Sometimes, it is false because an oral or implied contract has arisen between the brokerage firm and its client. More often, however, it is false because there is a margin agreement, a new account form, or another writing setting forth the brokerage firm's obligations.

Agreements between brokerage firms and investors often expressly provide that the brokerage firm will obey the rules and standards of the securities industry. Failure to follow those rules – for example, failure to follow the suitability rule or the supervision rules – becomes a breach of contract under those circumstances. The result is that the firm's client is entitled to the benefit of its bargain – *i.e.*, to be placed where he or she would be if the firm had not breached the contract.

9. The "no private right of action" defense is a ruse. Securities industry respondents often argue that a claimant cannot recover for violations of securities statutes or regulations or for violations of other securities industry rules or standards because of the lack of so-called "private rights of action." They assert, for example, that a customer who suffers losses because of a broker's unsuitable investment recommendations cannot recover his or her losses because the suitability rule does not expressly say that a victim of a violation can sue. It's a ridiculous argument.

But people, even intelligent people, sometimes are tricked into going down a wrong path. An example of this, if I can offer a brief and interesting analogy, was the so-called "sound barrier." In the years before Chuck Yeager flew the Bell X-1 past the speed of sound, many in aeronautical circles believed that the "sound barrier" was an absolute. The idea was that drag – the force that pushes backward against an aircraft – would become infinite as the speed of an aircraft approached "Mach one," the speed of sound. And there was some elaborate development of theory to support that point of view. The problem with the theory, though, was that rifle bullets left the barrel at twice the speed of sound or more. That simple fact was widely known, and should have prevented people from believing in an absolute sound barrier.

Speed – in this case, the speed of automobiles rather than airplanes – helps return the analysis to earth. Every state's laws include speed limits. California's Vehicle Code, for example, has a "basic speed law." The law contains no "express private right of action." So, to be consistent with their "no private right of action" defense in securities cases, securities industry defense counsel would have to argue that one cannot sue a speeding motorist for injuries caused by excessive speed. Put into an automotive analogy, the absurdity of the defense is clear.

The reality is that securities industry arguments about the supposed nonexistence of private rights of action for rule violations are a red herring. Even though they are wrong, it would not matter if they were right, because industry rules set up a standard of care. Violation of those rules violates the standard of care. That gives rise to a case for negligence and, in many states, for violation of state securities acts. If the broker is a fiduciary, the suitability violation establishes a breach of fiduciary duty as well. If a new account form or other contract between the customer and the brokerage firm obligates the firm to comply with securities industry rules and regulations, the firm's violation of industry rules will be a breach of contract. And if the act was deliberate, the customer may have a claim for fraud and/or violation of Rule 10b-5.

10. Income, growth, speculation: problems with new account forms and the meanings of words. New account forms that do not reflect investors' actual or appropriate goals are a growing problem in recent years. So are brokerage firm defenses based upon seemingly deliberate misinterpretation of those goals and objectives. Here are some examples:

10a. "Growth" is not a broker's carte blanche to invest in absolutely anything. Brokerage firms occasionally attempt to use a "growth" objective to justify all kinds of inappropriate, speculative investments in an account. But growth and speculation are not the same thing. Clearly, any investment ***might*** grow. But that doesn't make the investment any more appropriate for an account with a growth objective than a Petri dish with a bacterial colony that ***might*** grow.

The reality is that a "growth" objective has a specific meaning in the securities industry. It is what is known as a "term of art." Some investors might not know what it means, but brokerage firms and stockbrokers are required to know.

That meaning comprehends a range of acceptable levels of risk and excludes risks that are greater. A level of risk that is appropriate for an account with a "speculation" objective is not acceptable for an account with a "growth" objective, regardless of whether the speculative investment might grow.

Why does this defense run the risk of tricking arbitrators? What is behind the confusion? The difference between the broad, ordinary English meaning of "growth," on the one hand, and the very specific securities industry meaning of "growth" as an account objective, on the other. If respondents can get away with blurring those distinctions, they may succeed in fooling the arbitrators into making an incorrect decision.

10b. Many investors do not know what the terms mean. The securities industry and its defense counsel will use terms like "speculation" and "growth" correctly when it suits them, and the arbitrators often will understand the meanings. What arbitrators who have investment sophistication may not know is that many less-educated investors may have very different ideas about the meanings of those terms.

Many people, for example, use the term "speculate" as though it applies to any stock position. Indeed, that is the historical use of the term. Yet those with investment sophistication in modern times would not regard a purchase of Procter & Gamble shares to be speculative. Still, when an unsophisticated investor checks boxes, misunderstandings about the meanings of the words – not necessarily the plain English meanings, but the securities industry's term-of-art meanings – may prevent those checkmarks from indicating what truly is intended by and suitable for the investor.

10c. Rankings that include all possible account objectives can be inherently misleading. Another problem is the tendency of stockbrokers to fill out new account forms in such a way as to assign a ranking number to every one of the potential account objectives. Worse still is the listing of objectives without ranking. For purposes of illustration, though, let us assume that the four possible objectives are preservation of capital, income, growth and speculation. A new account form for an elderly client with a conservative profile should not rank those as 1, 2, 3 and 4, respectively. Rather, that client's form should leave speculation off the list entirely.

The problem has to do with what message is sent by having speculation on the list at all. Does having speculation as the customer's fourth choice mean that speculation is the fourth best thing and therefore still in the running and still a legitimate goal for part of the portfolio? Or does it mean that speculation is the last thing the investor would want, something that never should be done? Industry respondents invariably will argue for the former interpretation, although it virtually never will be consistent with the customer's true intent.

Menu items may be a good way to illustrate this concept for an arbitration panel. Suppose one is asked to rank the following items in order of preference: pizza, mashed potatoes, ice cream and contaminated cheese. Most people would know immediately that they would want only the first three items on the list.

Alas, securities are less susceptible of intuitive wisdom than is food. So the arbitrators may have to be educated about this ambiguity and the need to focus upon the client's real goals rather than upon the misleading picture of those goals that defense counsel paints at the hearing. Perhaps a start is to question the stockbroker about whether it is his or her custom and practice to give some ranking, however low, to each possible account objective.

11. Damages are not limited to a "net out-of-pocket" measure. Arbitrators often are confronted with defense arguments that the only permissible measure of damages is a net out-of-pocket measure. The argument is may be enticing because of its simplicity; but it is wrong. Many decades of well-

reasoned statutes and case law hold otherwise, and for good reason. The net out-of-pocket damage measure, like the oversimplification inherent in industry arguments about statutes of limitation, calls to mind the admonition that everything should be as simple as possible, but not simpler.

Taken at its extreme, the net out-of-pocket measure leads to bizarre results. Suppose a 25-year-old client opened an account with $50,000 in 1960, seeking growth with the idea of having the money available beginning in his late 60s. 43 years later, growth at a 10% annual rate has produced an account worth approximately $3,200,000. Now, suppose the broker does something very wrong with disastrous results on the eve of the client's retirement – it could be an unauthorized trade, grossly unsuitable recommendations, a period of wild churning or a host of other abuses. If the account is reduced to $40,000, what is the customer's loss? Is it $10,000, as the industry respondent might assert on a net out-of-pocket damage theory? Or is the mere suggestion of that damage figure just a nauseating injustice when the real damages are $3,160,000? One would hope that the arbitrators would be able to see that the real harm to a retiree who very reasonably relied on his prudently invested nest egg to see him through for the rest of his life is far closer to three million dollars than to ten thousand dollars.

Clients damaged by the negligence of others are entitled to be made whole. They are entitled to be placed where they would be if the negligence had not occurred. The example above illustrates one of the classic injustices of the net out-of-pocket measure: it assumes that the investor wanted a zero rate of return. If an investor truly wanted a zero rate of return, what would possess the investor to place his or her savings in the hands of a full-service broker? Indeed, if investors were interested in a zero rate of return on savings, why would brokerage firms exist at all?

Different causes of action allow for different damage measures. The damages for breach of contract are the "benefit of the bargain." This requires that the claimant be placed in the position he or she would be in if the contract had not been breached. Breach of fiduciary duty allows the same damage measure in California.

Statutory claims under state and federal securities laws provide still other measures of damages.

And then there are attorneys' fees – necessary if the investor is to be made whole, that is, placed in the same position he or she would be in if the wrongdoing had not occurred. Arbitrators who are disinclined to award attorneys' fees to an investor should ask themselves why they are subsidizing a wrongdoer by allowing it to pay for less then the total harm it has caused. One thing is certain: an investor who has to retain counsel to pursue a claim for something that never should have happened in the first place cannot be made whole without being compensated for his or her attorneys' fees.

And then there are punitive damages, controversial though they may be. Punitive damages solve the classic problem of remedies. Awarding damages to those who have been harmed by the misconduct of others serves two purposes long

recognized by courts and legislators: compensating victims; and deterring others from engaging in misconduct.

Compensation is not difficult so long as the proper compensatory damage measure is used. But compensation alone may not deter wrongdoing of the kind that led to the claim, because there are some people who will not assert claims and others who will assert them ineffectively.

What is the solution that will prevent wrongdoers from using the unevenness and inconsistency of litigation to retain the profits of their unlawful acts? Punitive damages. Punitive damages are necessary to take the profit out of wrongdoing. Without them, compensatory damage payments to injured parties are a mere tax on wrongdoing. The wrongdoing – the misconduct that the people, through their elected representatives, decided to eliminate from society -- must be stopped by the arbitrators, because the courts are out of the picture. It is essential that arbitrators uphold the laws of a self-governing people.

Conclusion

The problem areas described above are a start. But this list is far from complete. I encourage readers to think and write about other gaps in arbitrators' legal knowledge that might lead to incorrect and unfair results.

Analyze This: Drafting A Persuasive Statement of Claim In An "Analyst" Case

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In the "good ol' days" of customer-based securities arbitration, claims were primarily based on one or more of six types of misconduct. They were (1) making misrepresentations and omissions; (2) recommending unsuitable investments; (3) permitting a portfolio to become over-concentrated in one security; (3) inappropriate use of margin; (4) excessive trading or "churning"; (5) making unauthorized investments; and (6) failing to execute a customer order.

As the technology market crashed and regulators commenced investigations into the independence (or lack thereof) of Wall Street's research analysts, a relatively new claim has found its way into the lexicon of securities arbitration practitioners: the analyst case. Primarily grounded in fraud, the claim centers around losses in securities that the customer's brokerage firm published research on.

While the recent settlement[1] between the regulators and Wall Street firms over the practices of the analysts establishes a restitution fund to compensate customers who suffered losses as a result of the publication of tainted research, as of this writing the details of the administration of that fund are unavailable. In addition, it will likely take years for any claims from such a fund to actually be paid.[2] The settlement, however, does not bar individual claims. Thus, claimants who lost money in the hot stocks of the technology bubble will seek to use the settlement, and the treasure trove of damning evidence, against the firms. However, even with the firms' acknowledgement that they published fraudulent research[3], the primary issue for claimants and their attorneys will be to persuade an arbitration panel that they relied on the research. While there is little doubt that some will

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[1] The documents related to the settlement are available at http://www.nasd.com/global_settlement.asp.

[2] *See* Zuckerman and Craig, "Analyzing the Analysts," Wall Street Journal, April 29, 2003, available at http://online.wsj.com/article/0,,SB105157957989871000,00.html.

[3] *See e.g.*, NASD Letter of Acceptance, Waiver and Consent, No. CAF030018, re: Citigroup Global Markets, Inc., available at http://www.nasd.com/pdf_text/awc_ssb.pdf.

try to base a claim on a theory of "fraud on the market", it seems that the more viable claims will be those seeking damages from a firm that published research that was touted by the customer's broker. The article will focus on crafting a persuasive Statement of Claim in such a case.

Statement of Claim Basics (Briefly)

The first, and sometimes best, opportunity to persuade a panel is the Statement of Claim. It is the gateway document to the proceeding. Like the first pitch thrown in a baseball game, the Statement of Claim can set the tone for the entire case. Throw one in the dirt and you can be assured it will be a long day. Throw a blistering fastball over the corner of the plate, and you know you'll have everyone's attention.

The basics of writing a Statement of Claim have been set forth elsewhere with a precision and clarity that we all try to emulate.[5] In short, the Statement of Claim should be written to persuade the arbitrators of the righteousness of your position, not to strike fear on the hearts of you adversary. The SRO rules for drafting a Statement of Claim merely require that "[t]he Statement of Claim shall specify the relevant facts and the remedies sought."[5] The NASD's Uniform Forms Guide is more specific in stating that the Statement of Claim "should set forth the details of the dispute, including all relevant dates, names and account numbers, in a clear, concise and chronological fashion, and should conclude by indicating what relief . . . is requested." In other words, without formal constraints, common sense and vigorous advocacy govern.

What's It All About?

In order to determine precisely how to structure and present the facts in a Statement of Claim in an analyst case, a core question needs to be answered clearly: "How did the fraudulent analysis cause the losses suffered by the customer?" Taken to its logical conclusion, the customer purchased stock he might not otherwise have purchased but for the positive outlook given by the analyst. In other words, the stock was unsuitable. The trick is how to weave the headlines and sex of the analyst scandal into a Statement of Claim that, in straightforward terms, is a suitability case. Simple, draw a map.

In a suitability case, it is critical to set forth why the investments made were inconsistent with the customer's investment objectives. The client's prior investment experiences, life experience and relationship with the broker are important. The core of the suitability claim is that the broker breached his or her fiduciary duty by not advising against the investment.

However, where most suitability cases revolve around a breakdown of the customer's relationship with the broker, the analyst case is not dependent of such a breakdown. In fact, it is quite possible that the

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[4] *See* Robbins, **Securities Arbitration Procedure Manual**, § 7.2 at 7-8—7-16 (2002).

[5] *See* NASD Rule 10314(a) and NYSE Rule 612(a).

broker could be the customer's advocate in an analyst case. As part of the evidence recently made public in connection with the regulators' settlement, numerous comments from Salomon Smith Barney's retail financial consultants show there was no love lost between them and Jack Grubman, the former telecommunications analyst whose spectacular fall from grace is one of the lasting images of the situation. "What can you say? Poster child for conspicuous conflicts of interest." "His recommendations lost my clients many thousands." "Suspect a conflict of interest in his ratings between us in the retail sales side and the investment banking side." "I cannot covey (sic) enough the level of dismay and distress his `recommendations' have caused my clients. I have lost accounts because of him as well as the trust of many of my clients . . . . . One question—will he come to arbitration with us when the lawsuits begin."[6]

To Name or Not to Name (the Broker, that is)?

With this type of evidence, it is apparent that, in many cases, a tremendous rift existed between the retail brokers and the analysts. The best way to exploit, or the best way to avoid needlessly tangling up your hearing, is to avoid naming the broker and rely solely on the theory of respondeat superior to hold the firm liable for all of the acts of its employees, including the analyst for issuing baseless research and the broker for permitting the unsuitable investment.

The alternative is a potential trap. By naming the broker, you may find that he is as dismayed with the analyst (and by extension, his employer, or former employer for keeping the analyst around) as your client. The firm, seeing the writing on the wall, may then decide to turn on the broker and blame him for permitting the investments and violating firm rules. You are now stuck in a hearing with the respondents pointing fingers at each other. Rather then having your client's claim at center stage for the panel to judge and (hopefully) compensate, it becomes a sideshow which may leave the panel scratching their collective heads.

In addition, there are other advantages to only naming the firm. First, you have the deepest pocket possible. Second, you retain the flexibility to argue that the firm is liable on several levels: for countenancing the analyst's baseless reports; for failing to properly supervise the use of the research at the retail level; for failing to supervise the broker in permitting the unsuitable investment, as well as for the individual wrongs of the analyst and broker. The more theories, the greater the possibility that a panel will make an award to your client.

Let's Start At the Very Beginning

Every Statement of Claim should commence with an introductory paragraph that succinctly lays out your case. Remember that in all likelihood, this will be the first words the panel reads. First impressions are crucial. The goal is to suck the reader (the arbitrator) in, to intrigue him, and get him wanting to find out exactly how your client was wronged. No matter how complicated the facts are, boil them down to their essence. You do not want to leave your reader scratching his head wondering where you're heading with your argument. Otherwise, you will be playing catch up for the remainder of the case.

Here is the introduction from a recently filed case:

> Claimant . . . seeks to recover losses in excess of $ . . . that were incurred as a result of respondent Salomon Smith Barney, Inc. ("SSB") recommending to and permitting her to invest over a quarter of her investment portfolio in a single stock, WorldCom, Inc., once one of the world's largest telecom-munications companies, which is now in bankruptcy.

Notice that the first paragraph sets up the entire case. The panel knows exactly what is at stake in the case and the prime theory of recover. There is also a hint of what's to come: namely that the stock at issue, WorldCom, is in bankruptcy. The reader will want to see what the connection is.

> While recommending and permitting such an unsuitable investment and failing to allocate the portfolio in a diversified manner was bad enough, SSB's conduct was considerably more egregious. SSB recommended WorldCom as a Buy to its customers (including Claimant) from the stock's high of $67.94 in October 1999 all the way down to a price of $7.06 in March 2002. Throughout this period, the SSB broker handling Claimant's account promoted WorldCom stock, inducing Claimant to acquire a position that cost in excess of $214,000.00. Claimant continued to accumulate WorldCom stock, even as the share price dropped, based on her broker's exhortations that Jack Grubman, then-head telecommunications industry analyst for SSB, was the "guru," that Grubman "guaranteed" the stock price would rise and that WorldCom was a "humongous buy" that would come "roaring back."

This paragraph sets outs the heart of facts underlying the claim, specifically that SSB flogged the stock to the customer even as the price plummeted. Two related theories of wrongdoing are apparent: first, why recommend a stock whose price was collapsing? Is this the kind of stock that suits the customer's investment objectives? Second, why is SSB so optimistic about this stock? Why didn't SSB re-evaluate its rating while the price fell 90 percent? These are questions that you want embedded in the arbitrator's mind throughout the case. The introduction continues:

> Despite SSB's continued enthusiasm and optimism about WorldCom, the stock never recovered. Claimant suffered exorbitant losses in her portfolio that could have been prevented if her broker and SSB had recommended a suitably diverse investment position.

Moreover, SSB's "research" on WorldCom, which Claimant's broker touted and on which Claimant relied, was tainted by the fact that it was being primarily used by SSB and Grubman to attract and promote high-profit investment banking business, including business from WorldCom. In fact, Grubman's compensation, which reached in excess of $25 million, was based in part on the banking business he attracted, not the truth or

accuracy of his research and stock predictions. SSB recently agreed to institute a series of sweeping changes to its business to insulate its research analysts from investment banking pressure to ensure that future research is objective, and to pay a fine totaling $400 million. Facing accusations of misconduct by federal and state regulators, Grubman recently agreed to a lifetime ban from working in the securities industry and a fine totaling $15 million.

These last two paragraphs of the introduction tie the theories of the case together. The panel is told clearly that the customer lost a huge chunk of her investment. Next, the panel is told, in clear, concise terms, about the damage wrought by the tainted research published by SSB. For added effect, we throw in a few choice facts about the chief "bad guy" in this drama, Jack Grubman, despite the fact that he is not named as a respondent. This paragraph sets up the conflict between the customer (who suffered considerable losses) against Grubman (who collected a fortune in compensation) and then hammers home the fact that SSB and Grubman have already acknowledged their wrongdoing (why else would they pay such fines and agree to a ban?)

Thus, the introduction, in four paragraphs, has set up the theory of the case, throws in enough facts to show a good basis for finding in the customer's favor and whets the panelists' appetites for more. The introduction has also provided a road map for where the balance of the Statement of Claim is heading. As he proceeds through the rest of the statement, the reader should always be able to say to himself, "Oh yeah, he mentioned that in the introduction" or be able to tie a fact or theory back to the introduction.

<u>The Client</u>

The next section of the Statement of Claim should introduce your client to the panel in a way to put a human face on her. One of the great advantages that customers have in arbitration is that they are one individual fighting a large corporation. It is essential to have the panel sympathetic and empathetic to your claims. If your client is an inexperienced investor, you need to emphasize that fact. The panel can probably understand that a novice investor would fall prey to false research and guidance. Such an investor is relying on her broker and firm to protect her and provide the best possible information. If your client is a savvy investor, emphasize the success she previously had. The sophisticated investor is also one in which the "garbage in, garbage out" theory comes into play: even a savvy investor can't be successful with garbage research and his results will be garbage as well.

After introducing the client, the Statement of Claim should next turn to a detail analysis of the trades that were made. Specific references to the firm's recommendations at the time of the trade should also be made. This will enable the panel to start to see the connection between the client's actions and the firm's recommendations. Remember, one of the key elements that will need to be demonstrated is that the client <u>relied</u> on the research. Specific conversations in which the broker touts the stocks, sends research reports or makes other comments as to the research

department's bullish outlook on the stocks at issue will further bolster the reliance element.

Tainted Research, or The Reason We're All Here

The next session should be devoted to the research itself. Clearly, the evidence uncovered by Eliot Spitzer during the investigations[7] should be referred to, if relevant. Quotes from internal e-mails in which the analysts privately denigrated stocks they touted, or e-mails[8] in which the retail brokers complained about the research will all paint a picture of an organization out of step and out of control with market realities. Examples could include:

Grubman himself flaunted the traditional "Chinese wall" between the research and investment banking functions at the large Wall St. firms when he stated the "what used to be a conflict is now a synergy." In 2000, one broker commented that Grubman "sold us a bill of goods on [WorldCom] and [AT&T] and now we're bleeding red in our clients' accounts." Another stated that SSB's "blind support of banking (a la [WorldCom]/[AT&T] is hurting our retail clients."

Another very useful tactic would be to include an exhibit to the Statement of Claim which sets out, over the relevant time period for which your client is claiming damages, the actual share price of the stocks at issue, the rating given to the stock (i.e. high risk, low risk, etc.) the target price indicated in the various research notes published by the firm and the percentage deviation between the two. For example, in a case involving WorldCom, a portion of such a chart would look like this[9]:

Date	Price of WCOM	Rating	Risk Factor	Target Price	Percentage Forecasted Increase
2/15/00	$50.06	1-Buy	Medium		
6/27/00	$37.50	1-Buy	Medium	$87.00	132.00%
9/05/00	$33.75	1-Buy	Medium	$87.00	157.78%
10/04/00	$29.88	1-Buy	Medium	$87.00	191.16%
10/26/00	$25.25	1-Buy	Medium	$87.00	244.55%
11/01/00	$18.94	1-Buy	Medium	$45.00	137.59%
12/05/00	$14.81	1-Buy	Medium	$45.00	203.85%
1/02/01	$14.06	1-Buy	Medium	$45.00	220.06%

[9] The Spitzer materials are available at http://www.oag.state.ny.us/press/2003/apr/apr28a_03.html.

By setting forth the information in this way, the panel sees clearly how the firm never changed from its bullish rating even as the stock went into the toilet. The chart should be accompanied by a narrative setting juxtaposing the client's investment activities with the research reports:

> From the beginning of 2000 through January 2002, while WorldCom's stock fell from $50.06 to $12.00, SSB consistently set target prices that were 50% to 244% higher than the current stock quote. Annexed hereto is a chart that summarizes the actual stock prices and Grubman's ratings and target prices from February 2000 though January 2002.

In June 2000, approximately one month before Claimant began accumulating WorldCom stock, Grubman stated categorically that WorldCom was by far the cheapest stock in the world of global telecom and that analysts who worried about WorldCom's failure to excel in the wireless area would be sorely disappointed that they downgraded the stock. As the stock continued to decline, from a high of $49 per share (when Claimant first bought the stock) to $14 per share in December 2000, Grubman continued to project a tripling of WorldCom's stock price and labeled the stock "dirt cheap." Despite lowering his target price from $87 to $45 in November 2000, Grubman still rated the stock a "1/M"—Buy with medium risk.

In doing so, the panel will see that, in many instances, the targets set by the analysts had no relation to where the stock actually went, even as your client was buying the stock in reliance on the research and recommendations. Moreover, while the target price may have gotten adjusted downward, the percentage gain necessary to reach that target increased to a point of absurdity.

The Wrongdoing

Having worked through the facts, its now time to wrap it up in a package that the panel can get their arms around. The most effective method here is a series of paragraphs setting forth the various causes of action, referencing, in narrative form, those rules and regulations that were violated. Upon reaching this section, the panel should have their "Aha!" moment, realizing that, under any number of theories, your client was wronged and deserves to be made whole.

Conclusion

Leading an arbitration panel down the logical, legal and equitable path to the only acceptable conclusion is one of the hallmarks of a successful Statement of Claim. Cases based on the tainted research of the analysts will be one of the most active areas in investor arbitrations in the coming months and years. While several theories and strategies will undoubtedly prove to work, it is critical that the Statement of Claim be used to put a human face on the economic loss caused by this historic market.

Wrap –Fees, Managed Accounts, Financial Plans: Trinity of Abuse for the 21st Century

By Frederick W. Rosenberg

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Preface

Recent experience suggests that the days of the retail stockbroker are numbered. In fact, there is a significant trend gaining acceptance in the brokerage industry, Asset Gathering, in which registered representatives are encouraged to prospect for clients and then to hand off investment management responsibility to selected specialized portfolio managers or mutual funds. This strategy often equates to a "bait-and-switch" in which a broker first promises to take on account management only to switch the unprepared customer into a fee generating, professionally managed portfolio.

For the broker dealer (BD), the strategic advantages of fee-based accounts are immediately apparent, such as tapping into a new source of revenues, eliminating broker error and abuse such as churning, annuitizing commission income, and realizing substantial savings through reductions in retail brokerage personnel. Brokers are for the first time suggesting to customers that for a low annual fee they can obtain the services of a professional, pooled-investment manger, (to do what the customer expected the broker to do) for no greater expense than normal transaction costs. The more the customer commits to the program, the lower the annual fee percentage.

Asset Gathering methodology incorporates a spectrum of products and services to cement customer dependence such as wrap-fee accounts, financial plans, managed portfolios, proprietary funds, checking and credit card services, credit line (margin), direct deposit, and a panoply of other specialized reports and market letters that intentionally bind a customer's assets and finances to the brokerage account. These products and services originate not in the research or accounting departments, but almost always in the sales and marketing divisions whose goal is to tie the investor financially and psychologically to the BD over the long-term thereby building an annuity of fees.

The brokerage industry clearly understands that there are legal duties occasioned by its fiduciary, advisory, and banking services, and that investment management by individual brokers is a wellspring of potential liability that is best eliminated whenever possible. Some states make brokers fiduciaries by law. But to understand the link between broker liability and broker conduct, read DeKwiatkowski v. Bear Stearns, US Court of Appeals,

Docket No. 01-7112, 2nd Circuit, 9/19/2002, which amply demonstrates that it is often essential to prove that the broker fostered and induced the customer's reasonable fiduciary reliance as a necessary component of proving abusive conduct.

If you allow yourself to ignore these issues you may find yourself searching through BD policies and procedures manuals in the attempt to fit some account abuse into a predetermined supervisory category that will hopefully convince an arbitrator that your client should get his money back. Worse, you could mire yourself in a sideshow of confidentiality agreements and discovery motions only to be disappointed in the result. If you can demonstrate that fee-generating accounts are replete with conflicts of interest and are intentionally and structurally susceptible to abuse, you may, in many cases, be able to establish the necessary predicates to BD liability.

Take advantage of the economic environment we are now in. Every article, financial plan, analytical report, and market analysis stresses the significance of each percentage point of costs, fees, inflation, and interest rates. A 2% wrap-fee looks to be outrageous in a period in which an 8% return is aggressive and the Fed Funds rate is 1.25%. Wrap-fees, sometimes amounting to 2.25% annually for life, often exceed comparable mutual fund fees; e.g., "A" share management fees are usually less than .75%; B shares, 1.25%, and C shares 1.75%. Worse, the mutual fund could be held in a fee-based account creating an insurmountable hurdle to conservative growth. Illustrate that point arithmetically!

Focusing on every percentage point of fees is critical and convincing so long as you're able to persuade the panel of the substantial undisclosed conflicts of interest and self-dealing that are demonstrable in a wrap-fee account over a reasonable time-frame, eg.7-10 years. This also means that typical annual comparisons such as turnover, cost to equity, margin % etc, are often not evidentiary of wrap-fee abuse.

When the BD's defense amounts to allegations that the client is a moderate to aggressive long term investor, fee accounts can frequently be shown to be far more in the broker's best interest over time than that of the customer, a fiduciary breach under the broker's own assumptions. Over a ten-year period the excess of fees over commissions approaches unconscionable surcharge levels. Compare total fees and account expenses over 10 years with projected commissions and you will be able to make a compelling case that fee-accounts are abusive.

- Glossary

- **Asset Gathering** is the term brokerage firms use to describe their strategy of capturing all of a customers banking, financing, credit card, and investments in a single relationship. Unfortunately, virtually all these services effectively tie a customer's finances to the uncertainties of the market, and frequently require a margin account to prevent checks and credit card payments from bouncing. Brokers engaged in Asset Gathering have only two ways to increase their income, (no commissions you know), 1) adding more clients, or 2) growing the assets through appreciation. It is far easier to understand broker intent if you can tie his or her over-aggressiveness to his own objectives of increasing his or her "assets under management".

- **Managed Portfolios:** *Minimum Assets 100K+, Annual fee 1%-3%, No Commissions; Broker Shares in Fee*. All or a portion of a customer's investments are managed on a discretionary basis by identified portfolio strategists who direct investment according to a defined portfolio model. The broker recommends 3 to 6 such managers with various investment styles and risk profiles and, with the customer, chooses one or several. Known as "Consults" at Merrill and "Access" at UBS Paine Webber, most major BDs have a similar programs under their own service marks. The claimed benefit to the customer is "professional management" at no additional cost over and above normal commissions, (a freebie so to speak). The benefits to the brokerage firm are enormous as will be discussed below.

- **Cash Management Accounts:** *Small annual fee*. Virtually all firms provide cash management capability that involves automatic sweeps, checking, credit card, specialized reporting, and a margin agreement. Often a customer erroneously believes that he's actually getting a "managed portfolio." Yet, as with basic cable service, the cash-management account is a platform for sales of other products and services such as managed portfolios, checking, credit card, margin lending, newsletters and research, financial plans, specialized reports etc.

- **"Wrap-fee" Accounts:** *Annual fee 1%-3%.* To counter the potential for commission driven trading abuses, BDs have adopted an annual-fee revenue model generically known as "wrap-fee account." Ostensibly the purpose of wrap-fees is to reduce account costs and commission expense into one small asset-based fee that is justified on the basis of savings, while simultaneously removing the incentive for abuses such as churning. This will be elaborated upon in detail.

- **Financial Plans** are usually detailed analytical reports that serve as the foundation of the customer's financial needs. Based upon answers to a detailed questionnaire, the Financial Plan is primarily a sales tool used to build customer confidence and reliance, while getting the customer to identify all his investable assets. Ironically, many customers are charged a fee for giving up their personal financial information. The most obvious problem with financial plans is the failure to implement the recommendations. More importantly, virtually all financial plans are incomplete and misleading, offering a lawyer an open target of attack against broker credibility. Failure to challenge the underlying assumptions of the financial plan, (as most lawyers fail to do), is tantamount to ratifying many flawed assumptions and selective omissions that raise questions about a broker's intent and competence, and may amount to ratification of a flawed standard that could limit recovery. As will be shown below, most of the underlying assumptions either overstate or omit important facts leaving the customer with a typically erroneous portrait of his or her long-term financial condition that usually leads

to bad investment decisions.

Targets of Opportunity

Product A. **<u>FEE BASED ACCOUNTS</u>**: <u>The *Abuse of Choice for the 21st century!*</u> The intended consequences of fee-based accounts are 1) the annuitization of commission income regardless of market conditions and account activity, 2) the selling of unnecessary services to customers, 3) the separation of brokers from investment recommendations eliminating some types of potential commission-driven liability, 4) the binding of the customer to the BD making transfer of accounts difficult, and 5) the promotion of an erroneous perception that wrap-fees eliminate conflicts of interest. If the wrap-fee includes asset-management, a broker no longer has to actively manage his accounts to generate commission income. By parking a customer's investments in any number of fee-based managed accounts or pooled funds, the broker will free him or herself to focus on marketing activities, financed by annual fee income for the life of the customer. BD publications and promotional material represent that wrap-fees eliminate conflicts of interest ostensibly because they substitute fees, typically 1.5 %-3.0% of portfolio value (<u>not account equity)</u> for commissions as if churning were the only concern. But as described below, fee-based accounts are replete with undisclosed conflicts of interest that can support claims of material misrepresentation.

Point A1. ***Long-Term Strategy, Long-Term Analysis***: Asset gathering is a long-term strategy designed to produce an asset-based revenue stream over several years while binding the investor over that term. Consequently, your analyses must incorporate projections over the lifetime of the investor or at a minimum, a specific period such as 10 years, if you're to be persuasive in these cases. For a $200,000 account growing 5% annually over 10 years, total wrap-fees at 2% aggregate to $46,466. By contrast projected commissions at 1.25% of 60% annual turnover, (30% buys and 30% sells) aggregates to only $18,562 (Table 1). If you try to make your case by comparing costs year to year, (not aggregated over time) you will grossly understate the broker's intended benefit from fees and weaken your case by comparison.

Note. A1a. Don't give in to setting your client up for a fall. Always question whether the customer really needed active portfolio management as well as the annual-fee percentage. For large accounts contrast "A" share mutual funds with breakpoints and low management fees with the managed portfolio's costs and expenses. Be aware that the only way to analyze this factor is to project the impact and benefits over several years. Non-fee accounts will always grow faster than fee-based accounts and without the additional hurdle of the fee, the non-fee account can accomplish its objectives far less aggressively. That's pretty compelling if you illustrate that point.

Point A2. *"**Wrap-Fees- "Less is More, The Zen of Churning**."* Two principal distinctions between Churning and Wrap-fees are 1) time frame and 2) broker trading activity. Regarding time, most churning occurs over brief periods, 6 months to 3 years, or until the account is consumed by commissions, or until all the money is gone. With wrap-fees, account depletion is more insidious, occurring over several years if not a decade or more in a steady drip, drip, drip of fees each year until they aggregate to unconscionable levels. Churning is illegal and

relatively easy to distinguish and supervise. Wrap-fees are legal and have not been adequately scrutinized either by regulators or the plaintiff's bar; they are gaining

Note A2a. ***Look at the Whole "Book."*** Brokers, who use wrap-fees, tend to have most of their customers in wrap-fee accounts. This should be addressed in discovery to show the asset-gathering objective. Determine the percentage of accounts under wrap-fees as well as the percentage of income generated through those fees.

Note A2b. **Compare:** A $200,000 portfolio with a 2% wrap-fee generates an annual fee that is identical to 1% commissions with annual turnover of 100% buys and 100% sells. A conservative portfolio, with turnover of 30% buys and 30% sells, would produce commissions of $18,562 at 1.25% over 10 years in contrast to $46,446 in wrap-fees (250% of commissions) over the same period, an excess of $27,885 ($2,788/year) in costs. The conclusions are evident, for conservative accounts with less than 100% turnover/year an investor is likely to be far far better off paying the commissions. Arguably this type of analysis should persuade a panel that for many

acceptance without necessary challenge. In many cases the customer is actively deceived by misrepresentations and omissions about the conflicts of interest associated with conservative and senior citizen investors, wrap-fees equate to a structural commission driven abuse that heavily rewards the broker and offers only illusory benefits to the customer. Smoke it out!

A2b Issue a) The

operative litigation strategy will be to prove there to be no additional value for the extra cost, and that the only beneficiaries of the wrap-fees are the broker and the asset manager. The BD will defend that the customer's excessive costs are justified by the added value of the portfolio management, but rarely will performance comparisons between managed portfolios and conservative indexes or mutual funds support that conclusion over a 10 year period, especially after fees and costs. Do the math!

Point A3. *<u>Fees v Commissions; How Does a BD Benefit</u>*? One method of arriving at a fair market value for a company such as a BD is to place a value on its forecasted revenues. As those in the banking industry will attest, annual-fee income is a more reliable revenue source

wrap-fee accounts as well as the excess undisclosed financial benefits inuring to the broker at the expense of the Client.

than commission revenue generated by trading. For most lenders and investors, fee income is deserving of a higher multiple than commission revenues because of its stability, reliability, predictability, and relative immunity against cyclicality. Merely converting revenues from commissions to fees should have an immediate impact on the market value of the BD's stock to analysts.

Point A4. *<u>Do the Fees Fit the Investment?</u>* You can never

know if a wrap-fee is suitable unless you analyze the underlying investments under fee. The wrap-fee percentage should be directly related to the type and appropriateness of assets under fee, e.g. treasuries yielding 5% couldn't support a 2% wrap-fee. Mutual funds should rarely if ever be in wrap-fee accounts. Income accounts cannot support fees in excess of .5%. Identify any component of the portfolio that should not be in the Fee account.

Point A5. *<u>When is an 8% return not 8%:</u>* You cannot assess risk using net returns. Only gross return before fees

should be used. Make the point that achieving an 8% growth rate without a fee is exponentially less risky than achieving 8% return net of the 2% fee. While both net out to 8%, one account needs to gross 10% before fees, adding far greater risk to achieve the identical result. Illustrating risk and performance with net returns is thoroughly misleading. In short, fees mandate higher risk investments. The customer sees 8% projections and is not sophisticated enough to perceive when 8% really means 10%.

Point A6. *Margin:* Wrap-fees are calculated on "gross portfolio value," not "net equity" (portfolio value less debit balance). In margined accounts wrap-fees frequently are double that of the non-margined account with the identical account equity, effectively leveraging the fee! (Tables 2 and 4). When those fees are added to margin interest, it results in an almost insurmountable hurdle to conservative if not moderate growth. Look at Table 2 (5% appreciation) and Table 4 (10% appreciation) that are based upon a 2% wrap-fee on a $200,000 account. Table 2 illustrates that with 5% annual appreciation, 6.5% margin interest on the debit balance of 40%, and a 2% wrap-fee, account equity barely breaks even over 10 years ($207,000) in the margin account while account equity in the unmargined account grows to $267,662. Remarkably, despite its poorer performance, the cumulative fees and interest expenses on the margin account are $156,362 in 10 years compared to only $46,446 on the unmargined wrap-fee account illustrating the advantage to the BD of leveraged fee-based accounts. Even with 10% growth (Table 4) unmargined account equity is significantly higher than margin account equity after 10 years, $432,949 vs. $337,409 yet the margin account fees and interest aggregate to $201,554 vs. $60,402 for the cash account. This undisclosed disparity only highlights the impossible hurdles that fee-based accounts suffer.

Note. A6a. Margin investing and wrap-fees are basically incompatible. In virtually all scenarios the margin account adds risk and cost, and reduces return over the long-term. This suggests that margin is only a short-term device to enhance immediate returns, and that over the long term, margin's primary benefit in a wrap-fee account is to enhance fee and interest income.

Note A6b. Margin not only leverages fees, but in combination with wrap-fees substantially reduces growth by siphoning off investable funds, substantially negating the benefit of compounding.

Note A6c. Many customers never fully understand that using margin to pay monthly expenses, to purchase a car, or make other general purchases not only incurs an interest expense but also adds 1.5%-3% wrap-fee expense on top of that. Rarely does the customer comprehend the costs to carry his purchases or the negative impact those costs have on the underlying growth of his portfolio. A home equity line is always a better choice and there are no Reg. T restrictions or forced liquidations to boot.

Note A6d. While margin amplifies risk, margined portfolios are rarely rebalanced to reduce the additional risk caused by margin. Thus, not only is the customer paying both fees and interest at a combined "junk-bond" rate, but is also increasing risk and reducing returns.

Point A7. Fostering Asset Gathering: Wrap-fees and managed accounts typically facilitate a broker's promotional and marketing activities, something that most brokers

engaged in traditional account management activities have little time to do, i.e. a broker can churn only a few accounts at a time, but asset-fees can be applied across the board to all customer accounts. Churning is a tactical violation against the individual customer; wrap-fee accounts are structural changes focusing on maximizing revenues from the broker's book while facilitating the marketing capability of the broker.

Point A8. *Failure to Supervise*: Argue that wrap-fees should mandate regular supervisory reviews to protect the client against excessive costs on low or moderate turnover accounts. There should be an analysis annually to compare fees with commissions. Be careful of comparisons utilizing standard, undiscounted, commission schedules. Commission discounts are the norm for good customers. The SOC should allege that the failure to fully disclose costs and to supervise fee-based accounts is unsuitable at best, and motivated by an undisclosed conflict-of-interest related to fee income.

Point A9. *Higher Turnover: Self-Fulfilling Abuse*: Wrap-fees can only be justified on a cost saving basis. Inactive accounts are not suitable. Therefore many wrap-fee accounts are put under more active management to assure sufficient trading activity to justify the fees (self fulfillment). Unfortunately, for most investors and especially retirees with conservative income and capital preservation objectives, they're paying for services they could really do without and incurring greater risk and higher hurdles to profitability in the process.

Note. A9a. If the 2% fee reduces net profits from 8% to 6%, it is in the client's best interest to buy a 6%, AA rated corporate bond, skipping the annual fees and reducing investor stress.

Point A10. *Unsuitability and Disincentives for Conservative Investments*. Wrap-fee accounts are unsuitable for very conservative investments e.g. fixed income (bonds), fixed dollar (CD's), stable dividend paying stocks, and self liquidating investments such as Ginny Maes that normally yield 3%-7% because none can justify an annual wrap-fee that decreases the yield and increases risk. For this reason, those investments are not likely to be recommended to the customer and if they are, they are purchased via higher commission mutual funds and unit trusts outside of the wrap-fee agreement. If these investments wind up in a fee-based account, it=s a clear abuse because of unconscionable double fees.

Point A11. *Watch for Account Splitting:* Some brokers set up a wrap-fee account for inactive assets and a commission-based account for active trading accounts. In fact most BD's limit account activity in fee-based accounts. Always remember that fees can be eliminated entirely, simply by placing the inactive assets into the commission account, (like in the old days). Splitting off conservative assets into wrap-fee accounts is an abuse intended to monetize low turnover assets.

Point A12. *Total Costs*: Wrap-fees should be analogized to paying mortgage points on the principal balance every year for the life of the loan. Always evaluate and quantify Wrap-Fees over the period forecasted by a financial plan, ten years, or the actuarial lifespan of the customer. For a retiree whose accounts should have little or no turnover, the aggregate fees will prove to be abusive and based more on ability to pay than for the value of the services.

Note A12a. Chances are that your client will make a very credible witness when testifying that had it been disclosed that brokerage fees would amount to $75-$100,000 over ten years, he or she would never have agreed to the fees or the account manager, even if it meant the broker had to manage the account on commissions.

Note A12b. Taxing Income: For Income oriented accounts even a 1% wrap-fee typically equates to a 12%-50% tax on dividends and interest at best, and at worst, an erosion of equity in addition to inflation. In *Electronics Industries Assn v. FCC* 554 F2nd 1109 (1976) the Court reasoned, "ability to pay is frequently used as justification for levying a tax but is of very limited value in assessing a fee which is supposedly related as closely as reasonably possible to the cost of servicing each individual recipient." E.g. there is no evidence that an account that appreciates by 100% requires double the expense to manage than it did prior to its appreciation. Does this amount to sharing in an account or worse?

Point A13. *Sharing in an Account*: Asset-based fees are easily analogized to "Sharing in Accounts", a practice prohibited under NASD 2330(f)(1). The truth is in many ways they're worse, they're recurring and non-performance based, and the broker need not risk any of his or her money to participate in growth. The recurring fee also amounts to double taxation on the account's core value year after year. This should be seen as an abuse particularly for those accounts for older or retired investors.

Note A13a. Remember, Asset Gatherers can increase their fee income in only two ways, 1) grow the assets, and 2) find new clients. Is there any question that some aggressive, wrap-fee compensated brokers substitute their own higher risk, growth oriented objectives for the customer's more conservative ones?

Point A14. *How the BDs Views Fees*: A modest $200,000 account would have to appreciate $40,000 just to pay an annual 2% wrap-fee and breakeven over 10 years (2% growth). With the 10% growth typically forecasted in most financial plans, the BD would generate $60,402 in fees over 10 years or roughly 37% of the initial investment. Commissions on the other hand would be just $24,225 a savings of $36,177 (Table 3). Savings in general administrative and personnel expense under the asset-gathering model further supplement this direct revenue benefit. Also note that the equity in the commission account is $53,988 greater than in the wrap-fee account. What price does the customer really pay?

Point A15. *Liquidating Stocks to Generate Income*. Income oriented investments are typically unsuitable for wrap-fee accounts because the fees significantly reduce yield by 20%-40%. Many brokers circumvent this suitability problem by over-concentrating the entire portfolio in growth stocks and then liquidating a percentage of the portfolio monthly to generate cash flow. This is an abuse in which volatile long-term investments are used inappropriately as an income source and to generate a fee that would be unsuitable for an income investment such as a bond.

Point A16. *Over-Concentration Rationale*: Many wrap-fee accounts require minimum assets to qualify for favorable wrap-fee rates. But, parceling-out inappropriate investments into non-fee accounts will reduce the assets available for a fee-based portfolio, frequently below minimum account size.

As a consequence, brokers ignore conservative and income investments to purchase fee-generating equities in far greater concentration than is appropriate for most investors who require safety and income.

Point A17. ***Mutual Funds*****:** Because mutual funds already charge management fees and pay commissions, they are entirely unsuitable for wrap-fee accounts. Often, the broker will receive both dealer reallowance (commission) on a mutual fund as well as the wrap-fee. A 2% wrap-fee plus a fund's 1.25% operating costs, results in an insurmountable barrier to growth.

Note A171. Retaining mutual fund discounts, commissions on UIT's etc. is permitted regardless of the wrap-fee. Be aware of A, B or C shares in a wrap account. While C shares pay no commissions they have the highest management fees (1.75%). In evaluating suitability you need to determine the annual management fee of each mutual fund and add it to the wrap-fee and any margin interest to determine hurdle rate.

Product B. __MANAGED PORTOFLIOS__: View Managed Portfolios skeptically. Older customers with diversified and balanced portfolios do not require active management. Unfortunately, while most customers initially expect that the broker will be making recommendations, they wind up paying for account management services they never intended. For retirees and senior citizens, an account suitably allocated among low cost, low turnover, US, corporate, or municipal bonds with laddered maturities, low cost/equity index funds, and fixed income unit trusts or mutual funds should require very little active management, and likewise should experience de-minimis turnover with very low cost over time.

Point B1. Managed Portfolios are add-on services sold to the customer at extra cost. Too often however the managed portfolio is the highest risk alternative and not usually needed. Normally the client expects the broker to manage the account and may continue to assume that is what the broker is doing. But most BD's would prefer brokers not to pick stocks, the name of the game being "Assets Under Management." Typically the broker erroneously represents that portfolio management services can be added for the cost of normal commissions alone, and so the customer agrees to the logic believing he's getting added value for no additional cost. Unfortunately, oftentimes the representation is totally bogus, misleading, and unsupported in practice.

Point B2. Eliminating asset management fees could save tens of thousands of dollars over a client's lifetime even on modest accounts, typically without reduced performance. Never is the client given a fair or realistic comparison of his choices. Instead the client is generally kept in the dark about the potentially significant savings of commission-based accounts over wrap-fees accounts. Neither is it ever made clear that the broker is an Asset Gatherer who has no interest in being responsible for daily investment recommendations and account supervision. Instead the customer is induced to purchase management services as if the decision is self-evident and without additional cost or risk. Without understanding the hurdles, the customer can never make a reasoned decision.

Point B3. ***__About Comparisons:__*** As a rule of thumb, commissions should amount to no more than 1%-1.5% of the annual turnover (buys + sells). Customers should receive substantial

discounts off the standard commission schedule. A conservative portfolio should experience less than 20%-40% turnover annually (compare with analogous mutual fund). Compare projected commissions with the aggregate 2 % wrap-fees over for the life of the account and you'll build a case for intent.

Note. B3a. For a conservative $200,000 account, the $2,700/year difference between the $1,524 in year-one commissions and the $4,045 in annual wrap-fees (Table 1, 4Q Yr1) projected over 10 years adds additional expense of $225/month and $27,000 over 10 years. For a retiree, this could amount to income for a year.

Product C. <u>FINANCIAL PLANS</u>: A Financial Plan is the leading Asset Gathering tool, one that provides a detailed roadmap to all of a customer's investable assets. Financial Plans forecast income, expenses, and investment growth as a way of inducing customer trust. Unfortunately virtually all Financial Plans are unrealistic, overstated, and seriously misleading. Furthermore, the balanced portfolios typically recommended by financial plans are frequently ignored.

Point C1. *<u>Overstating Inflation</u>*: On average Financial Plans overstate the rate of inflation by anywhere from 1/2% to 1.75% resulting in a gross overstatement of future expenses. The average CPI Inflator for the last decade is 2.6%. A Financial Plan using a 3.1% CPI will overstate a client's needs by nearly $5,000 ($416/mo) in the tenth year for every $100,000 needed in year one. In year 15, the overstatement is double. Reliance on the higher CPI will necessitate higher risk investments than appropriate were a more moderate CPI used. Always allege that the CPI rate is too great and highly misleading for an older or retiring investor. (See discussion below "The CPI Illusion").

Point C2. *<u>Misapplication of Growth Rate in Projections</u>*: Virtually every Financial Plan incorporates a "Growth Table" illustrating the impact of portfolio appreciation at a recommended rate, often 10%. The table typically subtracts the projected annual inflated cash needs from the appreciated portfolio each year to arrive at the annual portfolio value. This presentation is seriously misleading and is clearly subject to serious attack. Older investors and retirees really have two well-defined objectives, 1) to not outlive their income or lifestyle, and 2) to grow their estate. To achieve objective # 1, a portion of the investor's current portfolio should be set aside and invested at very conservative rates to provide certainty that the required income will always be available and that the principal needed to assure that revenue stream is not depleted. Thereafter, any remainder would then be available for estate building, even at a more aggressive rate.

Note C2a. For example, if 50% of an investor's current portfolio needs to be invested in conservative, income generating instruments, only 50% of the portfolio would be available for estate building, albeit at the higher risk 10% growth rate. Arguably, the customer's objectives could be achieved at a blended rate of 6.5%, ((3%+10%)/2) not 10% as projected. By applying a 10% growth rate to the entire portfolio, not only is virtually everything subject to higher risk, but the investor is never given the opportunity to make appropriate investment decisions. Instead the investor is typically seduced into thinking he or she can achieve the projected growth conservatively.

Note C2b. When analyzing financial plans and cross examining the broker, be certain to draw the distinction

between investing to insure current lifestyle, and investing to build an estate. Unifying both objectives under a common 10% growth rate is both misleading and unsuitable.

Point C3. ***Failure to Reallocate***: Virtually all Financial Plans fail to reallocate a portfolio over the entire life of the investor. The logical inference from these forecasts is that at age 50, 60, 70, 80, 90, or 100 the client's investment objectives and risk tolerance would remain unchanged, an absurd assumption. Every financial planner will tell you that one's investment objectives and risk tolerance become more conservative with advancing age necessitating the periodic portfolio rebalancing that is typically omitted from financial projections.

Point C4. ***Ignoring Margin***: Margin significantly leverages risk, even for a conservatively allocated portfolio. For customers whose accounts are margined, their financial plan will likely be woefully inadequate on the subject. The projections will undoubtedly fail to reduce projected growth rates by margin interest (remember every percentage point reduction in growth is very meaningful over time); fail to include margin interest in monthly expenses, and will likely fail to conservatively adjust the portfolio allocations towards fixed income to defray the interest expense and reduce risk. Whether these omissions are negligent or criminal is a matter of degree and scienter.

Point C5. ***Failure to Disclose Impact of Fees and Costs***: All Financial Plans stress the profound significance of every percentage point of costs, inflation, and compounded returns that can over time have an enormous impact on safety, growth, and risk.

Note C5a. Financial Plans almost never adjust assumptions for the 2%+ annual wrap-fee. This significantly overstates projected appreciation and projected cash needs, while understating the risk necessary to achieve the net result. Among those important omitted factors that would negatively affect growth projections are wrap-fees, margin interest, and commissions, typically resulting in overstated and misleading growth projections. The customer typically accepts a "conservative" 10% return never understanding that the account actually needs to achieve a 13% return to net out 10%. You should clearly allege that the reason "above the line" expenses, such as transaction costs, margin interest, commissions, and wrap-fees, are entirely omitted from the financial plan is because the BD quite simply wants to prevent the customer from gagging on the totals over the life of the projections.

Point C6. ***Ignoring Revenue Sources***: Most Financial Plans fail to incorporate the tax-free cash flow generated from a sale of a personal residence or the obtaining of a home equity loan to conservatively cushion cash needs in advanced age. Most financial plan projections also fail to incorporate the revenue impact of a cash or installment sale of a professional practice or business. Older investors also trade down from larger homes to smaller ones in transactions that also free up cash. In short, most financial plans are highly biased towards securities-based solutions and ignore alternatives that could reduce market exposure if properly done. The failure to incorporate all potential revenue sources almost always overstates the customer's income deficiencies for planning purposes.

Point C7. ***Faulty Tax Assumptions***: Many Financial

Plans utilize post-retirement tax assumptions on the incremental tax rate (33%) in contrast to the effective tax rate 12%-15% for most retirees thereby overstating the tax impact on the projections.

Point C8. *Failure to Contrast Management Fees and Commissions*: The Financial Plan never contrasts wrap-fees with commissions to allow the customer to make an informed investment decision about the fee-based account. Neither do Financial Plans ever compare the costs of an actively managed account against a passively managed portfolio that is well positioned in a broad cross section of contra-performing investments, index funds, federal, municipal, or corporate bonds, cash equivalents, unit trusts, and real estate investment trusts. It also is not a reason to accept the additional risk just because the manager has consistently out-performed his bogey by the amount of his fee.

The CPI Illusion

Misapplied CPI inflation rates are responsible for substantial error in many projections and often result in investors chasing too high returns and incurring far greater risk than necessary to achieve long-term objectives. In part this is because many brokers erroneously believe that is actually more conservative to use a higher CPI on expenses than a lower one, getting it backwards. Remember, the lower the CPI inflator the more conservative the growth rate and the more conservative the investment.

The CPI tracks changes in a weighted basket of goods and services to arrive at the inflation rate. Older investors and retirees have decidedly different spending patterns and financial circumstances than the population at large and Financial Plans never make any adjustment. For example, in the CPI, housing expenses such as rent and furnishings are weighted at 40% of the index. Yet most retirees and senior citizens experience a reduction in housing costs as they pay off mortgages, move into retirement communities where expenses are substantially less and services such as transportation are included, or simply move into smaller accommodations after selling their home. Medicare will defray health-care costs as well. In short, using a full CPI for a retiree will likely overstate forecasted needs leading to investments with too high a risk. (See Appendix A, U.S Department of Labor's publication, "The Consumer Price IndexCWhy the Published Averages Don't Always Match An Individual's Inflation Experience." (See also Table 13, a spreadsheet showing the impact of various CPI inflator rates).

END NOTES

In asking for pre-publication comments from colleagues, I was queried as to whether fixed criteria were appropriate to establish abuse. In my opinion, the answer is no. I have not incorporated specific hard and fast rules of thumb except for commission rates. Rather, my premise is that investors should be well informed of their choices. Paying asset-based fees or hiring an asset manager can be easily analyzed, although it rarely is. Yet the decision to hire a manager or to pay an annual fee is every bit as important as any other investment decision. If the customer is kept in the dark on the subject, then the fiduciary duties of the broker mandate the choice most favorable to the investor.

A lawyer or his expert needs to do a comparative analysis to prove that material facts were omitted in presenting the fee-alternative, e.g. that fees over 10 yrs will be $65,000, 3 times that of the projected $22,000 in commissions. If the higher fees can be cost-justified, then

the broker should make that case to the customer instead of making unsupported and misleading claims that there is no difference. Unquestionably, the BD already has done the financial analysis of fee-based accounts and could easily compare fee-based accounts to commission accounts if it chose.

Many colleagues had also raised questions as to why certain abusive activities occur in wrap-fee accounts especially when there is no commission motive. Fee-based accounts are part of a shifting paradigm aimed at annuitizing the revenue stream over the long term. Long-term analysis is the only way to identify the broker's strategy and objectives in fee-based accounts. Since the delta

between commissions and fees grows significantly in the later years we are remiss in failing to highlight that fact. Furthermore, if losses come in the latter years of a fee-based account, failure to analyze the account from its inception can also be misleading. That's because focusing solely on the period in which losses occurred is like trying to understand Moby Dick by reading the middle chapter only.

In sum, determining what is abusive vs. what is suitable is really a comparative question, not a threshold question. Instead of having to prove 6x turnover, we have to illustrate why a fee-based account is unsuitable by comparing projected fees to projected commissions. Over time many fee-based accounts produce fees 3-4 times greater than normal commissions, adding excess risk, reducing growth, and impairing performance. Frequently, the only parties who benefit from fee-based accounts are the broker and the asset-manager. That's a fiduciary breach in my book. Fiduciaries are obliged to place the interests of their customers first.

TABLES AND ILLUSTRATIONS

While my discussion and examples are based upon a 2% fee structure with 5% and 10% growth rates, I am including additional tables (5-12) that illustrate the same comparison for accounts with a 1.5% and 2.5% wrap- fees. Table 13 is a spreadsheet matrix based upon CPI.

Wrap Fee v Commissions Tables		Margin Comparison Tables	
Table 1	5% growth, 2% Fee	Table 2	5% growth, 2% Fee
Table 3	10% growth 2% Fee	Table 4	10% growth, 2% Fee
Table 5	5% growth, 1.5% Fee	Table 6	5% growth, 1.5% Fee
Table 7	10% growth, 1.5% Fee	Table 8	10% growth, 1.5% Fee
Table 9	5% growth, 2.5% Fee	Table 10	5% growth, 2.5% Fee
Table 11	10% growth, 2.5% Fee	Table 12	10% growth, 2.5% Fee
Table 13	CPI Inflator Illustration		
Appendix A A A A	CPI- Why the Published Averages Don't Always Match An Individual's Inflation Experience		

TABLE 1

Comparison Table; Wrap-Fees Accounts vs. Commission-Based Accounts

Initial Investment	200,000		
Turnover	60%	*30% Buys & Sells*	
Commission Rate	1.25%		
Periods/ yr	4		

Appreciation Rate **5.00%** Wrap-Fee **2.00%**

	Wrap-Fee Account			Commission Account				Deltas	
A	B	C	D	E	F	G	H	I	J
Period	Account Value	Wrap-Fee	Cum Wrap-Fee	Account Value	T/O per Period	Comm'n	Cum Comm'n	Wrap-Fee excess over comm'ns	Comm'n acct equity excess over wrap-fee equity
1Q, Yr1	200,000	1,000	1,000	200,000	15.0%	375	375	625	-
2Q, Yr1	201,500	1,008	2,008	202,120	15.0%	379	754	1,254	620
3Q, Yr1	203,011	1,015	3,023	204,263	15.0%	383	1,137	1,886	1,252
4Q, Yr1	204,534	1,023	4,045	206,429	15.0%	387	1,524	2,521	1,895
1Q, Yr2	206,068	1,030	5,076	208,617	15.0%	391	1,915	3,160	2,549
2Q, Yr2	207,613	1,038	6,114	210,829	15.0%	395	2,310	3,803	3,215
3Q, Yr2	209,170	1,046	7,159	213,064	15.0%	399	2,710	4,450	3,893
4Q, Yr2	210,739	1,054	8,213	215,323	15.0%	404	3,114	5,099	4,583
1Q, Yr3	212,320	1,062	9,275	217,605	15.0%	408	3,522	5,753	5,286
2Q, Yr3	213,912	1,070	10,344	219,912	15.0%	412	3,934	6,410	6,000
3Q, Yr3	215,517	1,078	11,422	222,244	15.0%	417	4,351	7,071	6,727
4Q, Yr3	217,133	1,086	12,508	224,600	15.0%	421	4,772	7,736	7,467
1Q, Yr4	218,761	1,094	13,601	226,981	15.0%	426	5,197	8,404	8,220
2Q, Yr4	220,402	1,102	14,703	229,387	15.0%	430	5,628	9,076	8,985
3Q, Yr4	222,055	1,110	15,814	231,819	15.0%	435	6,062	9,751	9,764
4Q, Yr4	223,721	1,119	16,932	234,277	15.0%	439	6,502	10,431	10,556
1Q, Yr5	225,398	1,127	18,059	236,761	15.0%	444	6,945	11,114	11,362
2Q, Yr5	227,089	1,135	19,195	239,271	15.0%	449	7,394	11,801	12,182
3Q, Yr5	228,792	1,144	20,339	241,807	15.0%	453	7,847	12,491	13,015
4Q, Yr5	230,508	1,153	21,491	244,371	15.0%	458	8,306	13,186	13,863
1Q, Yr6	232,237	1,161	22,652	246,962	15.0%	463	8,769	13,884	14,725
2Q, Yr6	233,979	1,170	23,822	249,580	15.0%	468	9,237	14,586	15,601
3Q, Yr6	235,733	1,179	25,001	252,226	15.0%	473	9,710	15,291	16,492
4Q, Yr6	237,501	1,188	26,188	254,900	15.0%	478	10,188	16,001	17,398
1Q, Yr7	239,283	1,196	27,385	257,602	15.0%	483	10,671	16,714	18,319
2Q, Yr7	241,077	1,205	28,590	260,333	15.0%	488	11,159	17,432	19,256
3Q, Yr7	242,885	1,214	29,805	263,093	15.0%	493	11,652	18,153	20,207
4Q, Yr7	244,707	1,224	31,028	265,882	15.0%	499	12,150	18,878	21,175
1Q, Yr8	246,542	1,233	32,261	268,701	15.0%	504	12,654	19,607	22,158
2Q, Yr8	248,391	1,242	33,503	271,549	15.0%	509	13,163	20,339	23,158
3Q, Yr8	250,254	1,251	34,754	274,428	15.0%	515	13,678	21,076	24,174
4Q, Yr8	252,131	1,261	36,015	277,338	15.0%	520	14,198	21,817	25,206
1Q, Yr9	254,022	1,270	37,285	280,278	15.0%	526	14,724	22,561	26,256
2Q, Yr9	255,927	1,280	38,565	283,249	15.0%	531	15,255	23,310	27,322
3Q, Yr9	257,847	1,289	39,854	286,252	15.0%	537	15,791	24,062	28,405
4Q, Yr9	259,781	1,299	41,153	289,287	15.0%	542	16,334	24,819	29,506
1Q, Yr10	261,729	1,309	42,461	292,354	15.0%	548	16,882	25,579	30,625
2Q, Yr10	263,692	1,318	43,780	295,453	15.0%	554	17,436	26,344	31,761
3Q, Yr10	265,670	1,328	45,108	298,585	15.0%	560	17,996	27,112	32,916
4Q, Yr10	267,662	1,338	46,446	301,751	15.0%	566	18,562	27,885	34,089

F= % of portfolio turnover/period — I = D - H

G=Commissions on the total of buy and sell trades as a % of account equity — J = E - B

TABLE 1

TABLE 2

Impact Table: Effect of Margin in Wrap-Fees Account

Initial Investment	200,000	Average Equity %	60%
Commission Rate	1.25%	Margin %	40%
Periods/ yr	4	Margin Interest rate	6.50%

Appreciation Rate **5.00%** Wrap-Fee **2.00%**

	Cash Wrap-Fee			Margin Wrap-Fee Account						% comparison		
A	B	C	D	E	F	G	H	I	J	K	L	M
Period	Account Equity	Wrap-Fee	Cum Wrap-Fee	Portfolio Value	Equity	Wrap-Fee	Margin Interest	Total Annual Account Cost	Cum. Costs	Cum Cost as % of Investment	Annual Equity Hurdle Rate	Margin Wrap -Fee as % of Equity
1Q, Yr1	200,000	1,000	1,000	333,333	200,000	1,667	2,167	3,833	3,833	1.9%	7.67%	3.33%
2Q, Yr1	201,500	1,008	2,008	333,667	200,200	1,668	2,169	3,837	7,671	3.8%	7.67%	3.33%
3Q, Yr1	203,011	1,015	3,023	334,000	200,400	1,670	2,171	3,841	11,512	5.8%	7.67%	3.33%
4Q, Yr1	204,534	1,023	4,045	334,334	200,601	1,672	2,173	3,845	15,356	7.7%	7.67%	3.33%
1Q, Yr2	206,068	1,030	5,076	334,669	200,801	1,673	2,175	3,849	19,205	9.6%	7.67%	3.33%
2Q, Yr2	207,613	1,038	6,114	335,003	201,002	1,675	2,178	3,853	23,058	11.5%	7.67%	3.33%
3Q, Yr2	209,170	1,046	7,159	335,338	201,203	1,677	2,180	3,856	26,914	13.5%	7.67%	3.33%
4Q, Yr2	210,739	1,054	8,213	335,674	201,404	1,678	2,182	3,860	30,774	15.4%	7.67%	3.33%
1Q, Yr3	212,320	1,062	9,275	336,009	201,606	1,680	2,184	3,864	34,638	17.3%	7.67%	3.33%
2Q, Yr3	213,912	1,070	10,344	336,345	201,807	1,682	2,186	3,868	38,506	19.3%	7.67%	3.33%
3Q, Yr3	215,517	1,078	11,422	336,682	202,009	1,683	2,188	3,872	42,378	21.2%	7.67%	3.33%
4Q, Yr3	217,133	1,086	12,508	337,018	202,211	1,685	2,191	3,876	46,254	23.1%	7.67%	3.33%
1Q, Yr4	218,761	1,094	13,601	337,355	202,413	1,687	2,193	3,880	50,133	25.1%	7.67%	3.33%
2Q, Yr4	220,402	1,102	14,703	337,693	202,616	1,688	2,195	3,883	54,017	27.0%	7.67%	3.33%
3Q, Yr4	222,055	1,110	15,814	338,030	202,818	1,690	2,197	3,887	57,904	29.0%	7.67%	3.33%
4Q, Yr4	223,721	1,119	16,932	338,368	203,021	1,692	2,199	3,891	61,795	30.9%	7.67%	3.33%
1Q, Yr5	225,398	1,127	18,059	338,707	203,224	1,694	2,202	3,895	65,691	32.8%	7.67%	3.33%
2Q, Yr5	227,089	1,135	19,195	339,046	203,427	1,695	2,204	3,899	69,590	34.8%	7.67%	3.33%
3Q, Yr5	228,792	1,144	20,339	339,385	203,631	1,697	2,206	3,903	73,493	36.7%	7.67%	3.33%
4Q, Yr5	230,508	1,153	21,491	339,724	203,834	1,699	2,208	3,907	77,399	38.7%	7.67%	3.33%
1Q, Yr6	232,237	1,161	22,652	340,064	204,038	1,700	2,210	3,911	81,310	40.7%	7.67%	3.33%
2Q, Yr6	233,979	1,170	23,822	340,404	204,242	1,702	2,213	3,915	85,225	42.6%	7.67%	3.33%
3Q, Yr6	235,733	1,179	25,001	340,744	204,447	1,704	2,215	3,919	89,143	44.6%	7.67%	3.33%
4Q, Yr6	237,501	1,188	26,188	341,085	204,651	1,705	2,217	3,922	93,066	46.5%	7.67%	3.33%
1Q, Yr7	239,283	1,196	27,385	341,426	204,856	1,707	2,219	3,926	96,992	48.5%	7.67%	3.33%
2Q, Yr7	241,077	1,205	28,590	341,767	205,060	1,709	2,221	3,930	100,923	50.5%	7.67%	3.33%
3Q, Yr7	242,885	1,214	29,805	342,109	205,266	1,711	2,224	3,934	104,857	52.4%	7.67%	3.33%
4Q, Yr7	244,707	1,224	31,028	342,451	205,471	1,712	2,226	3,938	108,795	54.4%	7.67%	3.33%
1Q, Yr8	246,542	1,233	32,261	342,794	205,676	1,714	2,228	3,942	112,737	56.4%	7.67%	3.33%
2Q, Yr8	248,391	1,242	33,503	343,137	205,882	1,716	2,230	3,946	116,683	58.3%	7.67%	3.33%
3Q, Yr8	250,254	1,251	34,754	343,480	206,088	1,717	2,233	3,950	120,633	60.3%	7.67%	3.33%
4Q, Yr8	252,131	1,261	36,015	343,823	206,294	1,719	2,235	3,954	124,587	62.3%	7.67%	3.33%
1Q, Yr9	254,022	1,270	37,285	344,167	206,500	1,721	2,237	3,958	128,545	64.3%	7.67%	3.33%
2Q, Yr9	255,927	1,280	38,565	344,511	206,707	1,723	2,239	3,962	132,507	66.3%	7.67%	3.33%
3Q, Yr9	257,847	1,289	39,854	344,856	206,913	1,724	2,242	3,966	136,473	68.2%	7.67%	3.33%
4Q, Yr9	259,781	1,299	41,153	345,201	207,120	1,726	2,244	3,970	140,443	70.2%	7.67%	3.33%
1Q, Yr10	261,729	1,309	42,461	345,546	207,327	1,728	2,246	3,974	144,416	72.2%	7.67%	3.33%
2Q, Yr10	263,692	1,318	43,780	345,891	207,535	1,729	2,248	3,978	148,394	74.2%	7.67%	3.33%
3Q, Yr10	265,670	1,328	45,108	346,237	207,742	1,731	2,251	3,982	152,376	76.2%	7.67%	3.33%
4Q, Yr10	267,662	1,338	46,446	346,583	207,950	1,733	2,253	3,986	156,362	78.2%	7.67%	3.33%
				Totals		67,983	88,378					

B & F Equity=Portfolio appreciation columns E and B, reduced by previous period's total annual fees and costs, C or I respectively

Comparison Table; Wrap-Fees Accounts vs. Commission-Based Accounts

Initial Investment	200,000		
Turnover	60%	*30% Buys & Sells*	
Commission Rate	1.25%		
Periods/ yr	4		

Appreciation Rate **10.00%** Wrap-Fee **2.00%**

	Wrap-Fee Account			Commission Account				Deltas	
A	B	C	D	E	F	G	H	I	J
Period	Account Value	Wrap-Fee	Cum Wrap-Fee	Account Value	T/O per Period	Comm'n	Cum Comm'n	Wrap-Fee excess over comm'ns	Comm'n acct equity excess over wrap-fee equity
1Q, Yr1	200,000	1,000	1,000	200,000	15.0%	375	375	625	-
2Q, Yr1	204,000	1,020	2,020	204,616	15.0%	384	759	1,261	616
3Q, Yr1	208,080	1,040	3,060	209,338	15.0%	393	1,151	1,909	1,258
4Q, Yr1	212,242	1,061	4,122	214,169	15.0%	402	1,553	2,569	1,927
1Q, Yr2	216,486	1,082	5,204	219,112	15.0%	411	1,964	3,240	2,625
2Q, Yr2	220,816	1,104	6,308	224,168	15.0%	420	2,384	3,924	3,352
3Q, Yr2	225,232	1,126	7,434	229,342	15.0%	430	2,814	4,620	4,109
4Q, Yr2	229,737	1,149	8,583	234,634	15.0%	440	3,254	5,329	4,897
1Q, Yr3	234,332	1,172	9,755	240,049	15.0%	450	3,704	6,051	5,717
2Q, Yr3	239,019	1,195	10,950	245,589	15.0%	460	4,164	6,785	6,571
3Q, Yr3	243,799	1,219	12,169	251,257	15.0%	471	4,636	7,533	7,458
4Q, Yr3	248,675	1,243	13,412	257,055	15.0%	482	5,117	8,295	8,381
1Q, Yr4	253,648	1,268	14,680	262,988	15.0%	493	5,611	9,070	9,339
2Q, Yr4	258,721	1,294	15,974	269,057	15.0%	504	6,115	9,859	10,336
3Q, Yr4	263,896	1,319	17,293	275,266	15.0%	516	6,631	10,662	11,371
4Q, Yr4	269,174	1,346	18,639	281,619	15.0%	528	7,159	11,480	12,445
1Q, Yr5	274,557	1,373	20,012	288,118	15.0%	540	7,699	12,313	13,561
2Q, Yr5	280,048	1,400	21,412	294,767	15.0%	553	8,252	13,160	14,719
3Q, Yr5	285,649	1,428	22,841	301,570	15.0%	565	8,818	14,023	15,921
4Q, Yr5	291,362	1,457	24,297	308,530	15.0%	578	9,396	14,901	17,168
1Q, Yr6	297,189	1,486	25,783	315,650	15.0%	592	9,988	15,795	18,461
2Q, Yr6	303,133	1,516	27,299	322,935	15.0%	606	10,593	16,706	19,801
3Q, Yr6	309,196	1,546	28,845	330,387	15.0%	619	11,213	17,632	21,192
4Q, Yr6	315,380	1,577	30,422	338,012	15.0%	634	11,847	18,575	22,632
1Q, Yr7	321,687	1,608	32,030	345,813	15.0%	648	12,495	19,535	24,125
2Q, Yr7	328,121	1,641	33,671	353,794	15.0%	663	13,158	20,512	25,672
3Q, Yr7	334,684	1,673	35,344	361,958	15.0%	679	13,837	21,507	27,275
4Q, Yr7	341,377	1,707	37,051	370,312	15.0%	694	14,531	22,520	28,935
1Q, Yr8	348,205	1,741	38,792	378,858	15.0%	710	15,242	23,550	30,653
2Q, Yr8	355,169	1,776	40,568	387,601	15.0%	727	15,969	24,600	32,432
3Q, Yr8	362,272	1,811	42,379	396,546	15.0%	744	16,712	25,667	34,274
4Q, Yr8	369,518	1,848	44,227	405,698	15.0%	761	17,473	26,754	36,180
1Q, Yr9	376,908	1,885	46,112	415,061	15.0%	778	18,251	27,861	38,153
2Q, Yr9	384,446	1,922	48,034	424,639	15.0%	796	19,047	28,987	40,193
3Q, Yr9	392,135	1,961	49,994	434,439	15.0%	815	19,862	30,133	42,304
4Q, Yr9	399,978	2,000	51,994	444,465	15.0%	833	20,695	31,299	44,487
1Q, Yr10	407,977	2,040	54,034	454,723	15.0%	853	21,548	32,486	46,745
2Q, Yr10	416,137	2,081	56,115	465,217	15.0%	872	22,420	33,695	49,080
3Q, Yr10	424,460	2,122	58,237	475,953	15.0%	892	23,312	34,925	51,494
4Q, Yr10	432,949	2,165	60,402	486,937	15.0%	913	24,225	36,177	53,988

F= % of portfolio turnover/period I = D - H

G=Commissions on the total of buy and sell trades as a % of account equity J = E - B

TABLE 4

Impact Table: Effect of Margin in Wrap-Fees Account

Initial Investment	200,000	Average Equity %	60%
Commission Rate	1.25%	Margin %	40%
Periods/ yr	4	Margin Interest rate	6.50%

Appreciation Rate **10.00%** Wrap-Fee **2.00%**

	Cash Wrap-Fee			Margin Wrap-Fee Account						% comparison		
A	B	C	D	E	F	G	H	I	J	K	L	M
Period	Account Equity	Wrap-Fee	Cum Wrap-Fee	Portfolio Value	Equity	Wrap-Fee	Margin Interest	Total Annual Account Cost	Cum. Costs	Cum Cost as % of Investment	Annual Equity Hurdle Rate	Margin Wrap -Fee as % of Equity
1Q, Yr1	200,000	1,000	1,000	333,333	200,000	1,667	2,167	3,833	3,833	1.9%	7.67%	3.33%
2Q, Yr1	204,000	1,020	2,020	337,833	202,700	1,689	2,196	3,885	7,718	3.9%	7.67%	3.33%
3Q, Yr1	208,080	1,040	3,060	342,394	205,436	1,712	2,226	3,938	11,656	5.8%	7.67%	3.33%
4Q, Yr1	212,242	1,061	4,122	347,016	208,210	1,735	2,256	3,991	15,647	7.8%	7.67%	3.33%
1Q, Yr2	216,486	1,082	5,204	351,701	211,021	1,759	2,286	4,045	19,691	9.8%	7.67%	3.33%
2Q, Yr2	220,816	1,104	6,308	356,449	213,869	1,782	2,317	4,099	23,790	11.9%	7.67%	3.33%
3Q, Yr2	225,232	1,126	7,434	361,261	216,757	1,806	2,348	4,155	27,945	14.0%	7.67%	3.33%
4Q, Yr2	229,737	1,149	8,583	366,138	219,683	1,831	2,380	4,211	32,155	16.1%	7.67%	3.33%
1Q, Yr3	234,332	1,172	9,755	371,081	222,649	1,855	2,412	4,267	36,423	18.2%	7.67%	3.33%
2Q, Yr3	239,019	1,195	10,950	376,091	225,654	1,880	2,445	4,325	40,748	20.4%	7.67%	3.33%
3Q, Yr3	243,799	1,219	12,169	381,168	228,701	1,906	2,478	4,383	45,131	22.6%	7.67%	3.33%
4Q, Yr3	248,675	1,243	13,412	386,314	231,788	1,932	2,511	4,443	49,574	24.8%	7.67%	3.33%
1Q, Yr4	253,648	1,268	14,680	391,529	234,917	1,958	2,545	4,503	54,077	27.0%	7.67%	3.33%
2Q, Yr4	258,721	1,294	15,974	396,815	238,089	1,984	2,579	4,563	58,640	29.3%	7.67%	3.33%
3Q, Yr4	263,896	1,319	17,293	402,171	241,303	2,011	2,614	4,625	63,265	31.6%	7.67%	3.33%
4Q, Yr4	269,174	1,346	18,639	407,601	244,560	2,038	2,649	4,687	67,952	34.0%	7.67%	3.33%
1Q, Yr5	274,557	1,373	20,012	413,103	247,862	2,066	2,685	4,751	72,703	36.4%	7.67%	3.33%
2Q, Yr5	280,048	1,400	21,412	418,680	251,208	2,093	2,721	4,815	77,518	38.8%	7.67%	3.33%
3Q, Yr5	285,649	1,428	22,841	424,333	254,600	2,122	2,758	4,880	82,398	41.2%	7.67%	3.33%
4Q, Yr5	291,362	1,457	24,297	430,061	258,037	2,150	2,795	4,946	87,343	43.7%	7.67%	3.33%
1Q, Yr6	297,189	1,486	25,783	435,867	261,520	2,179	2,833	5,012	92,356	46.2%	7.67%	3.33%
2Q, Yr6	303,133	1,516	27,299	441,751	265,051	2,209	2,871	5,080	97,436	48.7%	7.67%	3.33%
3Q, Yr6	309,196	1,546	28,845	447,715	268,629	2,239	2,910	5,149	102,585	51.3%	7.67%	3.33%
4Q, Yr6	315,380	1,577	30,422	453,759	272,255	2,269	2,949	5,218	107,803	53.9%	7.67%	3.33%
1Q, Yr7	321,687	1,608	32,030	459,885	275,931	2,299	2,989	5,289	113,092	56.5%	7.67%	3.33%
2Q, Yr7	328,121	1,641	33,671	466,093	279,656	2,330	3,030	5,360	118,452	59.2%	7.67%	3.33%
3Q, Yr7	334,684	1,673	35,344	472,385	283,431	2,362	3,071	5,432	123,884	61.9%	7.67%	3.33%
4Q, Yr7	341,377	1,707	37,051	478,762	287,257	2,394	3,112	5,506	129,390	64.7%	7.67%	3.33%
1Q, Yr8	348,205	1,741	38,792	485,226	291,135	2,426	3,154	5,580	134,970	67.5%	7.67%	3.33%
2Q, Yr8	355,169	1,776	40,568	491,776	295,066	2,459	3,197	5,655	140,625	70.3%	7.67%	3.33%
3Q, Yr8	362,272	1,811	42,379	498,415	299,049	2,492	3,240	5,732	146,357	73.2%	7.67%	3.33%
4Q, Yr8	369,518	1,848	44,227	505,144	303,086	2,526	3,283	5,809	152,166	76.1%	7.67%	3.33%
1Q, Yr9	376,908	1,885	46,112	511,963	307,178	2,560	3,328	5,888	158,054	79.0%	7.67%	3.33%
2Q, Yr9	384,446	1,922	48,034	518,875	311,325	2,594	3,373	5,967	164,021	82.0%	7.67%	3.33%
3Q, Yr9	392,135	1,961	49,994	525,880	315,528	2,629	3,418	6,048	170,069	85.0%	7.67%	3.33%
4Q, Yr9	399,978	2,000	51,994	532,979	319,787	2,665	3,464	6,129	176,198	88.1%	7.67%	3.33%
1Q, Yr10	407,977	2,040	54,034	540,174	324,105	2,701	3,511	6,212	182,410	91.2%	7.67%	3.33%
2Q, Yr10	416,137	2,081	56,115	547,467	328,480	2,737	3,559	6,296	188,706	94.4%	7.67%	3.33%
3Q, Yr10	424,460	2,122	58,237	554,857	332,914	2,774	3,607	6,381	195,087	97.5%	7.67%	3.33%
4Q, Yr10	432,949	2,165	60,402	562,348	337,409	2,812	3,655	6,467	201,554	100.8%	7.67%	3.33%
				Totals		87,632	113,922					

B & F Equity=Portfolio appreciation columns E and B, reduced by previous period's total annual fees and costs, C or I respectively

Comparison Table; Wrap-Fees Accounts vs. Commission-Based Accounts

Initial Investment	200,000		Appreciation Rate **5.00%**	Wrap-Fee **1.50%**
Turnover	60%	*30% Buys & Sells*		
Commission Rate	1.25%			
Periods/ yr	4			

	Wrap-Fee Account			Commission Account				Deltas	
A	B	C	D	E	F	G	H	I	J
Period	Account Value	Wrap-Fee	Cum Wrap-Fee	Account Value	T/O per Period	Comm'n	Cum Comm'n	Wrap-Fee excess over comm'ns	Comm'n acct equity excess over wrap-fee equity
1Q, Yr1	200,000	750	750	200,000	15.0%	375	375	375	-
2Q, Yr1	201,750	757	1,507	202,120	15.0%	379	754	753	370
3Q, Yr1	203,515	763	2,270	204,263	15.0%	383	1,137	1,133	748
4Q, Yr1	205,296	770	3,040	206,429	15.0%	387	1,524	1,516	1,133
1Q, Yr2	207,092	777	3,816	208,617	15.0%	391	1,915	1,901	1,525
2Q, Yr2	208,904	783	4,600	210,829	15.0%	395	2,310	2,289	1,924
3Q, Yr2	210,732	790	5,390	213,064	15.0%	399	2,710	2,680	2,331
4Q, Yr2	212,576	797	6,187	215,323	15.0%	404	3,114	3,073	2,746
1Q, Yr3	214,436	804	6,991	217,605	15.0%	408	3,522	3,469	3,169
2Q, Yr3	216,313	811	7,802	219,912	15.0%	412	3,934	3,868	3,600
3Q, Yr3	218,205	818	8,621	222,244	15.0%	417	4,351	4,270	4,038
4Q, Yr3	220,115	825	9,446	224,600	15.0%	421	4,772	4,674	4,485
1Q, Yr4	222,041	833	10,279	226,981	15.0%	426	5,197	5,081	4,940
2Q, Yr4	223,984	840	11,119	229,387	15.0%	430	5,628	5,491	5,404
3Q, Yr4	225,943	847	11,966	231,819	15.0%	435	6,062	5,904	5,876
4Q, Yr4	227,920	855	12,821	234,277	15.0%	439	6,502	6,319	6,356
1Q, Yr5	229,915	862	13,683	236,761	15.0%	444	6,945	6,737	6,846
2Q, Yr5	231,926	870	14,552	239,271	15.0%	449	7,394	7,158	7,344
3Q, Yr5	233,956	877	15,430	241,807	15.0%	453	7,847	7,582	7,851
4Q, Yr5	236,003	885	16,315	244,371	15.0%	458	8,306	8,009	8,368
1Q, Yr6	238,068	893	17,208	246,962	15.0%	463	8,769	8,439	8,894
2Q, Yr6	240,151	901	18,108	249,580	15.0%	468	9,237	8,871	9,429
3Q, Yr6	242,252	908	19,017	252,226	15.0%	473	9,710	9,307	9,973
4Q, Yr6	244,372	916	19,933	254,900	15.0%	478	10,188	9,745	10,528
1Q, Yr7	246,510	924	20,857	257,602	15.0%	483	10,671	10,187	11,092
2Q, Yr7	248,667	933	21,790	260,333	15.0%	488	11,159	10,631	11,666
3Q, Yr7	250,843	941	22,731	263,093	15.0%	493	11,652	11,079	12,250
4Q, Yr7	253,038	949	23,679	265,882	15.0%	499	12,150	11,529	12,844
1Q, Yr8	255,252	957	24,637	268,701	15.0%	504	12,654	11,982	13,449
2Q, Yr8	257,486	966	25,602	271,549	15.0%	509	13,163	12,439	14,064
3Q, Yr8	259,739	974	26,576	274,428	15.0%	515	13,678	12,898	14,690
4Q, Yr8	262,011	983	27,559	277,338	15.0%	520	14,198	13,361	15,326
1Q, Yr9	264,304	991	28,550	280,278	15.0%	526	14,724	13,826	15,974
2Q, Yr9	266,617	1,000	29,550	283,249	15.0%	531	15,255	14,295	16,633
3Q, Yr9	268,949	1,009	30,558	286,252	15.0%	537	15,791	14,767	17,303
4Q, Yr9	271,303	1,017	31,576	289,287	15.0%	542	16,334	15,242	17,984
1Q, Yr10	273,677	1,026	32,602	292,354	15.0%	548	16,882	15,720	18,677
2Q, Yr10	276,071	1,035	33,637	295,453	15.0%	554	17,436	16,201	19,382
3Q, Yr10	278,487	1,044	34,682	298,585	15.0%	560	17,996	16,686	20,099
4Q, Yr10	280,924	1,053	35,735	301,751	15.0%	566	18,562	17,174	20,827

F= % of portfolio turnover/period

I = D - H

G=Commissions on the total of buy and sell trades as a % of account equity

J = E - B

TABLE 6

Impact Table: Effect of Margin in Wrap-Fees Account

Initial Investment	200,000	Average Equity %	60%
Commission Rate	1.25%	Margin %	40%
Periods/ yr	4	Margin Interest rate	6.50%

Appreciation Rate **5.00%** Wrap-Fee **1.50%**

	Cash Wrap-Fee			Margin Wrap-Fee Account						% comparison		
A	B	C	D	E	F	G	H	I	J	K	L	M
Period	Account Equity	Wrap-Fee	Cum Wrap-Fee	Portfolio Value	Equity	Wrap-Fee	Margin Interest	Total Annual Account Cost	Cum. Costs	Cum Cost as % of Investment	Annual Equity Hurdle Rate	Margin Wrap -Fee as % of Equity
1Q, Yr1	200,000	750	750	333,333	200,000	1,250	2,167	3,417	3,417	1.7%	6.83%	2.50%
2Q, Yr1	201,750	757	1,507	334,083	200,450	1,253	2,172	3,424	6,841	3.4%	6.83%	2.50%
3Q, Yr1	203,515	763	2,270	334,835	200,901	1,256	2,176	3,432	10,273	5.1%	6.83%	2.50%
4Q, Yr1	205,296	770	3,040	335,588	201,353	1,258	2,181	3,440	13,713	6.9%	6.83%	2.50%
1Q, Yr2	207,092	777	3,816	336,343	201,806	1,261	2,186	3,448	17,160	8.6%	6.83%	2.50%
2Q, Yr2	208,904	783	4,600	337,100	202,260	1,264	2,191	3,455	20,616	10.3%	6.83%	2.50%
3Q, Yr2	210,732	790	5,390	337,859	202,715	1,267	2,196	3,463	24,079	12.0%	6.83%	2.50%
4Q, Yr2	212,576	797	6,187	338,619	203,171	1,270	2,201	3,471	27,550	13.8%	6.83%	2.50%
1Q, Yr3	214,436	804	6,991	339,381	203,628	1,273	2,206	3,479	31,028	15.5%	6.83%	2.50%
2Q, Yr3	216,313	811	7,802	340,144	204,087	1,276	2,211	3,486	34,515	17.3%	6.83%	2.50%
3Q, Yr3	218,205	818	8,621	340,910	204,546	1,278	2,216	3,494	38,009	19.0%	6.83%	2.50%
4Q, Yr3	220,115	825	9,446	341,677	205,006	1,281	2,221	3,502	41,511	20.8%	6.83%	2.50%
1Q, Yr4	222,041	833	10,279	342,446	205,467	1,284	2,226	3,510	45,021	22.5%	6.83%	2.50%
2Q, Yr4	223,984	840	11,119	343,216	205,930	1,287	2,231	3,518	48,539	24.3%	6.83%	2.50%
3Q, Yr4	225,943	847	11,966	343,988	206,393	1,290	2,236	3,526	52,065	26.0%	6.83%	2.50%
4Q, Yr4	227,920	855	12,821	344,762	206,857	1,293	2,241	3,534	55,599	27.8%	6.83%	2.50%
1Q, Yr5	229,915	862	13,683	345,538	207,323	1,296	2,246	3,542	59,141	29.6%	6.83%	2.50%
2Q, Yr5	231,926	870	14,552	346,315	207,789	1,299	2,251	3,550	62,690	31.3%	6.83%	2.50%
3Q, Yr5	233,956	877	15,430	347,095	208,257	1,302	2,256	3,558	66,248	33.1%	6.83%	2.50%
4Q, Yr5	236,003	885	16,315	347,876	208,725	1,305	2,261	3,566	69,814	34.9%	6.83%	2.50%
1Q, Yr6	238,068	893	17,208	348,658	209,195	1,307	2,266	3,574	73,388	36.7%	6.83%	2.50%
2Q, Yr6	240,151	901	18,108	349,443	209,666	1,310	2,271	3,582	76,969	38.5%	6.83%	2.50%
3Q, Yr6	242,252	908	19,017	350,229	210,137	1,313	2,276	3,590	80,559	40.3%	6.83%	2.50%
4Q, Yr6	244,372	916	19,933	351,017	210,610	1,316	2,282	3,598	84,157	42.1%	6.83%	2.50%
1Q, Yr7	246,510	924	20,857	351,807	211,084	1,319	2,287	3,606	87,763	43.9%	6.83%	2.50%
2Q, Yr7	248,667	933	21,790	352,598	211,559	1,322	2,292	3,614	91,377	45.7%	6.83%	2.50%
3Q, Yr7	250,843	941	22,731	353,392	212,035	1,325	2,297	3,622	95,000	47.5%	6.83%	2.50%
4Q, Yr7	253,038	949	23,679	354,187	212,512	1,328	2,302	3,630	98,630	49.3%	6.83%	2.50%
1Q, Yr8	255,252	957	24,637	354,984	212,990	1,331	2,307	3,639	102,269	51.1%	6.83%	2.50%
2Q, Yr8	257,486	966	25,602	355,783	213,470	1,334	2,313	3,647	105,915	53.0%	6.83%	2.50%
3Q, Yr8	259,739	974	26,576	356,583	213,950	1,337	2,318	3,655	109,570	54.8%	6.83%	2.50%
4Q, Yr8	262,011	983	27,559	357,385	214,431	1,340	2,323	3,663	113,234	56.6%	6.83%	2.50%
1Q, Yr9	264,304	991	28,550	358,189	214,914	1,343	2,328	3,671	116,905	58.5%	6.83%	2.50%
2Q, Yr9	266,617	1,000	29,550	358,995	215,397	1,346	2,333	3,680	120,585	60.3%	6.83%	2.50%
3Q, Yr9	268,949	1,009	30,558	359,803	215,882	1,349	2,339	3,688	124,273	62.1%	6.83%	2.50%
4Q, Yr9	271,303	1,017	31,576	360,613	216,368	1,352	2,344	3,696	127,969	64.0%	6.83%	2.50%
1Q, Yr10	273,677	1,026	32,602	361,424	216,854	1,355	2,349	3,705	131,674	65.8%	6.83%	2.50%
2Q, Yr10	276,071	1,035	33,637	362,237	217,342	1,358	2,355	3,713	135,386	67.7%	6.83%	2.50%
3Q, Yr10	278,487	1,044	34,682	363,052	217,831	1,361	2,360	3,721	139,108	69.6%	6.83%	2.50%
4Q, Yr10	280,924	1,053	35,735	363,869	218,322	1,365	2,365	3,730	142,837	71.4%	6.83%	2.50%
						Totals	52,258	90,580				

B & F Equity=Portfolio appreciation columns E and B, reduced by previous period's total annual fees and costs, C or I respectively

Comparison Table; Wrap-Fees Accounts vs. Commission-Based Accounts

Initial Investment	200,000		Appreciation Rate **10.00%**	Wrap-Fee **1.50%**	
Turnover	60%	*30% Buys & Sells*			
Commission Rate	1.25%				
Periods/ yr	4				

	Wrap-Fee Account			Commission Account				Deltas	
A	B	C	D	E	F	G	H	I	J
Period	Account Value	Wrap-Fee	Cum Wrap-Fee	Account Value	T/O per Period	Comm'n	Cum Comm'n	Wrap-Fee excess over comm'ns	Comm'n acct equity excess over wrap-fee equity
1Q, Yr1	200,000	750	750	200,000	15.0%	375	375	375	-
2Q, Yr1	204,250	766	1,516	204,616	15.0%	384	759	757	366
3Q, Yr1	208,590	782	2,298	209,338	15.0%	393	1,151	1,147	747
4Q, Yr1	213,023	799	3,097	214,169	15.0%	402	1,553	1,544	1,146
1Q, Yr2	217,550	816	3,913	219,112	15.0%	411	1,964	1,949	1,562
2Q, Yr2	222,173	833	4,746	224,168	15.0%	420	2,384	2,362	1,996
3Q, Yr2	226,894	851	5,597	229,342	15.0%	430	2,814	2,783	2,448
4Q, Yr2	231,715	869	6,466	234,634	15.0%	440	3,254	3,212	2,919
1Q, Yr3	236,639	887	7,353	240,049	15.0%	450	3,704	3,649	3,410
2Q, Yr3	241,668	906	8,259	245,589	15.0%	460	4,164	4,095	3,921
3Q, Yr3	246,803	926	9,185	251,257	15.0%	471	4,636	4,549	4,454
4Q, Yr3	252,048	945	10,130	257,055	15.0%	482	5,117	5,013	5,008
1Q, Yr4	257,404	965	11,095	262,988	15.0%	493	5,611	5,485	5,584
2Q, Yr4	262,874	986	12,081	269,057	15.0%	504	6,115	5,966	6,183
3Q, Yr4	268,460	1,007	13,088	275,266	15.0%	516	6,631	6,457	6,807
4Q, Yr4	274,164	1,028	14,116	281,619	15.0%	528	7,159	6,957	7,455
1Q, Yr5	279,990	1,050	15,166	288,118	15.0%	540	7,699	7,466	8,128
2Q, Yr5	285,940	1,072	16,238	294,767	15.0%	553	8,252	7,986	8,827
3Q, Yr5	292,016	1,095	17,333	301,570	15.0%	565	8,818	8,516	9,554
4Q, Yr5	298,222	1,118	18,452	308,530	15.0%	578	9,396	9,055	10,308
1Q, Yr6	304,559	1,142	19,594	315,650	15.0%	592	9,988	9,606	11,091
2Q, Yr6	311,031	1,166	20,760	322,935	15.0%	606	10,593	10,167	11,904
3Q, Yr6	317,640	1,191	21,951	330,387	15.0%	619	11,213	10,738	12,747
4Q, Yr6	324,390	1,216	23,168	338,012	15.0%	634	11,847	11,321	13,622
1Q, Yr7	331,283	1,242	24,410	345,813	15.0%	648	12,495	11,915	14,529
2Q, Yr7	338,323	1,269	25,679	353,794	15.0%	663	13,158	12,520	15,470
3Q, Yr7	345,513	1,296	26,974	361,958	15.0%	679	13,837	13,137	16,446
4Q, Yr7	352,855	1,323	28,298	370,312	15.0%	694	14,531	13,766	17,457
1Q, Yr8	360,353	1,351	29,649	378,858	15.0%	710	15,242	14,407	18,505
2Q, Yr8	368,010	1,380	31,029	387,601	15.0%	727	15,969	15,060	19,591
3Q, Yr8	375,831	1,409	32,438	396,546	15.0%	744	16,712	15,726	20,716
4Q, Yr8	383,817	1,439	33,878	405,698	15.0%	761	17,473	16,405	21,881
1Q, Yr9	391,973	1,470	35,347	415,061	15.0%	778	18,251	17,096	23,088
2Q, Yr9	400,302	1,501	36,849	424,639	15.0%	796	19,047	17,801	24,337
3Q, Yr9	408,809	1,533	38,382	434,439	15.0%	815	19,862	18,520	25,630
4Q, Yr9	417,496	1,566	39,947	444,465	15.0%	833	20,695	19,252	26,969
1Q, Yr10	426,368	1,599	41,546	454,723	15.0%	853	21,548	19,998	28,355
2Q, Yr10	435,428	1,633	43,179	465,217	15.0%	872	22,420	20,759	29,789
3Q, Yr10	444,681	1,668	44,847	475,953	15.0%	892	23,312	21,534	31,272
4Q, Yr10	454,131	1,703	46,550	486,937	15.0%	913	24,225	22,324	32,807

F= % of portfolio turnover/period — I = D - H

G=Commissions on the total of buy and sell trades as a % of account equity — J = E - B

TABLE 8

Impact Table: Effect of Margin in Wrap-Fees Account

Initial Investment	200,000	Average Equity %	60%
Commission Rate	1.25%	Margin %	40%
Periods/ yr	4	Margin Interest rate	6.50%

Appreciation Rate **10.00%** Wrap-Fee **1.50%**

	Cash Wrap-Fee			Margin Wrap-Fee Account						% comparison		
A	B	C	D	E	F	G	H	I	J	K	L	M
Period	Account Equity	Wrap-Fee	Cum Wrap-Fee	Portfolio Value	Equity	Wrap-Fee	Margin Interest	Total Annual Account Cost	Cum. Costs	Cum Cost as % of Investment	Annual Equity Hurdle Rate	Margin Wrap -Fee as % of Equity
1Q, Yr1	200,000	750	750	333,333	200,000	1,250	2,167	3,417	3,417	1.7%	6.83%	2.50%
2Q, Yr1	204,250	766	1,516	338,250	202,950	1,268	2,199	3,467	6,884	3.4%	6.83%	2.50%
3Q, Yr1	208,590	782	2,298	343,239	205,944	1,287	2,231	3,518	10,402	5.2%	6.83%	2.50%
4Q, Yr1	213,023	799	3,097	348,302	208,981	1,306	2,264	3,570	13,972	7.0%	6.83%	2.50%
1Q, Yr2	217,550	816	3,913	353,439	212,064	1,325	2,297	3,623	17,595	8.8%	6.83%	2.50%
2Q, Yr2	222,173	833	4,746	358,653	215,192	1,345	2,331	3,676	21,271	10.6%	6.83%	2.50%
3Q, Yr2	226,894	851	5,597	363,943	218,366	1,365	2,366	3,730	25,001	12.5%	6.83%	2.50%
4Q, Yr2	231,715	869	6,466	369,311	221,587	1,385	2,401	3,785	28,787	14.4%	6.83%	2.50%
1Q, Yr3	236,639	887	7,353	374,758	224,855	1,405	2,436	3,841	32,628	16.3%	6.83%	2.50%
2Q, Yr3	241,668	906	8,259	380,286	228,172	1,426	2,472	3,898	36,526	18.3%	6.83%	2.50%
3Q, Yr3	246,803	926	9,185	385,895	231,537	1,447	2,508	3,955	40,481	20.2%	6.83%	2.50%
4Q, Yr3	252,048	945	10,130	391,587	234,952	1,468	2,545	4,014	44,495	22.2%	6.83%	2.50%
1Q, Yr4	257,404	965	11,095	397,363	238,418	1,490	2,583	4,073	48,568	24.3%	6.83%	2.50%
2Q, Yr4	262,874	986	12,081	403,224	241,934	1,512	2,621	4,133	52,701	26.4%	6.83%	2.50%
3Q, Yr4	268,460	1,007	13,088	409,172	245,503	1,534	2,660	4,194	56,895	28.4%	6.83%	2.50%
4Q, Yr4	274,164	1,028	14,116	415,207	249,124	1,557	2,699	4,256	61,151	30.6%	6.83%	2.50%
1Q, Yr5	279,990	1,050	15,166	421,331	252,799	1,580	2,739	4,319	65,470	32.7%	6.83%	2.50%
2Q, Yr5	285,940	1,072	16,238	427,546	256,528	1,603	2,779	4,382	69,852	34.9%	6.83%	2.50%
3Q, Yr5	292,016	1,095	17,333	433,852	260,311	1,627	2,820	4,447	74,299	37.1%	6.83%	2.50%
4Q, Yr5	298,222	1,118	18,452	440,252	264,151	1,651	2,862	4,513	78,812	39.4%	6.83%	2.50%
1Q, Yr6	304,559	1,142	19,594	446,745	268,047	1,675	2,904	4,579	83,391	41.7%	6.83%	2.50%
2Q, Yr6	311,031	1,166	20,760	453,335	272,001	1,700	2,947	4,647	88,037	44.0%	6.83%	2.50%
3Q, Yr6	317,640	1,191	21,951	460,021	276,013	1,725	2,990	4,715	92,753	46.4%	6.83%	2.50%
4Q, Yr6	324,390	1,216	23,168	466,807	280,084	1,751	3,034	4,785	97,537	48.8%	6.83%	2.50%
1Q, Yr7	331,283	1,242	24,410	473,692	284,215	1,776	3,079	4,855	102,393	51.2%	6.83%	2.50%
2Q, Yr7	338,323	1,269	25,679	480,679	288,407	1,803	3,124	4,927	107,320	53.7%	6.83%	2.50%
3Q, Yr7	345,513	1,296	26,974	487,769	292,661	1,829	3,170	5,000	112,319	56.2%	6.83%	2.50%
4Q, Yr7	352,855	1,323	28,298	494,964	296,978	1,856	3,217	5,073	117,393	58.7%	6.83%	2.50%
1Q, Yr8	360,353	1,351	29,649	502,264	301,359	1,883	3,265	5,148	122,541	61.3%	6.83%	2.50%
2Q, Yr8	368,010	1,380	31,029	509,673	305,804	1,911	3,313	5,224	127,765	63.9%	6.83%	2.50%
3Q, Yr8	375,831	1,409	32,438	517,191	310,314	1,939	3,362	5,301	133,066	66.5%	6.83%	2.50%
4Q, Yr8	383,817	1,439	33,878	524,819	314,891	1,968	3,411	5,379	138,446	69.2%	6.83%	2.50%
1Q, Yr9	391,973	1,470	35,347	532,560	319,536	1,997	3,462	5,459	143,904	72.0%	6.83%	2.50%
2Q, Yr9	400,302	1,501	36,849	540,415	324,249	2,027	3,513	5,539	149,444	74.7%	6.83%	2.50%
3Q, Yr9	408,809	1,533	38,382	548,387	329,032	2,056	3,565	5,621	155,065	77.5%	6.83%	2.50%
4Q, Yr9	417,496	1,566	39,947	556,475	333,885	2,087	3,617	5,704	160,769	80.4%	6.83%	2.50%
1Q, Yr10	426,368	1,599	41,546	564,683	338,810	2,118	3,670	5,788	166,557	83.3%	6.83%	2.50%
2Q, Yr10	435,428	1,633	43,179	573,012	343,807	2,149	3,725	5,873	172,430	86.2%	6.83%	2.50%
3Q, Yr10	444,681	1,668	44,847	581,464	348,879	2,180	3,780	5,960	178,390	89.2%	6.83%	2.50%
4Q, Yr10	454,131	1,703	46,550	590,041	354,025	2,213	3,835	6,048	184,438	92.2%	6.83%	1.50%
					Totals	67,477	116,961					

B & F Equity=Portfolio appreciation columns E and B, reduced by previous period's total annual fees and costs, C or I respectively

Comparison Table; Wrap-Fees Accounts vs. Commission-Based Accounts

			Appreciation Rate **5.00%**	Wrap-Fee **2.50%**
Initial Investment	200,000			
Turnover	60%	*30% Buys & Sells*		
Commission Rate	1.25%			
Periods/ yr	4			

	Wrap-Fee Account			Commission Account				Deltas	
A	B	C	D	E	F	G	H	I	J
Period	Account Value	Wrap-Fee	Cum Wrap-Fee	Account Value	T/O per Period	Comm'n	Cum Comm'n	Wrap-Fee excess over comm'ns	Comm'n acct equity excess over wrap-fee equity
1Q, Yr1	200,000	1,250	1,250	200,000	15.0%	375	375	875	-
2Q, Yr1	201,250	1,258	2,508	202,120	15.0%	379	754	1,754	870
3Q, Yr1	202,508	1,266	3,773	204,263	15.0%	383	1,137	2,637	1,755
4Q, Yr1	203,773	1,274	5,047	206,429	15.0%	387	1,524	3,523	2,655
1Q, Yr2	205,047	1,282	6,329	208,617	15.0%	391	1,915	4,413	3,570
2Q, Yr2	206,329	1,290	7,618	210,829	15.0%	395	2,310	5,308	4,500
3Q, Yr2	207,618	1,298	8,916	213,064	15.0%	399	2,710	6,206	5,446
4Q, Yr2	208,916	1,306	10,222	215,323	15.0%	404	3,114	7,108	6,407
1Q, Yr3	210,222	1,314	11,535	217,605	15.0%	408	3,522	8,014	7,384
2Q, Yr3	211,535	1,322	12,857	219,912	15.0%	412	3,934	8,923	8,377
3Q, Yr3	212,857	1,330	14,188	222,244	15.0%	417	4,351	9,837	9,386
4Q, Yr3	214,188	1,339	15,527	224,600	15.0%	421	4,772	10,755	10,412
1Q, Yr4	215,527	1,347	16,874	226,981	15.0%	426	5,197	11,676	11,455
2Q, Yr4	216,874	1,355	18,229	229,387	15.0%	430	5,628	12,601	12,514
3Q, Yr4	218,229	1,364	19,593	231,819	15.0%	435	6,062	13,531	13,590
4Q, Yr4	219,593	1,372	20,965	234,277	15.0%	439	6,502	14,464	14,684
1Q, Yr5	220,965	1,381	22,346	236,761	15.0%	444	6,945	15,401	15,795
2Q, Yr5	222,346	1,390	23,736	239,271	15.0%	449	7,394	16,342	16,924
3Q, Yr5	223,736	1,398	25,134	241,807	15.0%	453	7,847	17,287	18,071
4Q, Yr5	225,134	1,407	26,542	244,371	15.0%	458	8,306	18,236	19,236
1Q, Yr6	226,542	1,416	27,957	246,962	15.0%	463	8,769	19,189	20,420
2Q, Yr6	227,957	1,425	29,382	249,580	15.0%	468	9,237	20,146	21,622
3Q, Yr6	229,382	1,434	30,816	252,226	15.0%	473	9,710	21,106	22,843
4Q, Yr6	230,816	1,443	32,258	254,900	15.0%	478	10,188	22,071	24,084
1Q, Yr7	232,258	1,452	33,710	257,602	15.0%	483	10,671	23,039	25,344
2Q, Yr7	233,710	1,461	35,171	260,333	15.0%	488	11,159	24,012	26,623
3Q, Yr7	235,171	1,470	36,641	263,093	15.0%	493	11,652	24,989	27,922
4Q, Yr7	236,641	1,479	38,120	265,882	15.0%	499	12,150	25,969	29,242
1Q, Yr8	238,120	1,488	39,608	268,701	15.0%	504	12,654	26,953	30,581
2Q, Yr8	239,608	1,498	41,105	271,549	15.0%	509	13,163	27,942	31,942
3Q, Yr8	241,105	1,507	42,612	274,428	15.0%	515	13,678	28,934	33,323
4Q, Yr8	242,612	1,516	44,129	277,338	15.0%	520	14,198	29,931	34,725
1Q, Yr9	244,129	1,526	45,654	280,278	15.0%	526	14,724	30,931	36,149
2Q, Yr9	245,654	1,535	47,190	283,249	15.0%	531	15,255	31,935	37,595
3Q, Yr9	247,190	1,545	48,735	286,252	15.0%	537	15,791	32,943	39,062
4Q, Yr9	248,735	1,555	50,289	289,287	15.0%	542	16,334	33,955	40,552
1Q, Yr10	250,289	1,564	51,854	292,354	15.0%	548	16,882	34,972	42,065
2Q, Yr10	251,854	1,574	53,428	295,453	15.0%	554	17,436	35,992	43,600
3Q, Yr10	253,428	1,584	55,012	298,585	15.0%	560	17,996	37,016	45,158
4Q, Yr10	255,012	1,594	56,605	301,751	15.0%	566	18,562	38,044	46,739

F= % of portfolio turnover/period — I = D - H

G=Commissions on the total of buy and sell trades as a % of account equity — J = E - B

TABLE 10

Impact Table: Effect of Margin in Wrap-Fees Account

Initial Investment	200,000	Average Equity %	60%
Commission Rate	1.25%	Margin %	40%
Periods/ yr	4	Margin Interest rate	6.50%

Appreciation Rate **5.00%** Wrap-Fee **2.50%**

	Cash Wrap-Fee			Margin Wrap-Fee Account						% comparison		
A	B	C	D	E	F	G	H	I	J	K	L	M
Period	Account Equity	Wrap-Fee	Cum Wrap-Fee	Portfolio Value	Equity	Wrap-Fee	Margin Interest	Total Annual Account Cost	Cum. Costs	Cum Cost as % of Investment	Annual Equity Hurdle Rate	Margin Wrap -Fee as % of Equity
1Q, Yr1	200,000	1,250	1,250	333,333	200,000	2,083	2,167	4,250	4,250	2.1%	8.50%	4.17%
2Q, Yr1	201,250	1,258	2,508	333,250	199,950	2,083	2,166	4,249	8,499	4.2%	8.50%	4.17%
3Q, Yr1	202,508	1,266	3,773	333,167	199,900	2,082	2,166	4,248	12,747	6.4%	8.50%	4.17%
4Q, Yr1	203,773	1,274	5,047	333,083	199,850	2,082	2,165	4,247	16,994	8.5%	8.50%	4.17%
1Q, Yr2	205,047	1,282	6,329	333,000	199,800	2,081	2,165	4,246	21,239	10.6%	8.50%	4.17%
2Q, Yr2	206,329	1,290	7,618	332,917	199,750	2,081	2,164	4,245	25,484	12.7%	8.50%	4.17%
3Q, Yr2	207,618	1,298	8,916	332,834	199,700	2,080	2,163	4,244	29,728	14.9%	8.50%	4.17%
4Q, Yr2	208,916	1,306	10,222	332,750	199,650	2,080	2,163	4,243	33,970	17.0%	8.50%	4.17%
1Q, Yr3	210,222	1,314	11,535	332,667	199,600	2,079	2,162	4,242	38,212	19.1%	8.50%	4.17%
2Q, Yr3	211,535	1,322	12,857	332,584	199,550	2,079	2,162	4,240	42,452	21.2%	8.50%	4.17%
3Q, Yr3	212,857	1,330	14,188	332,501	199,501	2,078	2,161	4,239	46,692	23.3%	8.50%	4.17%
4Q, Yr3	214,188	1,339	15,527	332,418	199,451	2,078	2,161	4,238	50,930	25.5%	8.50%	4.17%
1Q, Yr4	215,527	1,347	16,874	332,335	199,401	2,077	2,160	4,237	55,167	27.6%	8.50%	4.17%
2Q, Yr4	216,874	1,355	18,229	332,252	199,351	2,077	2,160	4,236	59,403	29.7%	8.50%	4.17%
3Q, Yr4	218,229	1,364	19,593	332,169	199,301	2,076	2,159	4,235	63,639	31.8%	8.50%	4.17%
4Q, Yr4	219,593	1,372	20,965	332,086	199,251	2,076	2,159	4,234	67,873	33.9%	8.50%	4.17%
1Q, Yr5	220,965	1,381	22,346	332,002	199,201	2,075	2,158	4,233	72,106	36.1%	8.50%	4.17%
2Q, Yr5	222,346	1,390	23,736	331,919	199,152	2,074	2,157	4,232	76,338	38.2%	8.50%	4.17%
3Q, Yr5	223,736	1,398	25,134	331,837	199,102	2,074	2,157	4,231	80,569	40.3%	8.50%	4.17%
4Q, Yr5	225,134	1,407	26,542	331,754	199,052	2,073	2,156	4,230	84,798	42.4%	8.50%	4.17%
1Q, Yr6	226,542	1,416	27,957	331,671	199,002	2,073	2,156	4,229	89,027	44.5%	8.50%	4.17%
2Q, Yr6	227,957	1,425	29,382	331,588	198,953	2,072	2,155	4,228	93,255	46.6%	8.50%	4.17%
3Q, Yr6	229,382	1,434	30,816	331,505	198,903	2,072	2,155	4,227	97,482	48.7%	8.50%	4.17%
4Q, Yr6	230,816	1,443	32,258	331,422	198,853	2,071	2,154	4,226	101,707	50.9%	8.50%	4.17%
1Q, Yr7	232,258	1,452	33,710	331,339	198,803	2,071	2,154	4,225	105,932	53.0%	8.50%	4.17%
2Q, Yr7	233,710	1,461	35,171	331,256	198,754	2,070	2,153	4,224	110,155	55.1%	8.50%	4.17%
3Q, Yr7	235,171	1,470	36,641	331,173	198,704	2,070	2,153	4,222	114,378	57.2%	8.50%	4.17%
4Q, Yr7	236,641	1,479	38,120	331,091	198,654	2,069	2,152	4,221	118,599	59.3%	8.50%	4.17%
1Q, Yr8	238,120	1,488	39,608	331,008	198,605	2,069	2,152	4,220	122,820	61.4%	8.50%	4.17%
2Q, Yr8	239,608	1,498	41,105	330,925	198,555	2,068	2,151	4,219	127,039	63.5%	8.50%	4.17%
3Q, Yr8	241,105	1,507	42,612	330,842	198,505	2,068	2,150	4,218	131,257	65.6%	8.50%	4.17%
4Q, Yr8	242,612	1,516	44,129	330,760	198,456	2,067	2,150	4,217	135,474	67.7%	8.50%	4.17%
1Q, Yr9	244,129	1,526	45,654	330,677	198,406	2,067	2,149	4,216	139,690	69.8%	8.50%	4.17%
2Q, Yr9	245,654	1,535	47,190	330,594	198,357	2,066	2,149	4,215	143,906	72.0%	8.50%	4.17%
3Q, Yr9	247,190	1,545	48,735	330,512	198,307	2,066	2,148	4,214	148,120	74.1%	8.50%	4.17%
4Q, Yr9	248,735	1,555	50,289	330,429	198,257	2,065	2,148	4,213	152,333	76.2%	8.50%	4.17%
1Q, Yr10	250,289	1,564	51,854	330,346	198,208	2,065	2,147	4,212	156,544	78.3%	8.50%	4.17%
2Q, Yr10	251,854	1,574	53,428	330,264	198,158	2,064	2,147	4,211	160,755	80.4%	8.50%	4.17%
3Q, Yr10	253,428	1,584	55,012	330,181	198,109	2,064	2,146	4,210	164,965	82.5%	8.50%	4.17%
4Q, Yr10	255,012	1,594	56,605	330,099	198,059	2,063	2,146	4,209	169,174	84.6%	8.50%	4.17%
				Totals		82,928	86,246					

B & F Equity=Portfolio appreciation columns E and B, reduced by previous period's total annual fees and costs, C or I respectively

Comparison Table; Wrap-Fees Accounts vs. Commission-Based Accounts

Initial Investment	200,000		
Turnover	60%	*30% Buys & Sells*	
Commission Rate	1.25%		
Periods/ yr	4		

Appreciation Rate **10.00%** Wrap-Fee **2.50%**

	Wrap-Fee Account			Commission Account				Deltas	
A	B	C	D	E	F	G	H	I	J
Period	Account Value	Wrap-Fee	Cum Wrap-Fee	Account Value	T/O per Period	Comm'n	Cum Comm'n	Wrap-Fee excess over comm'ns	Comm'n acct equity excess over wrap-fee equity
1Q, Yr1	200,000	1,250	1,250	200,000	15.0%	375	375	875	-
2Q, Yr1	203,750	1,273	2,523	204,616	15.0%	384	759	1,765	866
3Q, Yr1	207,570	1,297	3,821	209,338	15.0%	393	1,151	2,670	1,767
4Q, Yr1	211,462	1,322	5,142	214,169	15.0%	402	1,553	3,590	2,707
1Q, Yr2	215,427	1,346	6,489	219,112	15.0%	411	1,964	4,525	3,684
2Q, Yr2	219,466	1,372	7,860	224,168	15.0%	420	2,384	5,477	4,702
3Q, Yr2	223,581	1,397	9,258	229,342	15.0%	430	2,814	6,444	5,760
4Q, Yr2	227,774	1,424	10,681	234,634	15.0%	440	3,254	7,428	6,861
1Q, Yr3	232,044	1,450	12,132	240,049	15.0%	450	3,704	8,428	8,005
2Q, Yr3	236,395	1,477	13,609	245,589	15.0%	460	4,164	9,445	9,194
3Q, Yr3	240,828	1,505	15,114	251,257	15.0%	471	4,636	10,479	10,429
4Q, Yr3	245,343	1,533	16,648	257,055	15.0%	482	5,117	11,530	11,712
1Q, Yr4	249,943	1,562	18,210	262,988	15.0%	493	5,611	12,599	13,045
2Q, Yr4	254,630	1,591	19,801	269,057	15.0%	504	6,115	13,686	14,427
3Q, Yr4	259,404	1,621	21,423	275,266	15.0%	516	6,631	14,791	15,862
4Q, Yr4	264,268	1,652	23,074	281,619	15.0%	528	7,159	15,915	17,351
1Q, Yr5	269,223	1,683	24,757	288,118	15.0%	540	7,699	17,057	18,895
2Q, Yr5	274,271	1,714	26,471	294,767	15.0%	553	8,252	18,219	20,497
3Q, Yr5	279,413	1,746	28,217	301,570	15.0%	565	8,818	19,400	22,157
4Q, Yr5	284,652	1,779	29,997	308,530	15.0%	578	9,396	20,600	23,877
1Q, Yr6	289,990	1,812	31,809	315,650	15.0%	592	9,988	21,821	25,661
2Q, Yr6	295,427	1,846	33,655	322,935	15.0%	606	10,593	23,062	27,508
3Q, Yr6	300,966	1,881	35,536	330,387	15.0%	619	11,213	24,324	29,421
4Q, Yr6	306,609	1,916	37,453	338,012	15.0%	634	11,847	25,606	31,403
1Q, Yr7	312,358	1,952	39,405	345,813	15.0%	648	12,495	26,910	33,455
2Q, Yr7	318,215	1,989	41,394	353,794	15.0%	663	13,158	28,235	35,579
3Q, Yr7	324,181	2,026	43,420	361,958	15.0%	679	13,837	29,583	37,777
4Q, Yr7	330,260	2,064	45,484	370,312	15.0%	694	14,531	30,953	40,052
1Q, Yr8	336,452	2,103	47,587	378,858	15.0%	710	15,242	32,345	42,406
2Q, Yr8	342,761	2,142	49,729	387,601	15.0%	727	15,969	33,761	44,841
3Q, Yr8	349,187	2,182	51,912	396,546	15.0%	744	16,712	35,199	47,359
4Q, Yr8	355,735	2,223	54,135	405,698	15.0%	761	17,473	36,662	49,963
1Q, Yr9	362,405	2,265	56,400	415,061	15.0%	778	18,251	38,149	52,656
2Q, Yr9	369,200	2,307	58,707	424,639	15.0%	796	19,047	39,660	55,440
3Q, Yr9	376,122	2,351	61,058	434,439	15.0%	815	19,862	41,196	58,317
4Q, Yr9	383,175	2,395	63,453	444,465	15.0%	833	20,695	42,758	61,291
1Q, Yr10	390,359	2,440	65,893	454,723	15.0%	853	21,548	44,345	64,364
2Q, Yr10	397,678	2,485	68,378	465,217	15.0%	872	22,420	45,958	67,539
3Q, Yr10	405,135	2,532	70,910	475,953	15.0%	892	23,312	47,598	70,818
4Q, Yr10	412,731	2,580	73,490	486,937	15.0%	913	24,225	49,264	74,206

F= % of portfolio turnover/period

G=Commissions on the total of buy and sell trades as a % of account equity

I = D - H

J = E - B

TABLE 12

Impact Table: Effect of Margin in Wrap-Fees Account

Initial Investment	200,000	Average Equity %	60%
Commission Rate	1.25%	Margin %	40%
Periods/ yr	4	Margin Interest rate	6.50%

Appreciation Rate **10.00%** Wrap-Fee **2.50%**

	Cash Wrap-Fee			Margin Wrap-Fee Account						% comparison		
A	B	C	D	E	F	G	H	I	J	K	L	M
Period	Account Equity	Wrap-Fee	Cum Wrap-Fee	Portfolio Value	Equity	Wrap-Fee	Margin Interest	Total Annual Account Cost	Cum. Costs	Cum Cost as % of Investment	Annual Equity Hurdle Rate	Margin Wrap -Fee as % of Equity
1Q, Yr1	200,000	1,250	1,250	333,333	200,000	2,083	2,167	4,250	4,250	2.1%	8.50%	4.17%
2Q, Yr1	203,750	1,273	2,523	337,417	202,450	2,109	2,193	4,302	8,552	4.3%	8.50%	4.17%
3Q, Yr1	207,570	1,297	3,821	341,550	204,930	2,135	2,220	4,355	12,907	6.5%	8.50%	4.17%
4Q, Yr1	211,462	1,322	5,142	345,734	207,440	2,161	2,247	4,408	17,315	8.7%	8.50%	4.17%
1Q, Yr2	215,427	1,346	6,489	349,969	209,982	2,187	2,275	4,462	21,777	10.9%	8.50%	4.17%
2Q, Yr2	219,466	1,372	7,860	354,256	212,554	2,214	2,303	4,517	26,294	13.1%	8.50%	4.17%
3Q, Yr2	223,581	1,397	9,258	358,596	215,158	2,241	2,331	4,572	30,866	15.4%	8.50%	4.17%
4Q, Yr2	227,774	1,424	10,681	362,989	217,793	2,269	2,359	4,628	35,494	17.7%	8.50%	4.17%
1Q, Yr3	232,044	1,450	12,132	367,435	220,461	2,296	2,388	4,685	40,179	20.1%	8.50%	4.17%
2Q, Yr3	236,395	1,477	13,609	371,937	223,162	2,325	2,418	4,742	44,921	22.5%	8.50%	4.17%
3Q, Yr3	240,828	1,505	15,114	376,493	225,896	2,353	2,447	4,800	49,721	24.9%	8.50%	4.17%
4Q, Yr3	245,343	1,533	16,648	381,105	228,663	2,382	2,477	4,859	54,580	27.3%	8.50%	4.17%
1Q, Yr4	249,943	1,562	18,210	385,773	231,464	2,411	2,508	4,919	59,499	29.7%	8.50%	4.17%
2Q, Yr4	254,630	1,591	19,801	390,499	234,299	2,441	2,538	4,979	64,478	32.2%	8.50%	4.17%
3Q, Yr4	259,404	1,621	21,423	395,283	237,170	2,471	2,569	5,040	69,518	34.8%	8.50%	4.17%
4Q, Yr4	264,268	1,652	23,074	400,125	240,075	2,501	2,601	5,102	74,619	37.3%	8.50%	4.17%
1Q, Yr5	269,223	1,683	24,757	405,026	243,016	2,531	2,633	5,164	79,783	39.9%	8.50%	4.17%
2Q, Yr5	274,271	1,714	26,471	409,988	245,993	2,562	2,665	5,227	85,011	42.5%	8.50%	4.17%
3Q, Yr5	279,413	1,746	28,217	415,010	249,006	2,594	2,698	5,291	90,302	45.2%	8.50%	4.17%
4Q, Yr5	284,652	1,779	29,997	420,094	252,057	2,626	2,731	5,356	95,658	47.8%	8.50%	4.17%
1Q, Yr6	289,990	1,812	31,809	425,240	255,144	2,658	2,764	5,422	101,080	50.5%	8.50%	4.17%
2Q, Yr6	295,427	1,846	33,655	430,450	258,270	2,690	2,798	5,488	106,568	53.3%	8.50%	4.17%
3Q, Yr6	300,966	1,881	35,536	435,723	261,434	2,723	2,832	5,555	112,124	56.1%	8.50%	4.17%
4Q, Yr6	306,609	1,916	37,453	441,060	264,636	2,757	2,867	5,624	117,747	58.9%	8.50%	4.17%
1Q, Yr7	312,358	1,952	39,405	446,463	267,878	2,790	2,902	5,692	123,440	61.7%	8.50%	4.17%
2Q, Yr7	318,215	1,989	41,394	451,932	271,159	2,825	2,938	5,762	129,202	64.6%	8.50%	4.17%
3Q, Yr7	324,181	2,026	43,420	457,468	274,481	2,859	2,974	5,833	135,035	67.5%	8.50%	4.17%
4Q, Yr7	330,260	2,064	45,484	463,072	277,843	2,894	3,010	5,904	140,939	70.5%	8.50%	4.17%
1Q, Yr8	336,452	2,103	47,587	468,745	281,247	2,930	3,047	5,976	146,915	73.5%	8.50%	4.17%
2Q, Yr8	342,761	2,142	49,729	474,487	284,692	2,966	3,084	6,050	152,965	76.5%	8.50%	4.17%
3Q, Yr8	349,187	2,182	51,912	480,300	288,180	3,002	3,122	6,124	159,089	79.5%	8.50%	4.17%
4Q, Yr8	355,735	2,223	54,135	486,183	291,710	3,039	3,160	6,199	165,288	82.6%	8.50%	4.17%
1Q, Yr9	362,405	2,265	56,400	492,139	295,283	3,076	3,199	6,275	171,562	85.8%	8.50%	4.17%
2Q, Yr9	369,200	2,307	58,707	498,168	298,901	3,114	3,238	6,352	177,914	89.0%	8.50%	4.17%
3Q, Yr9	376,122	2,351	61,058	504,270	302,562	3,152	3,278	6,429	184,344	92.2%	8.50%	4.17%
4Q, Yr9	383,175	2,395	63,453	510,448	306,269	3,190	3,318	6,508	190,852	95.4%	8.50%	4.17%
1Q, Yr10	390,359	2,440	65,893	516,701	310,020	3,229	3,359	6,588	197,440	98.7%	8.50%	4.17%
2Q, Yr10	397,678	2,485	68,378	523,030	313,818	3,269	3,400	6,669	204,108	102.1%	8.50%	4.17%
3Q, Yr10	405,135	2,532	70,910	529,437	317,662	3,309	3,441	6,750	210,859	105.4%	8.50%	4.17%
4Q, Yr10	412,731	2,580	73,490	535,923	321,554	3,350	3,483	6,833	217,692	108.8%	8.50%	4.17%

Totals 106,712 110,980

B & F Equity=Portfolio appreciation columns E and B, reduced by previous period's total annual fees and costs, C or I respectively

CPI Table

Table 13

YEAR	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Ann CPI	4.40%	4.60%	6.10%	3.10%	2.90%	2.70%	2.70%	2.50%	3.30%	1.70%	1.60%	2.70%	3.40%	1.60%	2.40%
								Ten Year Average			3.12%	2.93%	2.66%	2.51%	2.46%
$ 100,000															
CPI	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%
Yr 1	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Yr 2	101,900	102,000	102,100	102,200	102,300	102,400	102,500	102,600	102,700	102,800	102,900	103,000	103,100	103,200	103,300
Yr 3	103,836	104,040	104,244	104,448	104,653	104,858	105,063	105,268	105,473	105,678	105,884	106,090	106,296	106,502	106,709
Yr 4	105,809	106,121	106,433	106,746	107,060	107,374	107,689	108,005	108,321	108,637	108,955	109,273	109,591	109,910	110,230
Yr 5	107,819	108,243	108,668	109,095	109,522	109,951	110,381	110,813	111,245	111,679	112,114	112,551	112,989	113,428	113,868
Yr 6	109,868	110,408	110,950	111,495	112,041	112,590	113,141	113,694	114,249	114,806	115,366	115,927	116,491	117,057	117,626
Yr 7	111,955	112,616	113,280	113,948	114,618	115,292	115,969	116,650	117,334	118,021	118,711	119,405	120,102	120,803	121,507
Yr 8	114,083	114,869	115,659	116,454	117,254	118,059	118,869	119,683	120,502	121,325	122,154	122,987	123,826	124,669	125,517
Yr 9	116,250	117,166	118,088	119,016	119,951	120,893	121,840	122,794	123,755	124,723	125,696	126,677	127,664	128,658	129,659
Yr 10	118,459	119,509	120,568	121,635	122,710	123,794	124,886	125,987	127,097	128,215	129,342	130,477	131,622	132,775	133,938
Yr 11	120,710	121,899	123,100	124,311	125,533	126,765	128,008	129,263	130,528	131,805	133,093	134,392	135,702	137,024	138,358
Yr 12	123,003	124,337	125,685	127,046	128,420	129,807	131,209	132,624	134,052	135,495	136,952	138,423	139,909	141,409	142,923
Yr 13	125,340	126,824	128,324	129,841	131,373	132,923	134,489	136,072	137,672	139,289	140,924	142,576	144,246	145,934	147,640
Yr 14	127,722	129,361	131,019	132,697	134,395	136,113	137,851	139,610	141,389	143,189	145,011	146,853	148,718	150,604	152,512
Yr 15	130,148	131,948	133,771	135,617	137,486	139,380	141,297	143,240	145,207	147,199	149,216	151,259	153,328	155,423	157,545
Yr 16	132,621	134,587	136,580	138,600	140,648	142,725	144,830	146,964	149,127	151,320	153,543	155,797	158,081	160,397	162,744
Yr 17	135,141	137,279	139,448	141,649	143,883	146,150	148,451	150,785	153,154	155,557	157,996	160,471	162,982	165,529	168,114
Yr 18	137,709	140,024	142,376	144,766	147,193	149,658	152,162	154,705	157,289	159,913	162,578	165,285	168,034	170,826	173,662
Yr 19	140,325	142,825	145,366	147,950	150,578	153,250	155,966	158,728	161,536	164,390	167,293	170,243	173,243	176,293	179,393
Yr 20	142,991	145,681	148,419	151,205	154,041	156,928	159,865	162,855	165,897	168,993	172,144	175,351	178,614	181,934	185,313
Yr 21	145,708	148,595	151,536	154,532	157,584	160,694	163,862	167,089	170,376	173,725	177,136	180,611	184,151	187,756	191,428
Yr 22	148,477	151,567	154,718	157,932	161,209	164,550	167,958	171,433	174,976	178,589	182,273	186,029	189,859	193,764	197,746
Yr 23	151,298	154,598	157,967	161,406	164,916	168,500	172,157	175,890	179,701	183,590	187,559	191,610	195,745	199,965	204,271
Yr 24	154,172	157,690	161,284	164,957	168,710	172,544	176,461	180,463	184,553	188,730	192,998	197,359	201,813	206,364	211,012
Yr 25	157,102	160,844	164,671	168,586	172,590	176,685	180,873	185,156	189,536	194,015	198,595	203,279	208,069	212,967	217,976

U.S. Department of Labor
Bureau of Labor Statistics
Consumer Price Indexes

The Consumer Price Index--Why the Published Averages Don't Always Match An Individual's Inflation Experience

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The Consumer Price Index (CPI) is a measure of the average change in prices paid by urban consumers for a market basket of goods and services. Because the CPI is a statistical average, it may not reflect your experience or that of specific families or individuals, particularly those whose expenditure patterns differ substantially from the "average" urban consumer.

Because it is not practical to obtain prices for all consumer transactions in the United States, the CPI uses a carefully designed set of samples to estimate prices. These samples are the product of accepted statistical procedures to make the CPI representative of the prices paid for all goods and services purchased by urban consumers. Some of these samples include selected:

- Urban areas from all U.S. urban areas,
- Households within urban areas,
- Retail establishments from which these households (consumers) purchased goods and services,
- Specified and unique items--goods and services purchased by these consumers, and
- Housing units from the urban areas for the shelter component of the CPI.

Therefore, the CPI is an average based on many diverse households and not a reflection of any particular household.

While several factors can result in the national CPI being different from *your* price experience, one major factor is how *you* actually spend your money. Estimates of expenditures reported in the Consumer Expenditure Survey for each consumer good or service are used to produce "expenditure weights" for the CPI. These weights give each good or service in the CPI an importance relative to all the other goods and services in the market basket. For example, an increase of 5 percent in housing costs is more important than the same increase for telephone charges, because most consumers spend more for housing than for telephone service. Similarly, if you spend more than the average person on medical care and recreation, and prices rise sharply for these goods and services, the increase in your personal expenditures and personal

price index would be larger than the increase for the average consumer. Because the CPI is a comprehensive measure, it contains items that are included in some individuals' buying patterns and excluded from others. For example, if you are a homeowner, you are more likely to buy major appliances such as refrigerators and laundry equipment than a renter would be.

The CPI divides the consumer market basket into eight major groups of goods and services. You can estimate the approximate difference in *your* expenditure pattern by estimating your relative expenditures for major groups of consumer goods and services. You could then compare them to the CPI groups' relative importance data, which are approximately the weights used in CPI estimation. For example, the approximate weights for the eight major groups in the CPI for All Urban Consumers (CPI-U) are listed below under the CPI-U average column. If your expenditure pattern is sharply different from the CPI average, the same price changes for the same expenditure categories would result in different price change measures for the total market basket. An example of a hypothetical expenditure pattern for a consumer with high expenditures for medical care appears in the tabulation that follows.

	Relative Importance	
Expenditure category	CPI-U average (Dec.2001)	Hypothetical individual
Total (all items)	100.0	100.0
Food and beverages	15.7	20.5
Housing	40.9	25.0
Apparel	4.4	4.5
Transportation	17.1	13.5
Medical care	5.8	25.0
Recreation	6.0	4.0
Education and communication	5.8	3.0
Other goods and services	4.3	4.5
Total, all items	100.0	100.0

Let's assume that there is a price increase of 5 percent for food and beverages and a 10 percent increase for medical care costs, with no price changes for the other expenditure categories. This would result in a price index increase in the published CPI of 1.4 percent. However, it would result in an increase of 3.5 percent for the hypothetical individual's price index. The calculations for the national CPI and the hypothetical individual are shown in the following two tabulations.

National CPI-U average

Expenditure category	Relative Importance, CPI-U average (Dec.2001)	Relative price change	New relative expenditure

Food and beverages	15.7	x	1.05	=	16.5
Housing	40.9	x	1.00	=	40.9
Apparel	4.4	x	1.00	=	4.4
Transportation	17.1	x	1.00	=	17.1
Medical care	5.8	x	1.10	=	6.4
Recreation	6.0	x	1.00	=	6.0
Education and communication	5.8	x	1.00	=	5.8
Other goods and services	4.3	x	1.00	=	4.3
Total, all items	100.0				101.4

101.4/100.0 = 1.4 percent increase

Hypothetical individual

Expenditure category	Relative Importance, hypothetical individual		Relative price change		New relative expenditure
Food and beverages	20.5	x	1.05	=	21.5
Housing	25.0	x	1.00	=	25.0
Apparel	4.5	x	1.00	=	4.5
Transportation	13.5	x	1.00	=	13.5
Medical care	25.0	x	1.10	=	27.5
Recreation	4.0	x	1.00	=	4.0
Education and communication	3.0	x	1.00	=	3.0
Other goods and services	4.5	x	1.00	=	4.5
Total, all items	100.0				103.5

103.5/100.0 = 3.5 percent increase

The area in which you live also can affect your price experiences. You should not expect the national or a regional CPI to always mirror your price experiences. It is possible, for example, that sharp price increases in one area are offset by lower prices in other areas, resulting in a more moderate price change published for the Nation or a region.

Another factor in whether you think the CPI reflects your price experience is that most consumers notice price changes in those goods and services purchased frequently. These items, such as food, clothing, and gasoline, have relatively large price swings because of the seasonal influences in supply and demand. Less attention is paid to many items (such as most household appliances) that are purchased infrequently, which often have relatively stable prices.

The CPI is used extensively to adjust incomes, lease payments, retirement benefits, food stamp and school lunch benefits, alimony, and tax brackets. The CPI, because of the many ways in which it is used, affects nearly all Americans. Because the CPI is based on the buying habits of the "average" consumer, it

may not be a perfect reflection of your individual price experience. However, the CPI is the most economically feasible method for providing a statistic that is the most useful in all it's applications.

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For further information, access the CPI internet site.

Last Modified Date: October 16, 2001

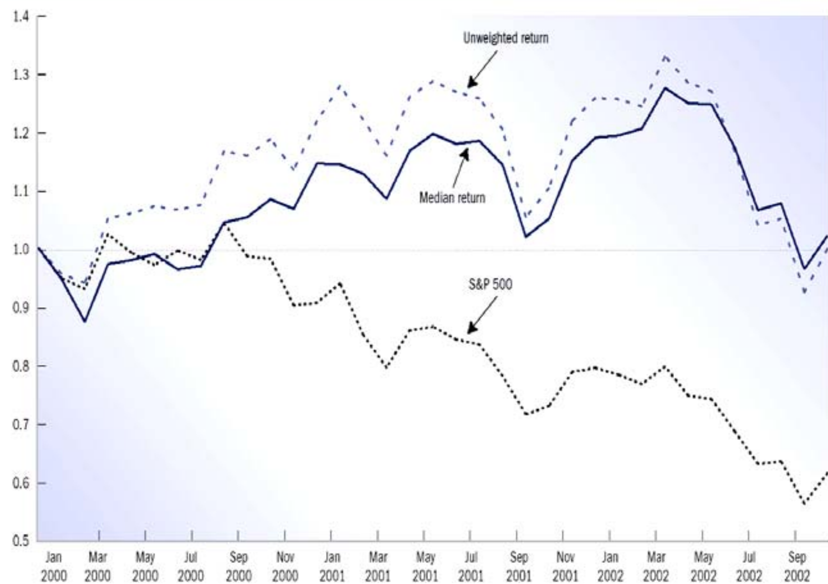
Timely Observations in Finance

By Bradley R. Stark, MA, MSF, JD

I. No Bear Market in S&P500 Index: Only a Sector Bubble

Brokerage firms are fond of saying *in a bear market losses are the norm for investors*. This statement does not tell the complete story.

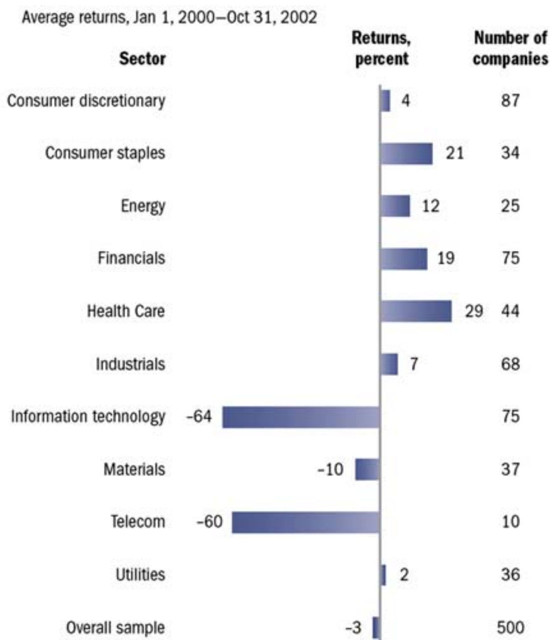
Two thirds (2/3) of the S&P500 either rose in value or at most lost 10% from January 2000 to October 2002. Forty-one percent (41%) of the S&P500 companies showed a share price gain over this period of time. The reason for the 37% decline in the value of the S&P500 index from January 2000-October 2002, is that it is a market capitalization weighted index. Bigger companies comprise a correspondingly bigger percentage of the index. If each company is given an equal weight, the index does not reflect a bear market.
Ex. A[1].

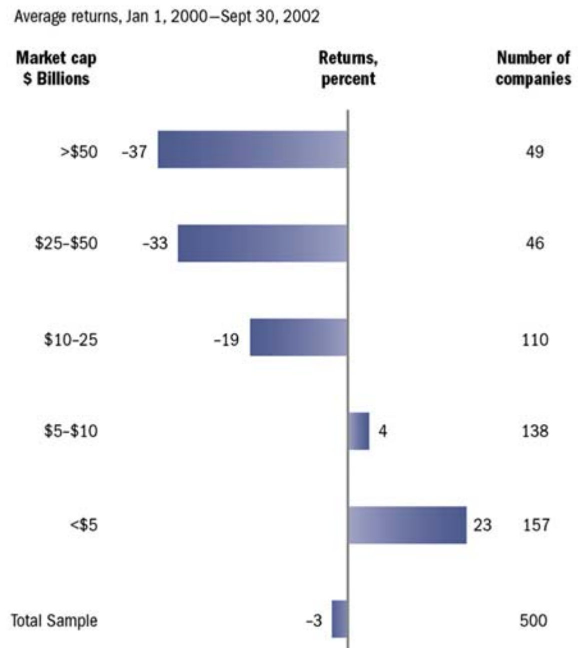


Bradley R. Stark, MA, MSF, JD is a PIABA member and Adjunct, Department of Finance professor at Florida International University in Miami, Florida. He may be reached at 305.662.6697 or info@portfoliolaw.com.

[1] Koller and Williams, *Anatomy of a Bear Market*, McKinsey on Finance (Winter 2003) <http://corporatefinance.mckinsey.com/_downloads/knowledge/mof/2002_no6/bear_market2.pdf>, where this graph appeared and these observations are described in detail. Design and layout by Rick Gideon. <http://www.legalboards.com>.

A review of the S&P500, sector by sector, highlights that the decline in the index was caused by a sector bubble. Ex. B, C.[2]



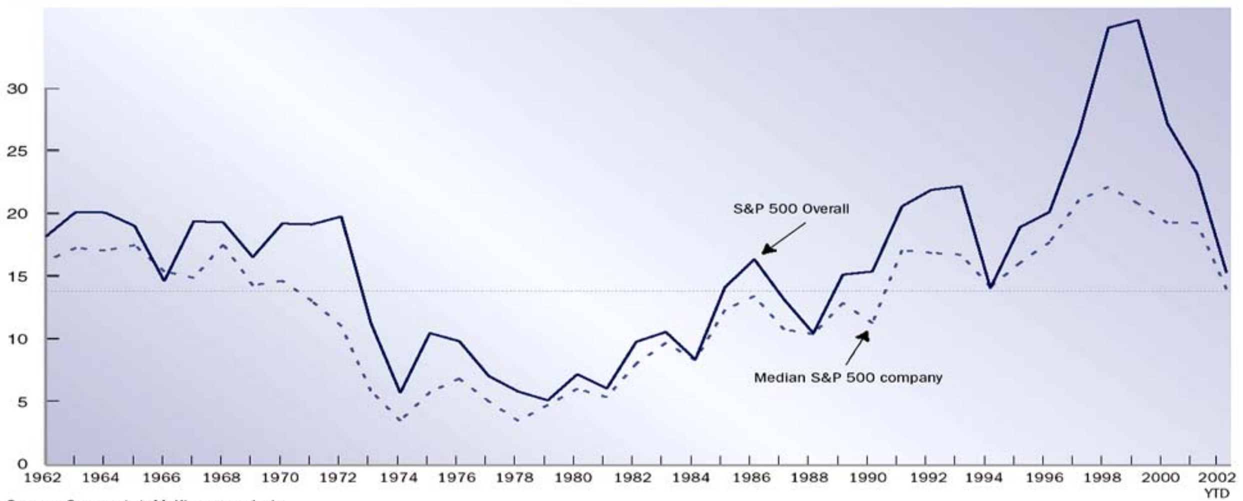


Thus a smaller number of stocks concentrated in several sectors had a disproportionate effect upon the index because of the greater weighting accorded market capitalization. Telecom, media and technology sectors comprised 45% of the S&P500 at the *market top* and have since returned to a historical range of 15-25% while Price to Earnings ratios (P/E) are returning to historical norms. Ex. D.[3] (*see* page 75)

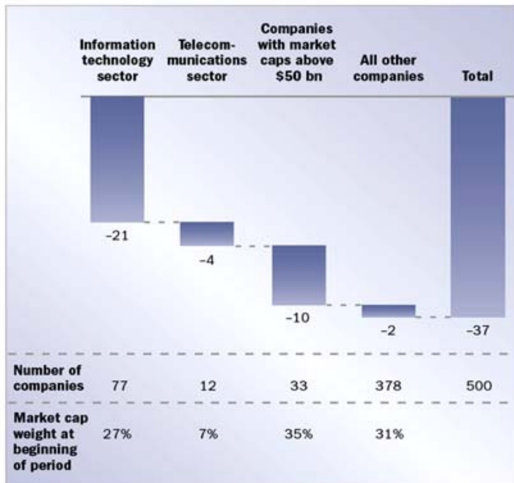
An examination of the bubble sectors reveals that of the 37% decline in the S&P500 from January 2000 to October 2002, Information Technology accounted for 21 percentage points of this 37% decline.

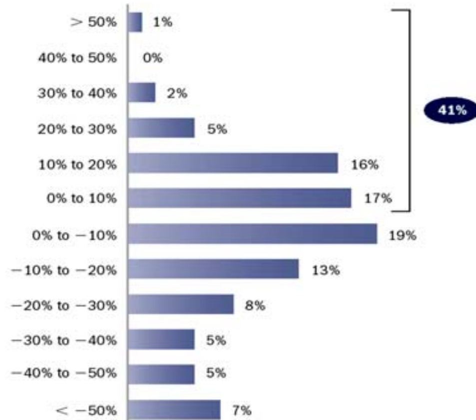
Larger companies with valuations in excess of $50 billion accounted for another 9 percentage points of this 37% decline in the S&P500. Ex. E.[4] (*see* page 75)

[2] *Id.*
[3] *Id.*
[4] *Id.*



When companies in the S&P500 are viewed on an individual basis Ex. F[5], it is clear that 41% of the companies in the S&P500 actually increased in value from January 2000 to October 2002.[6]





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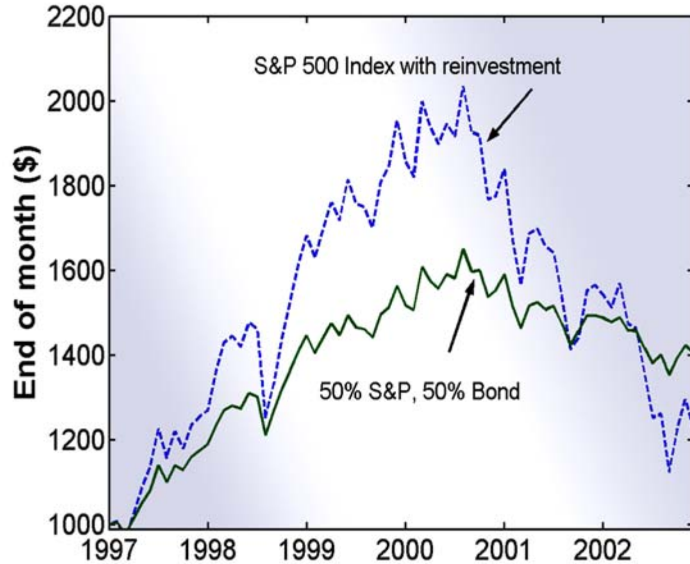
[5] Id.

[6] Over 90% of the return of a portfolio is a function of asset allocation. Brinson, Singer and Beebower.

Stock portfolios that suffered dramatic declines usually did so as a result of over-concentration in the bubble sectors.[7]



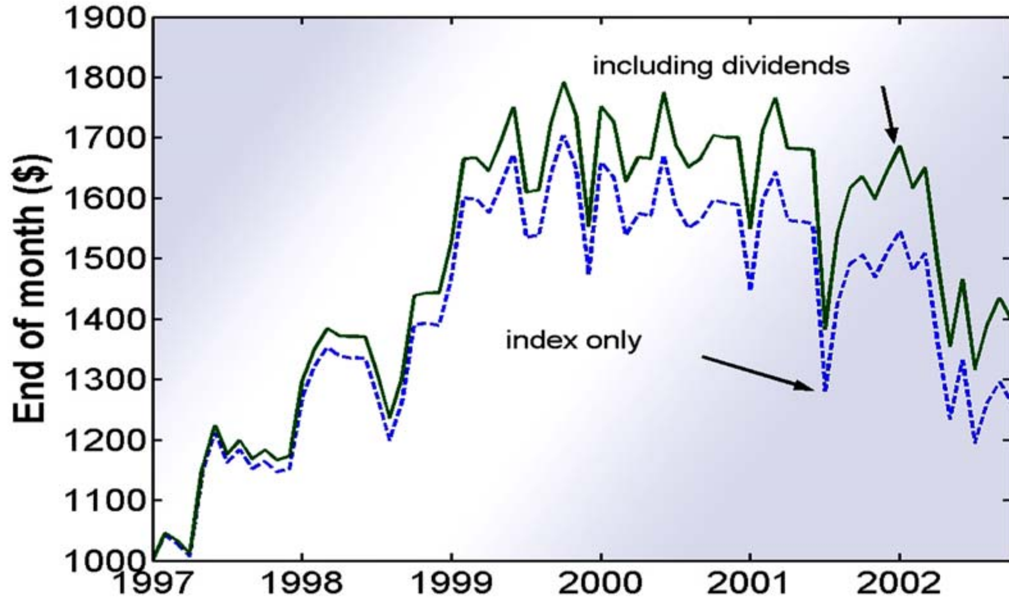
A portfolio generated by throwing darts at the 500 companies in the S&P500 and investing an equal or random amount of money in each of these stocks, would have a greater probability of avoiding over concentration and achieving a favorable return. These loses are more severe when compared to a diversified portfolio with compounded dividends. Ex. G[8]. Compounding of dividends since 1997 adds over 4% to the return of the S&P500 and an even grater return for the Dow Jones Industrial Average. Ex. H[9].

[7] There is some support for the contention that a market bubble eventually results in a bear market. Thus the argument would be that the fraud that created the sector bubble created the bear market losses in all stocks. The author raises this issue because of its logic as a form of fraud on the market. *See* Charles P. Kindleberger, *Manias, Panics, and Crashes*, (4th edition 2000). *Accord* Kodres and Pritsker, *A Rational Expectations Model of Financial Contagion*, Journal of Finance (Spring 2002).

[8] Data reflects daily closing price for S&P 500. Damages calculated and chart generated by Dr. Frank Urban, Department of Electrical and Computer Engineering, Florida International University, <urban@fiu.edu>.

[9] *Id.*

Exhibit H - Dow Jones with Dividends



Source: www.dowjones.com

II. Venture Capitalists and Investment Bankers recognized the Bubble.

The Internet Bubble, which predicted the bursting of the bubble in 1999, instructs on the IPO and Venture Capital markets. Anthony B. Perkins was the Editor-in-Chief and Michael C. Perkins the Founding Editor of the wildly popular and influential magazine ***Red Herring***, a primer for the venture capital and IPO industries. Their book chronicles the excesses of venture capitalists and investment bankers, who supplied the grist for the technology bubble. The sampling below of quotes from prominent investment bankers and venture capitalists gives a flavor for how these communities viewed the inflating bubble.

> "It's emotion, its frenzy, it's the fad, and 90 percent of the companies should never have gone public and will go out of business or hit very hard times"

Perkins and Perkins, *The Internet Bubble* 7 (1999) (*quoting* Jim Breyer, managing partner of Accel Partners).

> "More than 95% of the venture capitalists I work with like to say, 'The ducks are quacking: it's time to feed them' says Jim Breyer, managing partner of Accel Partners, whose Internet home runs include UUNET and Real Networks".

Id. at 18.

> "But the bankers make no apologies about taking fledging companies public to meet this demand. 'It's our job to put food on the stoop', declares Cristina Morgan, managing director at the investment bank Hambrecht & Quist. 'If the cat eats it, we've done our job.'"

The Internet Bubble 18 (1999) (Hambrecht & Quist is now part of J.P. Morgan Chase).

"Two groups of speculators: Insiders and outsiders. Insiders control IPOs.

Actually, the insiders control the market for public offerings. They're like the house in Las Vegas or Atlantic City-the insider will win in the end. 'The game has always been rigged,' says Sahlman. 'And after 30 minutes of this poker game you don't now who the sucker is, you're in trouble'".

The Internet Bubble 8 (1999) (*quoting* Bill Sahlman of Harvard Business School).

"We haven't figured out how to shorten the time it takes to build a real company from 10 years down to 1. Why do companies go public after 1 year instead of 10? Because we have stopped putting the effort into actually trying to build a company. We've put our effort into building stocks, because we can do that pretty quickly.

You can put together a team, spin a story, get rich quick".

The Internet Bubble 8-9 (1999) (*quoting* Bandel Carano, a venture Capitalist with Oak Investment Partners).

As with all bubbles, there was a tidal wave of new capital.[10] In 1998 there was $17 billion spent on venture capital, with 139 new funds created.[11]

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[10] The recent bubble followed the pattern of previous bubbles. In *Manias, Panics, and Crashes*, 4th edition 2000, Charles P. Kindleberger applies historical facts to the research on bubbles to build the following model.

I-Displacement: some exogenous shock to economic system bringing new opportunities in some areas and closing out opportunities in others. Displacement varies from speculative boom to another. E.g. Unanticipated change in monetary policy, expansion of bank credit enlarging money supply, etc.

II-Overtrading: Positive Feedback Loops develop as new investment leads to increases in income, stimulating further investment and income. Wild speculation occurs.

III-Monetary Expansion: buying on margin, buying by installments, too much leverage where the purpose is to speculate rather than invest.

IV-Revulsion: a specific symbol of past excesses occurs causing a rush to liquidate speculative positions. Panic often develops. E.g. bank failures, swindle revealed, etc.

V-Lender of Last Resort: provides liquidity to clean up the mess.

Kindleberger, *Manias, Panics, and Crashes* also describes the irrationality of the market as it evolves from rational to irrational:

(1) Mob Behavior
(2)People begin as rational and gradually lose touch with reality
(3Rationality can differ amongst different groups based upon how far along they are in the process mentioned in (2) above
(4)Fallacy of Composition: belief that the total is greater than the sum of the parts
(5)Over-or-Under Reaction
(6)Cognitive Dissonance and Social and Cultural Contagion

On the cover of the 2000 edition (the first edition of this book was published in 1978) Dr. Paul Samuelson, a Nobel Prize winning economist, introduces the text with the statement "(s)ometime in the next five years you may kick yourself for not reading and re-reading this book". *Id*.

[11] Perkins and Perkins, *The Internet Bubble* 5 (1999).

This 47.5% annual increase was the largest in history.[12] From 1996-1998 new mutual fund deposits totaled $500 billion, bringing the total to $5.2 trillion.[13] In 1998 technology accounted for 1/3 of all GDP growth and 37% of all new jobs.[14] According to Morgan Stanley Dean Witter, at the end of 1998 there had been 1,243 technology IPOs in the prior 19 years totaling $2.1 trillion in market value.[15]

How could investment bankers and venture capitalists, that provided the products peddled by analysts often all within the same firm, not notice the gossamer character of the inflating bubble?[16] The analysts now making news for their wrong doings were *mouthpieces* for their more knowledgeable brethren.

III. The Tech Wreck Parable: The broker's experience as interpreted by Behavioral Finance[17]

Behavioral Finance offers an interpretation of brokers' thought processes during the bull market and subsequent crash. Their actions were primal and predictable. Because most brokers are not educated in Finance, years of research in Portfolio Theory, asset allocation, valuation, and other principles of Finance slowly garnered through the laborious process of research and publication after peer review, did not aid these salesmen.[18] What follows is the story of the *tech wreck* as *seen through the eyes* of a typical broker and perhaps interpreted by Behavioral Finance.

The *Tech Wreck* Parable

As the bull market evolved, brokers ignored accepted principles of Finance. Instead new beliefs gaining currency amongst peers in the brokerage industry were embraced. Valuation metrics became *eyeballs* per webpage, potential size of the *Old Economy* industry or the numbers of *click throughs* on an advertising banner. Financial planning yielded to momentum trading.

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[12] Id.

[13] Id. at 6

[14] Id. at 6.

[15] Id. at 6.

[16] The venture capital arm of investment banks is often organized as a subsidiary.

[17] The first advances in a behavioral understanding of human decision making under conditions of risk, loss, gain and uncertainty began in the fields of sociology, psychology and anthropology. These insights are now being applied to financial markets in an attempt to explain anomalies. As Behavioral Finance is quickly becoming a mainstream part of Finance and Economics, many journal articles now offer both a rational and behavioral explanation for market anomalies. *E.g.*, Kohn, *Comment on "Good Policies for Bad Governments: Behavioral Political Economy" by Daniel J. Benjamin and David I. Laibson* (June 10, 2003) <http://www.federalreserve.gov/boarddocs/speeches/2003/20030610/>.

[18] A high degree of education and proficiency testing is required of those who manage another's important affairs such as health, tax and legal matters; much less proficiency is required of stewards for the fruits of a lifetime of labor. Requiring a greater proficiency as demonstrated by a graduate degree or CFA (Certified Financial Analyst) exam, might worthy consideration.

Diversification as articulated in the Brinson studies, that 91.5% of the return of a portfolio is a function of diversification rather than active portfolio management, was ignored.[19] Economic realities such as the massive amounts of personal debt, margin debt, historically high valuations for equities and other *Old Economy* concepts fell on deaf ears.[20] These new beliefs gained traction within the brokerage industry, particularly among younger brokers who had never seen a bear market.[21] "(T)he fact is that it is really quite comfy to be part of the crowd," Tvede, *The Psychology of Finance* 54 (1999) (*quoting* Adam Smith). "Men, it has been well said, think in herds: it will be seen that they go mad in herds while they recover their senses slowly and one by one." Tvede, *The Psychology of Finance* 129 (1999) (*quoting* Charles Mackay in *Memoirs of Extraordinary Popular Delusions*) (1852).[22]

Brokers engaged in **Cognitive Dissonance,**[23] creating convoluted irrational arguments to justify their view of a never ending bull

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[19] Brinson, Singer and Beebower *Determinants of Portfolio Performance II: An Update*, Financial Analysts Journal (May/June 1991).

[20] Debt as a percentage of personal income soared in 1973 to 58%, in 1989 to 76% and in 1997 to 85%. Credit card debt soared from $243 billion in 1990 to $560 billion in 1997, while the average American family carried a credit card debt of $7,000 and 1 in 68 American families filed for personal bankruptcy in 1998, a seven fold increase from the rate in 1980. *The Internet Bubble* at 19.

[21] The stock market crash of 1987 was a bear market because the decline exceeded 20%, a popular definition of a bear. But since this market quickly recovered and exceeded prior valuations, the experience was relatively painless. The lesson from the 1987 crash was *buy the dips*. This strategy proved profitable throughout the bull market.

[22] The comfort that is derived from a peer group or organization is astounding. The *Milgram Experiment* illustrates the capacity for extreme behavior when partially absolved of responsibility by a hierarchy of authority, group or social community. In the Milgram experiment *teachers* were instructed to administer an electrical shock of 15 volts to *learners* for each incorrect answer while increasing the voltage another 15 volts with each subsequent incorrect answer. The voltages administered began at 15 volts and ended at 450 volts. The *teachers* administering the shocks were told that no permanent tissue damage would occur from the shocks. They were given a 45 volt shock as a reference point. They saw the *learners* being strapped into a chair with electrodes attached to their arms (in reality a shock never exceeded 45 volts, unbeknownst to the *teachers*). The machine used to administer the shocks was labeled *Slight Shock* up to *Danger: Sever Shock* and finally *XXX* beneath the most severe shock. *Teachers* administering the shocks were able to hear through the walls the responses of the *learners*, which range from a grunt of pain at 75 volts and complaints of pain at 120 volts. At 150 volts the *learners* screamed in pain that they wished to discontinue the experiment; at 270 volts the screams were agonizing. At 300 volts *learners* no longer responded, thus the *teachers* had no way of knowing if the *learners* were conscious. Of 40 original *teachers* 26 continued to administer shocks into the 450 volts range. This experiment has been replicated in numerous countries with the same findings. This finding comports with philosopher Hannah Arendt's observations in *A report on the banality of evil* (Arendt 1965) which discusses her observations of the Adolf Eichmann trial. Despite being the architect of the holocaust, Arendt observed that the only thing extraordinary about Eichmann was his ordinariness. *E.g.,* John Sabini, *Social Psychology* 49 (1992).

market. Brokers feared the **Regret**[24] of missing the raging bull market. Brokers embraced the *buy the dips* investing fad wherein every decline was a short term buying opportunity, regardless of valuation. After late fall of 1998, when the market quickly recovered from the shock that resulted from the devaluation of the Russian Rubble, *buy the dips* was further vetted. The herd mentality and number of broker disciples flourished. Brokers ignored that which was not acknowledged by the other members of their group, a form of **Social or Cultural Contagion**.[25] Newer brokers outperformed stalwart *old-timers* in the industry who insisted on diversification and bonds. As a form diversification from their over-concentrated technology positions, brokers herded into Large Cap stocks (some of which were technology), rationalizing this as a form of diversification instead of bonds or other negatively correlated investments.

Instead of analysis, analysts and brokers relied upon comments of corporate management and those leading their herd. Their **Attention** was focused only on that to which they had ready **Availability** within the context of their group.[26] Outrageous share price projections by analysts were articulated and then quickly actualized in the market, as

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Brokers felt a reduced sense of responsibility as a result of being merely a follower of their peers and analysts within their firms. When combined with the institutional bias of the industry to place the responsibility for trades on the client, it is easy to understand why brokers became reckless in their salesmanship.

[23] "**Cognitive Dissonance** is the mental conflict that people experience when they are presented with evidence that their beliefs or assumptions are wrong; as such, cognitive dissonance might be classified as a sort of pain of regret, regret over mistaken beliefs." Taylor and Woodford, editors, *Handbook of Macroeconomics*, Shiller, *Human Behavior and the Efficiency of the Financial System* (1999) <http://www.econ.yale.edu/~shiller/online/handbook.html>. People irrationally "take actions to reduce cognitive dissonance that would not normally be considered fully rational: the person may avoid the new information or develop contorted arguments to maintain the beliefs or assumptions." *Id*. For example, this is why short-term traders became *long-term investors* after market crashes.

[24] "There is a human tendency to feel the pain of **Regret** at having made errors, even small errors, not putting such errors into a larger perspective." *Id*. This leads to a **Modified Utility Function** "which is a function of the utility they achieve from a choice as well as the utility they would have received from another choice that was considered." *Id*.

[25] **Culture and Social Contagion** is when people irrationally discount relevant data based upon the perceptions of their group. "People tend not to remember well facts or ideas that are not given attention in the social cognition, even though a few people may be aware of such facts. If one speaks to groups of people about ideas that are foreign to their culture, one may find that someone in the group will know of the ideas, and yet the ideas have no currency in the group and hence have no influence on their behavior at large." *Id*.

[26] William James summed it up well when he stated "(m)y experience is what I agree to attend to. Only those items which I notice shape my mind-without selective interest, experience is utter chaos". Tvede, *The Psychology of Finance* 67 (1999) (quoting William James). "Economic theories that are most successful are those that take proper account of the limitations and capriciousness of attention." Shiller, *Human Behavior and the Efficiency of the Financial System*, (1999) <http://www.econ.yale.edu/~shiller/online/handbook.html>. The Black-Scholes option pricing model, for example, requires only a small fraction of investors to pay attention to arbitrage opportunities.

with the outrageous projections for Quallcom and Amazon.com in 1999, quickly increasing these share prices by several multiples. Brokers became **Overconfident**[27] in their own abilities and followed unproven market indicators and the recommendations of those who had been successful in the past, despite the lack of logic to their trading. Brokers engaged in **Magical and Quasi Magical Thinking**[28]**,** seeing patterns in past profitable trades, when none existed. We are hardwired to see patterns when none exist.[29] Human beings find it

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The **Availability Heuristic** is the "ease with which instances or associations come to mind"…'vividness' of presentation or 'salience' of object affects the attention given." *Id*. "Investment fashions and fads, and the resulting volatility of speculative asset prices, appear to be related to the capriciousness of public attention (Shiller (1984), (1987)). Investor attention to categories of investments (stocks versus bonds or real estate, investing abroad versus investing at home) seems to be affected by alternating waves of public attention or inattention. Investor attention to the market at all seems to vary through time, and major crashes in financial markets appear to be phenomena of attention, in which an inordinate amount of public attention is suddenly focused on the markets." *Id*.

[27] **Overconfidence and Representative Heuristic** describes "a common bias towards overconfidence. Overconfidence is apparently related to some deep-set psychological phenomena: Ross (1987) argues that much overconfidence is related to a broader difficulty with 'situational construal,' a difficulty in making adequate allowance for the uncertainty in one's own view of the broad situation, a more global difficulty tied up with multiple mental processes. Overconfidence may also be traced to the 'representativeness heuristic,' Tversky and Kahneman (1974), a tendency for people to try to categorize events as typical or representative of a well-known class, and then, in making probability estimates, to overstress the importance of such a categorization, disregarding evidence about the underlying probabilities. One consequence of this heuristic is a tendency for people to see patterns in data that is truly random, to feel confident, for example, that a series which is in fact a random walk is not a random walk." Shiller, *Human Behavior and the Efficiency of the Financial System* (1999) <http://www.econ.yale.edu/~shiller/online/handbook.html>. Studies show that where people were certain they were correct, they were incorrect 20% of the time. Other studies reflect that 80% of people believe they are *better than average* drivers. *Id*. "Overconfidence may have more clear implications for the volume of trade in financial markets". *Id*. "The extent of the volume of trade in financial markets has long appeared to be a puzzle. The annual turnover rate (shares sold divided by all shares outstanding) for New York Stock Exchange Stocks has averaged 18% a year from the 1950s through the 1970s, and has been much higher in certain years. The turnover rate was 73% in 1987 and 67% in 1930. It does not appear to be possible to justify the number of trades in stocks and other speculative assets in terms of the normal life-cycle ins and outs of the market." *Id*.

[28] **Magical Thinking** was seen in starved pigeons (fed at 15 second intervals) that developed a superstition about their random behavior (head ducking, counter-clockwise turns, head thrusts into corner of the cage), believing these random movements caused feedings. In **Quasi-Magical Thinking** a person acts in a magical manner though at some level of thought they understand that they have no such influence. This is particularly true for future events over which they have no influence. For example, people place larger bets before a coin toss than after an unrevealed toss.

[29] "We want to feel that our lives are governed by a grand plan. The need is especially strong in an age when paranoia runs rampant. 'Coincidence feels like a loss of control perhaps,' says John Allen Paulos, a professor of mathematics Temple University…Finding a reason or a pattern where none actually exists 'makes it less frightening,'" Lisa Belkin, *The odds of that*, New York Times Magazine 32 (Aug 11, 2002). "Given that there

impossible to contemplate true randomness. Because **Gambling**[30] is a fundamental human trait, the urge to make bigger and riskier investments (bets) began to feed on itself; a feedback loop developed wherein irrational speculation encouraged more speculation.

Towards the *market top* intoxicated brokers collecting record commissions and generating record returns, disregarded reason and insisted nervous clients do the same. It was a *New Era*, a *New Economy*, an ilk not heard since the last bubble.[31] The past **Lessons of History** were irrelevant.[32] Icons of the investing world did not *get it.*[33] They were seen to be discredited. Leon Levy (former Chairman of the Oppenheimer Funds, now A Division of Fahnestock & Co. Inc.) observed, "I had seen euphoric markets before, but never one like this". Leon Levy, *The Mind of Wall Street* 20 (2002). Levy "played a game with the directors of the Oppenheimer Funds" wherein he asked directors "to project themselves a few years forward after the market crashed, and to put themselves into the mind of a

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are 280 million people in the United States, he says, '280 times a day, a one-in-a-million shot is going to occur,'" explains Dr. Persi Diaconis, a Stanford statistician. *Id*. "'We are hard-wired to overreact to coincidences,' says Persi Diaconis. 'It goes back to primitive man. You look in the bush, it looks like stripes, you'd better get out of there before you determine the odds that you're looking at a tiger'". *Id*. at 36. *Cf.* John Allen Paulos, *A Mathematician Plays the Stock Market* (2003) (for some counterintuitive mathematical observations of the market and trading systems).

[30] "A tendency to gamble, to play games that bring on unnecessary risks, has been found to pervade widely divergent human cultures around the world, and appears to be indicative of a basic human trait, Bolen and Boyd (1968). Kallick et al. (1975) estimated that 61% of the adult population in the United States participated in some form of gambling or betting in 1974." Shiller, *Human Behavior and the Efficiency of the Financial System* (1999) <http://www.econ.yale.edu/~shiller/online/handbook.html>.

[31] *Accord* John Rothchild, *The Bear Book : Survive and Profit in Ferocious Markets* (1998) (for an enjoyable description of past bubbles, their recognizable patterns and common vernacular).

[32] **"**One particular kind of overconfidence that appears to be common is a tendency to believe that history is irrelevant, not a guide to the future, and that the future must be judged afresh now using intuitive weighing only of the special factors we see now. This kind of overconfidence discourages taking lessons from past statistics; indeed most financial market participants virtually never study historical data for correlations or other such statistics; they take their anchors instead from casual recent observations. Until academic researchers started collecting financial data, most was just thrown away as irrelevant." Shiller**,** *Human Behavior and the Efficiency of the Financial System,* <http://www.econ.yale.edu/~shiller/online/handbook.html>. "A human tendency to believe in historical determinism would tend to encourage people to assume that past exigencies (the stock market crash of 1929, the great depression, the world wars, and so on) were probably somewhat known in advance, or, at least, that before these events people had substantial reason to worry that they might happen. There may tend to be a feeling that there is nothing definite on the horizon now, as there presumably was before these past events. It is in this human tendency toward believing history is irrelevant that the equity premium puzzle, discussed above, may have its most important explanation. People may tend just not to think that the past stock market return history itself gives any indication of the future, at least not until they perceive that authorities are in agreement that it does." *Id*.

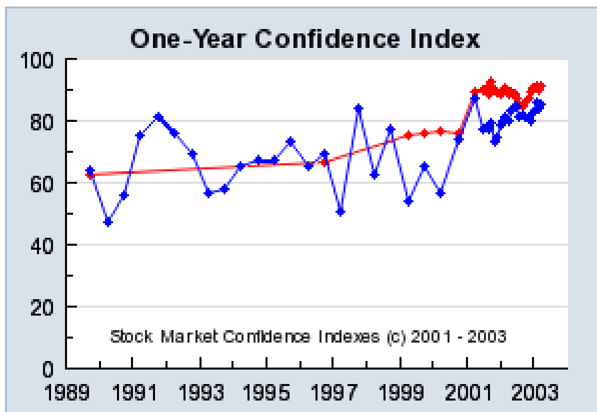
[33] This expression described those who embraced the limitless future of the technology revolution.

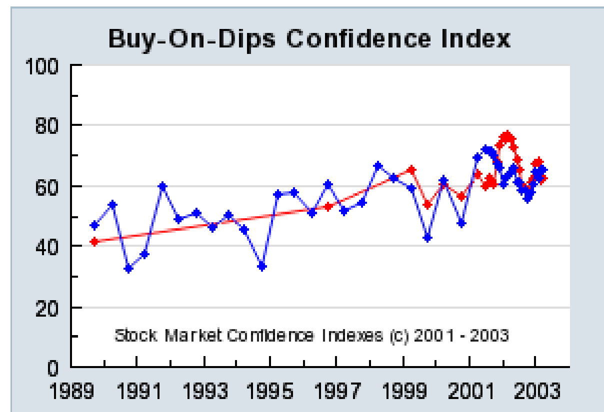
congressional staffer who was charged with orchestrating hearings for the Senate Finance Committee on the causes of the crash of the markets. They thought I was an old fool and paid little attention to me". *Id*. at 18.

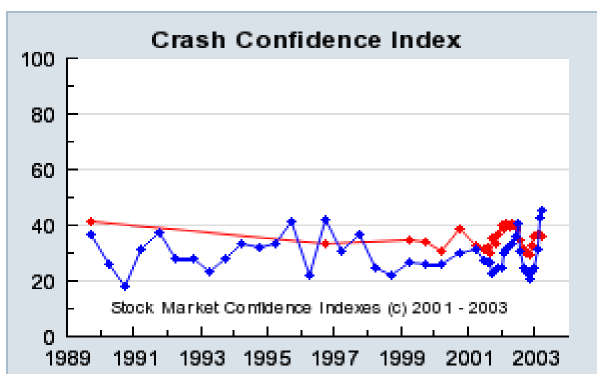
Then the market began to turn. Brokers argue that no one could foresee a bear market and foibles articulated by Behavioral Finance do not apply to *skilled professionals*. On this later point the crash of 1987 instructs. A contemporaneous survey found that 42% of institutional investors (professional money managers) experienced *Physical Symptoms of Anxiety* (sweaty palms, tightness in the chest, irritability or rapid pulse) while only 23% of individual investors did so.[34] These findings are consistent with current studies showing that professionals evince a more volatile disposition than retail investors.[35] Often the small investor remained calm and asked about

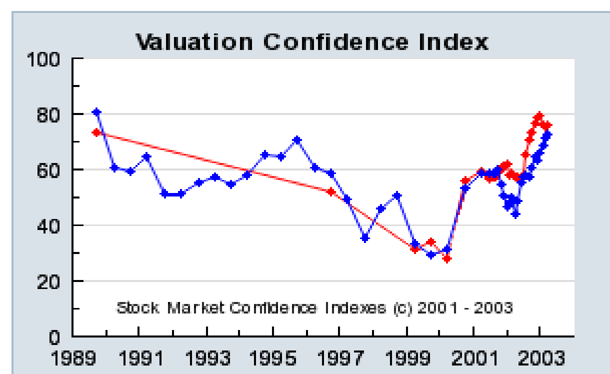
[34] Shiller, *Speculative Prices and Popular Models*, Journal of Economic Perspectives (Spring 1990).

[35] The Investor Behavior Project at Yale University has continuously surveyed investor attitudes since 1989. The following stock market confidence indexes are derived from this survey data. Shiller, *Investor Behavior Project at Yale University*, <http://icf.som.yale.edu/confidence.index/> (2003).









Institutional Investors shown in blue (more volatility), Individual Investors shown in red (less volatility).

d*iversification*, *puts*, *stop-losses* and selling to preserve capital long before brokers paid heed.[36] Brokers engaged in **Cognitive Dissonance,** ignoring harbingers of the

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[36] It is ironic that brokers now claim investors requested the excessive risk that caused their losses. It was the brokers who inhaled the intoxicating aroma of the bubble as an avocation.

One group of people that kept a rational perspective on the mania was the upper management of the brokerage firms. These experienced market watchers had seen bull and bear markets. They understood the underpinnings of the bubble and reaped profits while investors suffered catastrophic losses. Brokerage firms engage in proprietary trading (trading with their own money). As an industry, Income before taxes from proprietary trading increased to 25-32% from 2000 to 2002, differing from historical averages of 10-20%. Paula Lace, *Wall Street Banks Make Risky Bets as Business Sags*, Markets Reporter, The Street.com (11:47 AM EST 03/12/2003) <http://www.thestreet.com/markets/paulalace/10073476.html>. At Goldman Sachs proprietary trading accounted for 28% of income before taxes and at Lehman Brothers proprietary trading accounted for 40% of income before taxes during 2002. *Id*. Net Income (defined as profits derived from all sources, after deductions of expenses, taxes, and fixed charges, but before any discontinued operations, extraordinary items, and dividend payments) was also robust. The following chart reflects Net Income for the major Brokerage houses. The interesting thing to note is that 78% of the brokerages are more profitable after the crash than in 1996 when Federal Reserve Chairman Alan Greenspan first declared that the markets were possessed by *irrational exuberance*.

MILLION $

Ticker	Company	2001	2000	1999	1998	1997	1996	1991
BSC	BEAR STEARNS COMPANIES INC	625.0	773.2	673.0	660.4	613.3	490.6	142.9
AGE	Edwards (A G) INC	71.5	287.5	382.9	292.1	269.3	219.1	105.5
GS	Goldman Sachs Group INC	2,310.0	3,067.0	2,708.0	2,428.0	2,746.0	NA	NA
JEF	JEFFERIES GROUP INC	59.5	55.0	48.8	69.7	63.6	43.6	9.9
LEH	LEHMAN BROTHERS HOLDINGS INC	1,255.0	1,775.0	1,132.0	736.0	647.0	416.0	NA
MER	MERRILL LYNCH & CO	573.0	3,784.0	2,618.0	1,259.0	1,906.0	1,619.0	696.1
MWD	MORGAN STANLEY	3,610.0	5,456.0	4,791.0	3,393.0	2,586.0	1,029.0	475.1
RJF	RAYMOND JAMES FINANCIAL GROUP	96.4	125.2	85.1	92.7	98.9	66.0	26.7
IFIN	INVESTORS FINANCIAL SVCS CP	50.2	33.6	21.3	15.1	11.6	7.8	NA
JNS	JANUS CAPITAL GROUP INC	302.3	663.7	313.1	152.2	NA	NA	NA
LM	LEGG MASON INC	152.9	156.2	142.5	89.3	76.1	56.6.	21.1
MEL	MELLON FINANCIAL CORP	436.0	1,007.0	989.0	870.0	771.0	733.0	280.0
NEU	NEURBERGER BERMAN INC	132.7	150.4	135.6	285.0	NA	NA	NA
MTRS	NORTHERN TRUST CORP	487.5	485.1	405.0	353.9	309.4	258.8	127.4
TROW	PRICE (T. ROWE) GROUP	195.9	269.0	239.4	174.1	144.4	98.5	30.4
STT	STATE STREET CORP	628.0	595.0	619.0	436.0	380.0	293.0	139.3
WDR	WADDELL&REED FINL INC - CL A	107.2	139.0	81.8	83.7	70.3	66.7	NA

Robert McMillan, *Investment Services*, Standard & Poors (May 1, 2003).

impending doom. Individual investors relied upon the assurances of brokers and maintained a less manic perspective. As prices and portfolios slid, some brokers planned to sell out positions once the stocks returned to their purchase prices, so as to *get even*. These brokers were suffering from ***get-evenitis***.[37] After becoming *long-term investors*, it was only a *paper loss*.[38] These contorted thoughts became talismanic mantras.

Most brokers had at least a few positions that were showing a profit. Rather than looking at the complete portfolio performance and making a decision to sell, they compartmentalized their thinking into **Mental Compartments.**[39] Brokers compared the number of winners to losers without regard to the total performance of the portfolio. "From a psychological standpoint, the easiest strategy is to stick with what he has in the portfolio. In his mind, the most likely scenario is that he is right and that the stocks he has selected will rise. But in 2000-2002 the market continued to fall." Leon Levy, *The Mind of Wall Street* 174 (2002).

[37] **Disposition Effect** or *get-evevitis*, the need to get even before selling rather than the advantageous decision to accept a loss.

[38] The *buy and hold* system of investing may not prove to be the robust investment vehicle it has been to date. A significant percentage of the returns from the *buy and hold* philosophy have come from the expansion of what the market place was willing to pay for future earnings, or P/E (price to earnings ratio) expansion. At the turn of the century stocks were valued much as bonds; investors required stocks to pay a dividend in excess (due to risk) of the interest payment on bonds. With time investors realized that stocks were safe enough that an investor could look into the future several years to recoup his/her investment through dividends and thus a very modest P/E became acceptable. In 2000 the P/E of the S&P500 was 30; an investor would have to wait 30 years to receive his/her initial investment returned in earnings (assuming all earnings were paid out in dividends). This contrasts to a P/E of 15 in 1995. Alan Greenspan, *Economic volatility* (August 30, 2002), <http://www.federalreserve.gov/boarddocs /speeches/2002/20020830/default.htm>. Thus, part of the upward climb of the markets in the 20th century was P/E expansion, a phenomenon that has inherent limits. *See also* B. Mark Smith, *Towards Rational Exuberance* (2001).

It is ironic that the road toward a stock market safer for investors, providing for P/E expansion, was paved by market reforms often induced by scandals. After the crash of 1930 Wall Street professionals claimed there had been no fraud and the markets would not survive the Securities Act of 1933 that forbad insider trading, stock manipulation and required increased disclosure. "Wall Street has always operated on the basis of caveat emptor; Roosevelt proposed that 'the burden of telling the whole truth (be placed) on the seller.'" *Id*., at 121 (*quoting* Robert Sobel, *The Big Board* 294 (1965)).

[39] **Mental Compartments** "is a human tendency to place particular events into mental compartments based on superficial attributes. Instead of looking at the big picture, as would be implied by expected utility theory, they look at individual small decisions separately". Shiller, *Human Behavior and the Efficiency of the Financial System*, <http://www.econ.yale.edu/~shiller/online/handbook.html>. This helps to explain the January Effect wherein the stock market rises in January in 15 different countries with differing tax years. People view the previous year as a time of reckoning and the new year as a new beginning. Investors also tend to hedge specific trades, rather than the total portfolio. Investors often track *winners and losers* rather than the present market value of the portfolio. During the months of January to November winners are 70% more likely to be sold than losers, so as to capture gains before the end of the year. Only in December are losers 2% more likely to be sold than winners. Ironically, these losers sold tend to outperform the losers held. *Id*. at 116.

Despite dramatic market volatility, a *down trend* and aggressive increases of the discount rates by the Federal Reserve, consistent with the **Kahneman-Tversky Weighting Function** brokers underestimated the very probable likelihood that the market was entering a *down market* and overestimated the very improbable likelihood that the market would rebound[40].

For those that had *money on the sidelines* in 2001, or to date had avoided the *tech wreck*, it was time to buy aggressively. Brokers were **Anchored**[41] in their valuations to past grossly inflated stock prices. Prices in the declining market appeared *cheap* in comparison to past prices, though overvalued pursuant to the valuation metrics culled over years of research.

For those with loses in 2001, these brokers became *risk seeking* in their efforts to recover past losses, consistent with **Prospect Theory**[42] the seminal work of Dr. Daniel Kahneman, winner of the 2002 Nobel Prize in Economics. Brokers used margin, derivatives or increased exposure to volatile stocks to recoup losses, as they plied the *buy the dips* mantra. Because people experience losses 2.5 times[43] more deeply than gains, brokers were *risk seeking* in an effort to alleviate the pain and **Regret** of their losses. For those few investments that were well positioned, these positions

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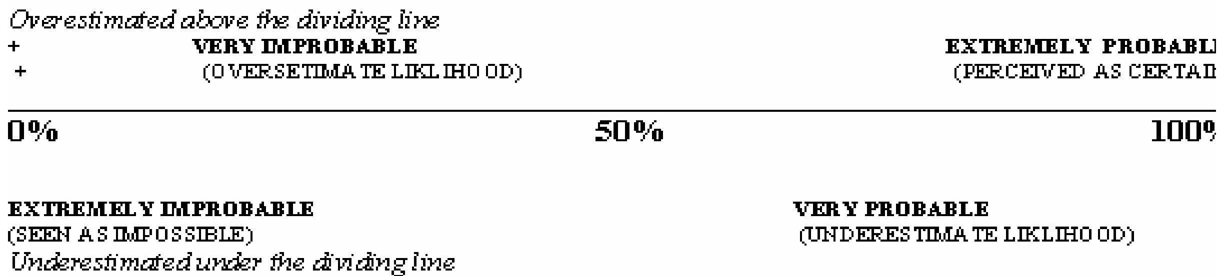
[40] With the **Kahneman-Tversky Weighting Function** an individual views extremely improbable events as impossible and extremely probable events as certain. In addition, people overestimate the likelihood of very improbable (not extremely improbable) events. People also underestimate the likelihood of very probable (not extremely probable) events. This is reflected in the chart below.



[41] **Anchoring** is when quantitative assessments are influenced by random suggestion. For example, in one experiment participants were asked to spin a *Wheel of Fortune* and then asked the number of countries from Africa represented in the United Nations. When the average spin of the wheel was 10, the average estimate was 25 African countries in the U.N. When the average spin was 65, the average estimate of African countries in the U.N. was 45. Thus the *Wheel of Fortune* influenced the quantitative assessment, though the two are totally unrelated.

[42] Studies show that Fund Managers who find themselves in the middle of the pack at midyear increase the risk in their portfolio in the second half of year. Hersh Shefrin, *Beyond Greed and Fear* 117 (2000). As the Kahneman-Tversky Value Function describes, investors often sell their winners too early and hold losers to long.

were sold so as to capture the gains and avoid the **Regret** of having not sold earlier, if the position were to decline.

As it became clear to brokers that at least a *downturn* was in the offing, regardless of the amount of **Cognitive Dissonance** a broker was willing to embrace, brokers sold some positions but did not engage in full scale selling. Instead they took a *wait and see* approach. With the dramatic losses, less exposure to equities was warranted, regardless of market direction, due to the changed net worth and thus risk profile of the client. Brokers exhibited the **Disjunction Effect** when they sold clients a *wait and see* story, though they knew a reduction of equity exposure was required regardless of market direction.[44]

Because brokers frequently placed all their clients into the same *tech darlings*, brokers were confronted with the prospect of liquidating the majority of holdings in the majority of their clients' portfolios and then explaining to each individual client why their

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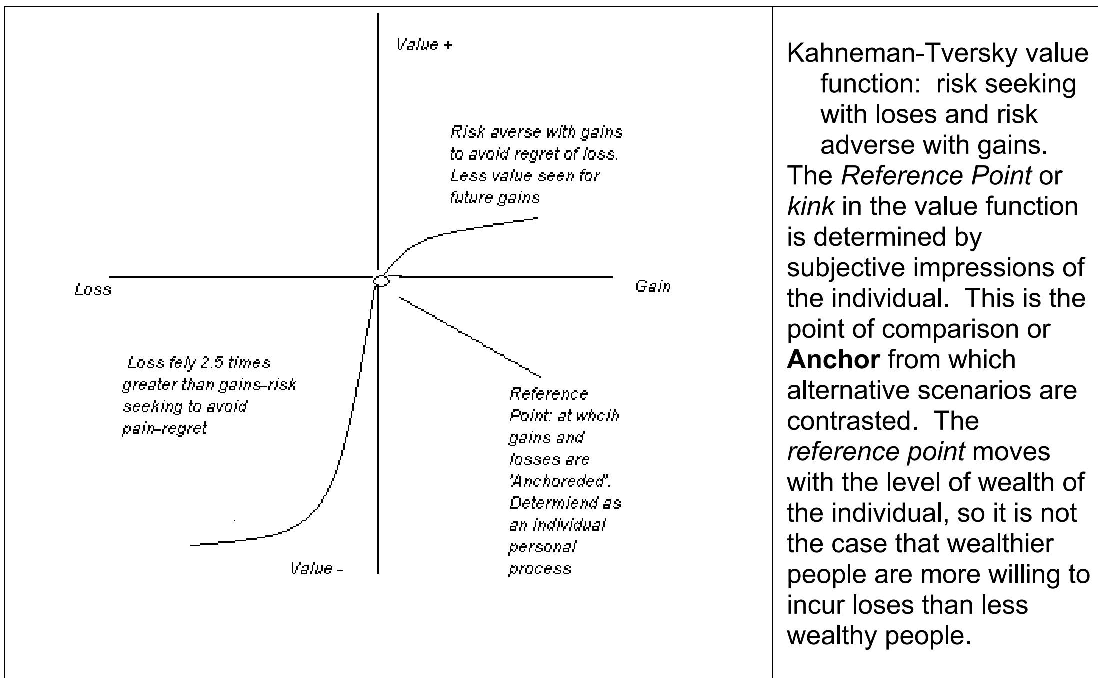
Kahneman-Tversky Value Function



[43] *Id*. at 24.

[44] This *wait and see* attitude, though the new information adds no new useful information, is known as the Disjunction Effect. This helps explain the low volatility and low volume of trade just before an important announcement such as by the Federal Reserve and higher volatility and volume after the announcement, though the contents of the announcement were well anticipated.

recommendations were erroneous. This reluctance to sell can perhaps be explained by **Myopic Loss Aversion**.[45] This is the failure to accept many bets (or investment decisions) when considered individually (each liquidated position would require an individual explanation to the client), though the bets are favorable when viewed collectively. This failure to accept favorable bets when considered separately occurs because people become **Anchored** in the status quo,generating a **status quo bias**[46] against action. Instead brokers engaged in **Cognitive Dissonance** and sold clients on the *long term*, though the brokers' projections were for immediate gains when these *tech darlings* were purchased**.**

After record amounts of losses and stale explanations by brokers, investors became *fed up* and moved their portfolios.

At arbitration the broker spoke rationally, denying culpabilityand asserting that the client asked for the level of risk received. This testimony is aptly characterized by the 18th century German thinker Friedrich Schiller: "Anyone taken as an individual, is tolerably sensible and reasonable-as a member of a crowd, he is at once a blockhead."[47]

The End[48]

[45] The *kink* in the Kahneman-Tversky Value Function affects each individual bet but is not relevant when 100 bets are viewed collectively. In studies wherein persons were shown 30 individual one-year stock returns, these people allocated 40% of their portfolio to stocks. When persons viewed stock returns collectively over a 30 year period, they allocated 90% of their portfolio to stocks.

[46] "One implication of loss aversion is that individuals have a strong tendency to remain at the status quo, because the disadvantages of leaving loom larger than advantages" though this is not reality. Kahneman and Tversky, *Choices, Values and Frames* 163 (2000) (*quoting* Kahneman, Knetsch and Thaler, *The Endowment Effect, Loss Aversion, and the Status Quo Bias* Journal of Economic Perspectives (1991)).

[47] Lars Tvede, *The Psychology of Finance* 209 (1999).

[48]

Expert's Forum: The Suitability of Exercise and Hold

By Craig McCann, PhD and Dengpan Luo, PhD

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Hundreds of lawsuits are currently working their way through the courts and through arbitration panels over an investment strategy referred to as *exercise and hold*. [1] Under the exercise and hold strategy, employees exercise their employee stock options and hold the acquired shares for at least one year to garner preferential tax treatment. The tax-based rationale offered for the exercise and hold strategy is incomplete, sometimes completely illusory and almost always results in unsuitably concentrated positions.

There are two common types of employee stock options, incentive stock options ("ISOs") and non-qualified stock options ("NQSOs"). ISOs and NQSOs are treated quite differently for tax purposes. The benefit an employee receives when he exercises a NQSO is taxed as ordinary independent of how long the acquired shares are subsequently held. This same benefit upon exercise of an ISO is taxed as a long-term capital gain if the acquired shares are held for one year after the option exercise. With either type of option, any increase or decrease in the value of the acquired shares after the exercise will be treated as long-term or short-term capital gains according only to whether the acquired shares are held for more or less than one year.

In this note, we first explain why in a world without taxes an employee should rarely exercise stock options and should not hold the acquired stock if it represents a large proportion of the employee's portfolio. Then we illustrate the tax argument for the exercise and hold strategy. It is unsuitable, under virtually any circumstance, to recommend that an employee exercise NQSOs and hold the acquired stock since there is no tax benefit and the acquired shares add to the diversifiable risk in an employee's wealth. While there is a potential tax benefit to exercising ISOs, it is usually small relative to the significant diversifiable risk taken on through the acquired position.

The advice to exercise and hold either NQSOs or ISOs is essentially advice to acquire and maintain a concentrated position. As such, the advice can be evaluated within the familiar suitability framework.

I. Employee Stock Options

A. Introduction

Public companies frequently grant their employees options

[1] "Outrage is Rising as Options Turn to Dust" The New York Times, March 31, 2002.

to buy company stock in the future at an *exercise* price equal to the company stock price on the day the options are granted.[2] The options cannot be exercised until they *vest*, usually after three or four years, and expire if unexercised after ten years. When an employee leaves a company, he is usually required to exercise or forfeit any vested options. These options are valuable because the employee only exercises the option to buy when the stock is worth more than the exercise price.

Technology companies have been especially active issuers of employee stock options as they have competed to attract, retain and motivate employees. These companies have also seen their stock prices rise and fall dramatically in recent years. Employees who exercised stock options and held the acquired shares not only lost tremendous option value but in some cases found themselves owing large margin balances or taxes exceeding the value of the stock acquired and still held.

B. Non-Qualified Stock Options ("NQSOs")

The tax treatment of NQSOs is simple. An employee who receives NQSOs does not recognize any income until the options are exercised. When the options are exercised a significant tax event is triggered; the difference between the value of the shares acquired and the exercise cost is taxed as ordinary income and the tax basis for the acquired shares is set to the current value of the acquired shares. Any change in the value of the acquired shares between the exercise and the subsequent disposition of the shares is treated as long term capital gain or short term capital gain according to whether the shares are held more than or less than one year. The acquisition of stock through the exercise of a NQSO is treated as current income equal to the benefit received when the option is exercised and simultaneous purchase of the acquired stock.

C. Incentive Stock Options ("ISOs")

The tax treatment of ISOs is slightly more complex.

1. Sell the Acquired Stock Within One Year

If an employee sells stock acquired through the exercise of an ISO within one year of the option exercise, part of the proceeds will be treated as current income and part will be treated as a capital gain. If the stock is sold for less than the exercise price the difference is treated as a capital loss. If the stock is sold for more than the exercise cost but less than the stock price at the time of the option exercise, the profit is treated as current income and taxed at the employee's marginal tax rate. If the stock is sold for more than the stock price at the time of the option exercise the difference between the stock price at the time of the option exercise and the exercise cost is treated as current income and the difference between the sale price and the price at the time of the exercise is treated as a capital gain. The sale of

[2] We assume throughout that the employer's stock is publicly traded.

[3] The various possible combinations of applications of the AMT, marginal income, short term and long term capital taxes make a complete analysis too complicated for our present purposes.. We recommend Kaye A. Thomas's "Consider Your Options, 2nd Edition" *Fairmark Press* 2002 to readers interested in a complete treatment of tax issues.

stock the time of the exercise and the cost of the exercise. In future years when the stock is sold, the employee gets a credit for the AMT paid but in certain circumstances the AMT credit may never be fully used up.[3] AMT is not due on stock sold during the year in which it was acquired through an option exercise because the profit is taxed as ordinary income or short-term capital gains as described above.

2. Sell the Acquired Stock After One Year

If the acquired stock is held for at least one year, the employee will pay long-term capital gains tax on the difference between the proceeds of the ultimate sale and the exercise cost paid at the time of the option exercise. That is, the change in the value of the stock between when it was acquired and when it was sold plus the difference between the value of the stock when it was acquired and the exercise cost when the option was exercised is treated as capital gain and the lower long-term capital gains tax rate is applied.

Herein lies the potential tax benefit to *exercise and hold*. If stock acquired through the exercise of ISOs is held for one year, the tax code reaches back through time past the option exercise to the original grant date and treats all appreciation as long-term capital gains. If the acquired stock is sold within one year of exercise this potential benefit is lost.

II. A World Without Taxes

A. Early Exercise Without Taxes

Imagine an employee who has $40,000 in cash and the right to buy one thousand shares of the employee's company's stock for $40 per share any time in the next year. The stock is currently trading in the market place for $100.

The employee is considering whether to exercise the options today and hold the stock for one year or to delay the exercise of the options for one year. If he follows the exercise and hold strategy, he will convert the options and cash into one thousand shares of the employer's stock, and at the end of one year will have one thousand shares of stock. If instead the employee chooses to delay exercising the options until the end of the year he will have the intact options, $40,000 and interest on $40,000 for one year. Table 1 illustrates the year-end

Table 1
Payoffs to Early Exercise and Holding Stock

Stock Price After One Year	Exercise and Hold	Delay Exercise
Greater than $40	1,000 shares	1,000 shares *plus* interest
Less than $40	1,000 shares (worth less than $40,000)	$40,000 *plus* interest

[3] The various possible combinations of applications of the AMT, marginal income, short term and long term capital taxes make a complete analysis too complicated for our present purposes.. We recommend Kaye A. Thomas's "Consider Your Options, 2nd Edition" *Fairmark Press* 2002 to readers interested in a complete treatment of tax issues.

payoffs to these two alternative strategies.

If the stock price at the end of the year is above $40, the employee can tender the options and $40,000 in exchange for one thousand shares of stock. By delaying exercising the options until the end of the year, he will have both the value of one thousand shares of stock *plus* the interest earned on the $40,000 for one year. If the stock price is less than $40 at the end of the year, the employee can throw away the option and still have $40,000 in cash. Since the stock price is below $40, $40,000 cash is worth more than the one thousand shares he would have if he had followed the exercise and hold strategy *plus* he will have the interest on the $40,000 for one year. In a world without taxes, employees should never voluntarily exercise options to hold the acquired shares.[4]

This simple analysis can be extended to include the possibility that the stock pays dividends, that the cash used to pay for the option exercise must be borrowed and many other alternative details but the fundamental result remains; regardless of the employee's view of the future price of the stock – in fact, regardless of the realized price – in a world without taxes the early exercise of options destroys value and should very rarely be done.

Value is destroyed when an option is exercised early because the employee pays the exercise price earlier than necessary and therefore forgoes interest income. The employee illustrated in Table 1, loses interest for one year on $40,000 by exercising the options early no matter what the stock price is at the end of the year. Also, value is destroyed because the employee would have been better off not exercising the option whenever the stock price falls below the exercise price at the end of the year. The employee illustrated in Table 1 would be better off having the cash rather that the shares when the stock price is less than $40 at the end of the year. By delaying the exercise, the employee has the option to keep the $40,000 cash when 1,000 shares are worth less than $40,000.

The amount of value destroyed by early exercise can be estimated. Employee stock options can be valued using slightly modified standard options valuation models.[5] Options are usually worth substantially more than the difference between the underlying stock's price and the exercise price.[6] For instance, an option with a $50 strike price and 5 years to expiration on a $100 stock is worth about $65. If this option is exercised, the employee tenders $50 and the option in exchange for a $100 stock, effectively receiving $50 for the option worth about $65. In this example, early exercise of the option destroys $15 in value. The $15 difference between the option value and the in-the-money amount results from the interest on $50 for 5 years and the chance that at the end of 5 years the stock

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[4] In rare instances, typically very late in the life of an option, it is optimal to exercise an option on a stock that pays a very high dividend but, ignoring taxes for the moment, the acquired shares should be sold and the proceeds diversified.

[5] Craig J. McCann, "How (And Why) Companies Should Value Their Employee Stock Options," *Journal of Applied Corporate Finance,* vol. 7, no. 2 Summer 1994 pp. 91-99.

[6] If the underlying stock's price exceeds the exercise price of an option, the option is said to be *in-the-money*. If the underlying stock's price is less than the exercise price, the option is said to be *out-of-the-money*. If the underlying stock's price is equal to the exercise price, the option is said to be *at-the-money*.

currently selling for $100 would be worth less than $50.

B. Holding Concentrated Positions

Employees may exercise options because they are separating from their employer, to raise money or to diversify risk in the options associated with his employer. In these cases, it is rarely optimal to hold the concentrated stock position acquired as the concentrated position exposes the employee to excessive, uncompensated risk.

1. Diversification Reduces Risk Without Reducing Expected Returns

Professor Harry Markowitz won the 1990 Nobel Prize in economics for his pioneering work in the 1950s and 1960s in investment management. His insight was that if investors like higher expected returns and dislike greater fluctuations in realized returns they should diversify their wealth across many investments. A security's returns fluctuate around its average returns and when any particular security is experiencing an above average return other securities are likely experiencing below average returns. Diversification allows investors to bear less risk while maintaining the expected return of a portfolio constant because above average returns earned on some securities offset below average returns earned on other securities.

The average (and expected) return to a portfolio of individual securities is a weighted average of the returns to the individual securities, where the weights are just the fraction of the beginning portfolio value accounted for by each security.

$$1)\qquad r_p = \sum_{i=1}^{N} W_i r_i$$

The risk in the returns to a portfolio is typically measured by the standard deviation of the returns. The risk is (approximately) the square root of the average squared difference between the observed daily returns and the average daily return. *See* Equation 2). While this equation looks complicated its interpretation is quite simple. It captures how widely realized returns are spread out around the average or expected return; returns that fluctuate widely have higher standard deviations (more risk) than returns that fluctuate less.

$$2)\qquad \sigma_i \equiv \left(\frac{\sum_{i=1}^{n} \left[r_i - \bar{r} \right]^2}{n-1} \right)^{1/2}$$

The risk in the returns to a portfolio of individual securities is a more complicated function of the risk in the returns to the individual securities.

$$3)\qquad \sigma_p = \left[\sum_{i=1}^{N} \sum_{j=1}^{N} W_i W_j \rho_{ij} \sigma_i \sigma_j \right]^{1/2}$$

The critical factor determining the effectiveness of diversification is the correlation between the returns to pairs of securities, ρ_{ij}. If the securities returns are perfectly correlated, $\rho_{ij} = 1$ and the risk in a portfolio is equal to a weighted average of the risk in the individual securities. In this polar case, combining securities into portfolios does not provide any diversification benefits. Fortunately, returns to securities are not perfectly correlated; many combinations of securities, in fact, have negative correlations. Because securities returns are not perfectly correlated it is possible to combine securities and reduce the risk without reducing expected returns.

2. Competitive Pressures Reduce Expected Returns So That Only Non-Diversifiable Risk is Rewarded

Prices of securities are set as a result of investors buying and selling in search of higher returns for bearing investment risk. As a result of diversification, an investor who adds an individual security to a

portfolio of other securities bears less risk from the added individual security than an investor who holds the individual security as his only asset. Since investors can reduce risk through diversification, diversifying investors are willing to pay more for securities. Investors who are best able to diversify the diversifiable risk in a security will be willing to pay the most for the security.

Competitive pressures drive the price of a security up to the point where expected returns just compensate investors for the risk remaining in a security's returns after the security has been included in a well-diversified portfolio. This remaining risk is referred to as non-diversifiable risk. In other words, competitive forces, acting on prices, drive expected returns down to levels that compensate only for the non-diversifiable risk in a security.

3. Prudent Investors Diversify Concentrated Positions

Since only non-diversifiable risk is rewarded with higher expected returns, prudent investors diversify up to the point where transaction costs make further diversification inefficient. Investors who don't diversify diversifiable risk are bearing risk without any expected compensation.

The portfolios of securities with the lowest risk for each level or expected return comprise what is referred to as the *efficient frontier*. Portfolios on the efficient frontier can also be thought of as offering the greatest expected return for each level of risk borne. Individual securities and other imperfectly diversified portfolios plot below the efficient frontier in Figure 1. Investors combine the risky asset with the risk free asset to attain the desired combination of risk and expected return along the capital allocation line.

Figure 1
The Risk / Expected Return Tradeoff

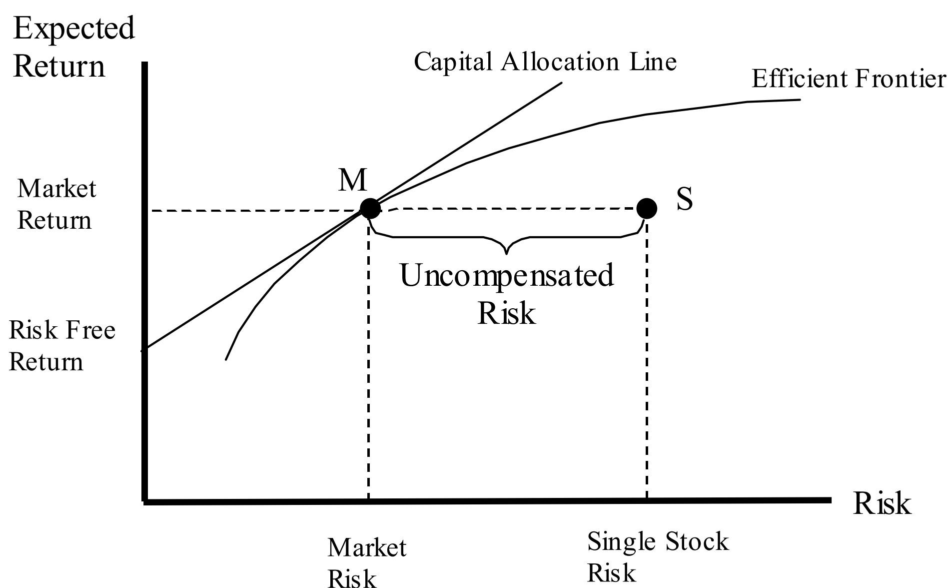


Figure 1 illustrates the benefits of diversification. The market portfolio, M, has the same expected return as the single stock, S, in this example but has much lower risk than the single stock. Risk-averse investors holding the single stock portfolio S should diversify by selling S and buying the market portfolio M. The investor could choose to bear more risk than in the market portfolio by leveraging his investments in search of higher expected returns. Doing so would allow the investor to benefit from a higher expected return than with the single stock portfolio while still bearing much less risk. Another way of viewing the tradeoff between M and S is that S exposes the investor to considerably more risk than M and offers no more expected return.

Financial economists use this framework developed by Professor Markowitz and refined by other Nobel Prize winning economists to assess the suitability of investments.[7] Well-diversified portfolios plot on or near the efficient frontier. Poorly diversified portfolios plot well below the efficient frontier, exposing the investor to uncompensated risk.

The Capital Allocation Line emanates from the expected return axis at the risk free rate of return and goes through the point representing the expected return and the risk of the market portfolio. Portfolios along the Capital Allocation Line with some risk have expected returns greater than the risk free rate of return. Portfolios along the Capital Allocation Line are created by combining the risky market portfolio with short or long positions in the risk free asset. Portfolios plotting to the left of the market portfolio are invested partly in the market portfolio and partly in the risk free asset. Borrowing and investing more than the portfolio's net value in the market portfolio creates portfolios plotting to the right of the market portfolio.

Conservative investors combine an investment in a diversified portfolio of risky assets with an investment in the risk free asset. Aggressive investors borrow and invest more than their equity in risky assets.

When an employee receives a concentrated position in his employer's stock he should sell it and invest the proceeds in a diversified portfolio unless the acquired position is small relative to a diversified portfolio the employee already holds. The concentrated position unnecessarily exposes the employee to fluctuations in his wealth without any additional compensation. Moreover, since the employee's labor income is tied to the fortunes of his employer, the employee has an even greater need to diversify than a non-employee investor in the employer's stock.

III. Taxes

A. NQSOs

Taxes have no impact on the unambiguous case for holding or exercising and diversifying NQSOs. Exercising NQSOs and holding the acquired stock increases the diversifiable risk the employee bears. If the additional diversifiable risk is small because the acquired shares are a small part of the employee's wealth then the unexercised options were also a small part of the employee's wealth. In such a case, the NQSOs should not be exercised because the exercise destroys option value without any corresponding benefit.

If the NQSO's are a significant part of the

[7] An early application of the Markowitz model to issues of suitability can be found in Stephen B. Cohen "The Suitability Rule and Economic Theory" *Yale Law Journal* (1971) 80:1604-1635.

employee's wealth and they are deep in the money it might be suitable to exercise the options but it is unsuitable to recommend that the employee hold the stock received. The option exercise will increase the already significant diversifiable risk in the employee's wealth – especially if the exercise cost and tax withholdings are funded with margin debt or with the sale of other assets – and *there are no tax benefits to holding the concentrated position acquired as a result of exercising NQSOs*.

B. ISOs

1. At-the-Money Option

If an option is at-the-money it should not be exercised; any tax or investment benefit from receiving the stock and holding it or selling it can be achieved by just buying the stock in the open market with the cash used to exercise the option. In every future state of the world, the unexercised option will have value in addition to whatever value the purchased stock has.

2. Deep-in-the-Money ISO

If an option on a $100 stock has a strike price of only $1 then it makes sense to exercise the option early since it is almost certainly going to be exercised. The cost of exercising the option is so low that the foregone interest on the exercise price is negligible. By exercising early the investor will receive any dividends paid on the underlying stock if it is held and will benefit from diversification if the stock is sold. The question then becomes "Should the employee hold the underlying stock for one year and get the long term capital gains tax treatment or sell and get the benefits of diversification?" More on this below.

3. In-the-Money ISO

An option that is moderately in-the-money creates interesting and complex tradeoffs. Exercising an option eliminates the pure option value and paying the exercise price early has a time-value cost. The closer the in-the-money option is to being at-the-money the greater these costs. Also the closer the in-the-money ISO is to being at-the-money, the smaller that tax benefit to holding the underlying stock acquired as a result of the exercise of an ISO for a year since the tax rate differential applies to the difference between the sale proceeds and the exercise cost of the option.

C. ISOs – To Sell or Hold Acquired Shares

1. Selling the Stock Immediately

If the employee sells stock acquired as a result of an ISO exercise immediately and invests the proceeds in a diversified portfolio he will pay income tax on the profits from the option exercise and stock sale and capital gains tax on the growth in the value of the diversified portfolio. If the acquired stock or a diversified portfolio is held for at least one year the change in value after the option exercise (and possibly the simultaneous sale of the stock received) is treated as a long-term capital gain. Thus the differential tax treatment resulting from the decision to hold the concentrated position or to diversify applies primarily to the in-the-money amount when the option is exercised.

For options that are deep in-the-money early exercise can be optimal, especially if the acquired stock is going to be sold and the proceeds invested in a diversified portfolio. Selling the acquired stock before the end of the year in which the option was exercised replaces the AMT on the excess of the value of the shares over the exercise cost when the option was exercised earlier in the year with marginal income tax on the excess of the sale proceeds over the exercise cost if the stock price has declined. If the stock price has increased since the option exercise, an investor selling the stock during the calendar year the options

were exercised will pay income tax at his marginal tax rate on the difference between the value of the stock when acquired and the exercise cost, and short term capital gains on the increase in the value of the stock between the exercise date and when the stock is sold.

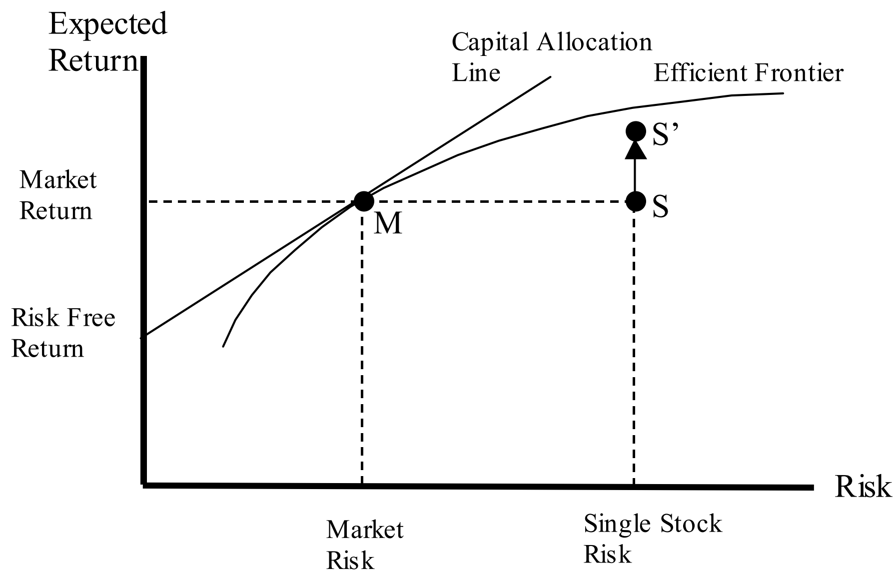
2. Holding the Acquired Stock

Holding the acquired shares for one year has some superficial appeal because the "profits" will be taxed at 20% rather than at likely higher marginal income tax rates, but this impression is misleading.

Taxes lower expected returns and the variability of those returns, moving all the items in Figure 1 down and in towards the origin. The expected return and risk of the single stock portfolio shifts in less proportionately than do the other items in Figure 1 because the single stock portfolio will be taxed at a lower rate than the alternative investments if it is held for more than one year. Figure 2 illustrates the impact of taxes on the decision to hold the concentrated stock position or to diversify by selling the acquired position and buying a diversified portfolio. To simplify matters, we have left the efficient frontier, the risk free return and the capital allocation line unchanged and shifted the expected return up to S'. [8]

The shift from S to S' makes the results of the suitability analysis of the exercise and

Figure 2
The Risk / Expected Return Tradeoff With Taxes



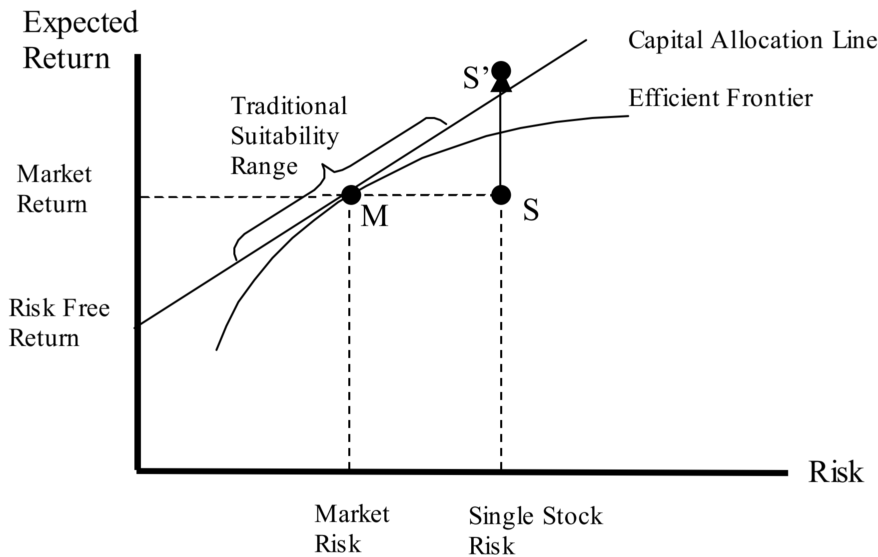
[8] The differential tax treatment also has a small impact on risk but this impact is small (S' could be ever so slightly to the left or right of S) and is ignored for present purposes.

hold strategy more ambiguous. The differential tax treatment increases the expected after-tax return of S relative to M. If the differential tax rate benefit is large enough, S' shifts up to the after-tax Capital Allocation Line as in Figure 3. In this case, the concentrated position is efficiently diversified given the tax considerations but contains risk equivalent to a highly leveraged diversified portfolio. As such, even in rare cases where the tax benefit justifies a lack of diversification the resulting risk profile makes the investment strategy unsuitable for all but the most aggressive investors.

To a first approximation, the difference in expected returns between S' and S is equal to the percentage by which the option is in-the-money when exercised multiplied by the difference in the investor's marginal income tax rate and the long term capital gains tax rate. If the option on a $100 has a strike price of $40, the marginal income tax rate is 36% and the long term capital gains tax rate is 20% the difference in expected return from S to S' is 9.6%.[9] Since the expected after tax equity risk premium is about 6.5%, the single stock portfolio in our example is not tax-efficiently diversified if it contains more than two and a half times the risk of the market portfolio. The average single stock portfolio has about two and a half times the risk of the market portfolio.[10] The technology stocks typically encountered in the exercise and hold cases tend to have much more risk than two and a half times the risk of the market portfolio.

Even if S' is tax-efficiently diversified, it may still embody far more risk than is traditionally considered suitable for most investors. In addition to the additional risk

Figure 3
The Suitability of Exercise and Hold



[9] $9.6\% = ([\$100 - \$40] \div \$100) \times (36\% - 20\%)$

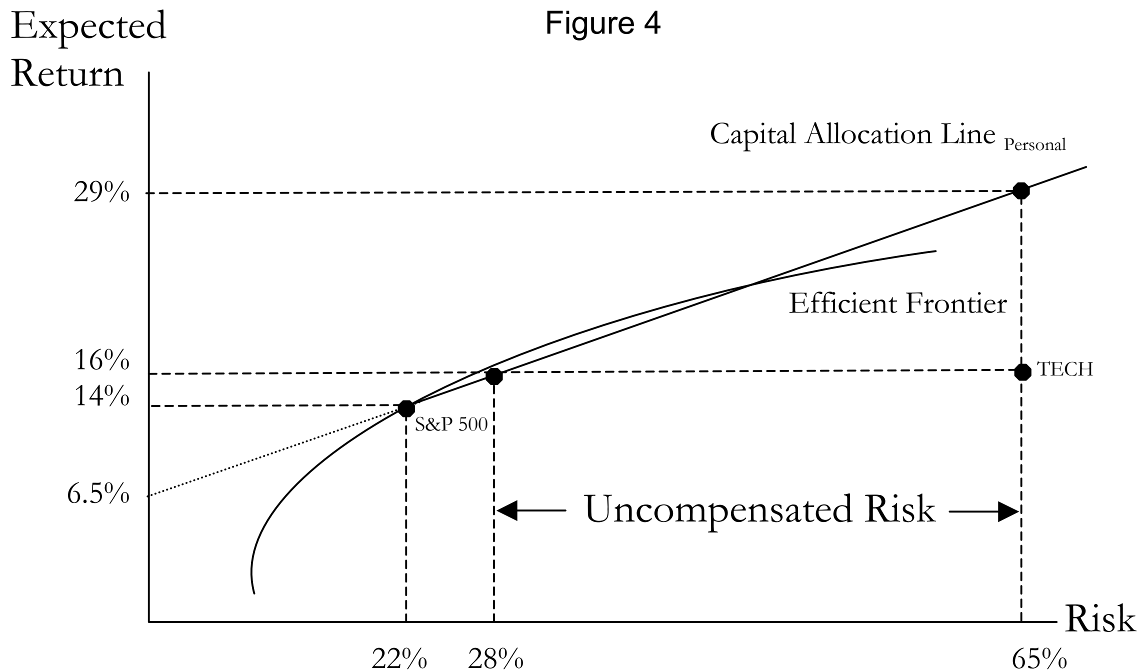
[10] *See* Meir Statman "How Many Stocks Make a Diversified Portfolio?" *Journal of Financial and Quantitative Analysis* 1987 pp. 353-363.

borne in search of the tax advantage, the early option exercise destroys pure option value. The pure option value lost as a result of exercising the options early will often exceed the sought tax benefit. The cost of early exercise should be included in assessing any exercise and hold strategy.

The specific facts of each situation can be modeled but except in rare cases, the employee can achieve the concentrated position's after-tax expected return at much lower risk by selling the acquired shares and diversifying. Figure 4 presents an example of the analysis of a concentrated position in a single technology stock.[11]

In this example, the technology stock's returns have an annualized standard deviation of 65% compared to the 22% annualized standard deviation of the S&P 500's returns over the preceding year. The technology stock's β was slightly greater than 1 and therefore its expected return is a little bit greater than the expected return on the S&P 500. The technology stock's expected return of 16% could be achieved by leveraging an investment in the S&P 500. The returns to this leveraged position in the S&P 500 had an annualized standard deviation over the preceding year equal to 28%. Thus, the expected return of the technology stock can be achieved with 60% less

Figure 4



[11] The analysis in the example assumes for simplicity that the concentrated position is the employee's only investment. The analysis can be readily extended to include any other investments. A reader versed in modern portfolio theory will notice that the Capital Allocation Line in Figure 4 cuts through the efficient frontier. This is because the personal Capital Allocation Line's vertical intercept is above the risk free rate to reflect the fact that individuals borrow at rates approximately 2% above the risk free rate. *See* Meir Statman, How Many Stocks Make a Diversified Portfolio? *Journal of Financial and Quantitative Analysis,* 22, 353-363.

risk in the technology stock through diversification. The risk in the technology stock position in excess of the risk of the leveraged investment in the S&P 500 is uncompensated risk.

This is the proper framework for analyzing the exercise and hold strategy. In this example the rate of return read off the Capital Allocation Line $_{\text{Personal}}$ required to compensate for the total risk in the technology stock is 29%. Since the technology stock's expected return is only 16%, the tax benefit would have to be greater than 13% on a pre-tax basis for the employee to be compensated for the risk of holding the concentrated position for one year. Even if the tax benefit is this large, the strategy may be unsuitable since it embodies the risk and return of an investment in the S&P 500 that is leveraged 3 to 1.

3. Selling the Stock After Price Declines During the Calendar Year

If the tax advantages from not diversifying a concentrated position acquired as a result of an ISO exercise outweigh the costs of holding the acquired stock by enough to justify exercising the options early, the analysis needs to be re-evaluated frequently. Aspects of the employee's financial situation will change after the option exercise and the price of the acquired stock will fluctuate. For example, the employee might experience short-term losses on other investments that could be used to offset short term gains from selling some part of the acquired stock position thereby allowing for partial diversification without a tax penalty.

If the acquired stock's price has declined significantly before the end of the calendar year the option was exercised in, it may be advantageous to sell the acquired shares and diversify. Consider the following example: On March 1, 2002 you exercised options to buy 20,000 shares at $1 per share when the stock was trading for $126 per share. If you hold these shares through the end of the year you will have to pay $700,000 in AMT.[12] If by December 15, 2002 the stock has declined to $41 you can reduce your impending tax payments by selling the stock and paying $320,000 taxes on $800,000 in current income rather than $700,000 in AMT.[13] Selling the stock postpones and may forever eliminate the payment of hundreds of thousands of dollars of taxes. In this case, selling the stock that has declined in value during the year provides for diversification and reduces taxes.

The opportunity to replace the AMT with ordinary income tax is a valuable option on the tax treatment that expires at the end of the calendar year in which the stock option is exercised. Like any option, this tax option is more valuable the greater the remaining life of the option and so, other things equal, employee stock options should be exercised early in the year. Also, since taxes are due in April, options should be exercised early in the year to allow for a one year holding period prior to the sale of the concentrated position or of the diversified portfolio the following year to fund tax payments.

IV. Hedging Strategies

If an employee holds a concentrated position

[12] $\$700{,}000 = 28\% \times 20{,}000 \text{ shares} \times (\$126 - \$1)$

[13] $\$320{,}000 = 40\% \times 20{,}000 \text{ shares} \times (\$41 - \$1)$

acquired as a result of an option exercise, there are many strategies the investors could use to hedge the risk.[14] For instance, the employee could consider the following alternative strategies:

1. Put Options
2. Collar Contracts
3. Variable Prepaid Forward Contracts
4. Portfolio Insurance

A. Put Options

The employee may be able to purchase long-term put options on the stock position. Put options provide downside protection while the stock is being held. This strategy typically will not be completely effective because put options are not usually available with expirations of one year. In order to get downside protection for longer periods the employee would have to purchase, and roll forward at expiration, shorter term puts. Moreover, purchasing put options require significant capital outlays.

B. Collar Contracts

The employee could avoid some of the problems associated with purchasing puts by entering into a collar contract. In a collar contract, the employee buys a put option and sells a call option on the underlying stock. The proceeds from the sale of the call options can be used to fund part of the cost of purchasing the put contracts. In order to avoid being treated as a sale of the underlying stock, the exercise price of the call option has to be significantly greater than the exercise price of the put option, thereby not eliminating all the risk associated with the underlying stock. Collar contracts are customized by brokerage firms and have significant embedded transaction costs. These costs should be carefully analyzed.

C. Variable Prepaid Forward Contracts

Variable prepaid forward contracts combine a collar with a deferred-interest loan secured by the underlying stock. Variable prepaid forwards provide the hedging benefit and the transaction costs of a collar with immediate funds that can be invested in a diversified portfolio.

D. Portfolio Insurance

A concentrated position's value can be partially *insured* even when puts, collars and variable prepaid forward contracts cannot be written on the underlying stock because of a lockup agreement or for some other reason. Put options can be bought, or a collar can be entered into, on an index or portfolio of securities whose value is correlated with the value of the concentrated stock position. In this way, investors will get the long-term capital gains treatment and the desired diversification. The greater the correlation between the value of the portfolio or index and the value of the concentrated position, the more effective is the insurance.

V. Conclusions

Non-qualified stock options should never be exercised early for the purpose of holding the acquired stock; exercising NQSOs early destroys value, holding concentrated stock positions entails bearing risk that is not compensated and *there is no tax benefit*.

Incentive stock options should rarely be exercised early for

[14] The first three of these strategies provide for diversification but run afoul of tax straddle rules and therefore restart the holding period for determining capital gains tax treatment when the strategies are unwound. As such, the first three strategies do not allow the investor to qualify for long term capital gains tax treatment.

the purpose of holding the acquired stock. If the employee has an unusually high tolerance for risk and the options' exercise price is extremely low it might be optimal to exercise ISOs and hold the acquired stock for one year. In these rare situations, limit prices should be set to trigger sales before year-end thereby avoiding the AMT and hedging strategies should be considered to reduce the diversifiable and therefore uncompensated risk.

Expert's Forum: The Damage Is Done: Calculating Damages in the New Era

By Rob Shaff

Rob Shaff is an expert residing in Oklahoma City, Oklahoma. He can be reached at RShaff@coltonnet.com.

The Symptoms

The Securities and Exchange Commission spoke volumes on Monday, April 28, 2003 when they publicized their historic $1.4 billion settlement with the "Gang of Ten." While the settlement has been much ballyhooed in the news, it only allocated $387.5 million to "reimburse" damaged investors, a pittance compared to the actual damages incurred. At this point, most readers are well versed in the details of the settlement as well as the symptoms precipitating the SEC's action.

A timely example of these symptoms has been chronicled and published recently. In what can be described as a front-line expose of the securities industry, former Wall Street analyst Andy Kessler offers a credible explanation of the cancer infecting Wall Street, ultimately leading to the SEC investigation. In his book, *Wall Street Meat*, Kessler affords the reader insight into the actions of the now infamous and former industry superstars. Kessler worked with Jack Grubman while at Paine Webber, Frank Quattrone and Mary Meeker while at Morgan Stanley, and became well acquainted with Henry Blodgett after leaving behind his positions as an industry analyst. Kessler tells the tale of how the industry went from one of defending buy/sell calls to making misguided and unfounded calls. Toward the end of the book, Kessler quotes a conversation with Blodgett wherein Blodgett blows Kessler away with the following statement:

> "You've got to understand. If I stop recommending a stock, and the shares keep going up, there is hell to pay. Brokers call you up and yell at you for missing more of the upside. Bankers yell at you for messing up their relationships. There is just too much risk in not recommending these stocks."

Another incredible and poignant passage can be found on page 84 where Quattrone defines the ubiquitous "Chinese Wall," or separation of research and banking within Wall Street firms. Quattrone and Kessler were leaving the corporate offices of Cirrus Logic after doing the required "dog and pony" show. Kessler was interested in other deals Quattrone might have in the

works and decided to feel him out.

"What else do you have going on, Frank?"

"I an't tell you," Quattrone replied.

"Top secret or something?"

"Hasn't anyone told you about the Chinese Wall?"

"The what?"

The disappearance of this Wall became one of the focal points of the enforcement actions against the Gang of Ten and particularly, Quattrone.

Identifying Affected Investors and Stratifying Damages

While various estimates exist quantifying projected market losses as a result of the bursting Internet bubble, these figures are not indicative of recoverable losses. The daunting task facing securities attorneys and experts is the quantification of investor damages at the individual level. And, while many are stoked at the "free" discovery provided by the SEC and New York Attorney General, the ability to properly calculate, quantify, present and convince arbitration panels of sustained losses for a public investor is not going to be a walk in the park.

The disgorgement portion of the SEC settlement totaling some $387.5 million has definitely defined the floor for reimbursable losses to damaged investors. The manner in which these funds will be doled out is still undecided but some level of consensus exists that this fund will be encumbered for those investors with smaller losses, say, under $20,000. While this is not concrete, it is logical as the cost of bringing an action against a brokerage house is always weighed against the possible recovery. Consequently, once this "minimum" level can be stratified, those with quantified losses greater than this tacit minimum will be filing a Statement of Claim.

How many SOCs will be filed? Estimates vary but they range as high as tens of thousands. As I write this article (May 2003), the latest statistics from the NASD web site indicate new arbitration case filings in 2003 are up 25% over the same period in 2002...and this is only through April 30, 2003. Inasmuch as the SEC announcement was April 28, 2003, the prospective reports on this web site will prove interesting and certainly historical (for those interested in monitoring this activity, the NASD Dispute Resolution Statistics can be found on the web at *www.nasdadr.com/statistics.asp*).

Qualifying Attacks on the Rise

Before touching on the damages issues experts will face in coming hearings, it is important to note that respondents are beginning to utilize inventive and imaginative paths relative to *Daubert/Kumho* challenges. In his article, "*Resisting a Motion to Exclude Expert Testimony in Arbitration*," presented in the Fall 2002 issue of the *PIABA Bar Journal*, Jay Salamon recounts a case in which a *Daubert/Kumho* attack was presented by way of a motion in limine. Mr. Salamon details his successful repression of the respondent's motion along with pertinent references. While this is just one example of the type of peripheral attacks facing any expert, it is poignant in that

the coming deluge of litigation will generate new and creative tactics to exclude testimony and damage methodologies. He further quotes an article written by PIABA member Tom Mason which recharacterizes the *Daubert/Kumho* criteria for application to arbitrations. As a new era in securities litigation is ushered in, these recharacterizations Mr. Mason aptly crafted are extremely timely.

1. Professional Standards – was the expert as careful in preparing for testimony in this case as s/he would be in real life, outside the courtroom?

2. Verifiability/Falsifiability – can the opinion be objectively corroborated, or is it just "one person's opinion?" Can the conclusions be tested against other explanations? Did this expert test the conclusions against other possible explanations?

3. Methodology – methodology is fundamental to assessing the reliability of the proposed testimony. How the expert reaches a conclusion is, for admissibility purposes, much more important than the conclusion itself. Are this expert's techniques or methodologies (even if he is, e.g., a perfume tester) of a kind that others in his field would recognized as acceptable?

(C. Thomas Mason III, *Challenging Experts in Securities Arbitration*, Securities Arbitration 2000 {Practicing Law Institute, 2000}, pp. 762-763.

Damage Assessment – New Techniques?

As always, the facts of each case dictate the methodologies available to determine public customer damages but, in many instances, conflicts associated with the best methodology will arise, certain to cause the expert a great deal of consternation. For instance, assume a case is centered on suitability issues but with the addition of untimely purchases of WorldCom (WCOM) and Enron (ENE). While most experts will begin calculating damages under market-adjusted damages theories, the "sore thumb" of WCOM and ENE complicate the matter somewhat as further investigation might indicate the timing and solicitation of these purchases adds a further element of gross negligence to the case facts. In addition, while the claim of 'failure to supervise' is certain to be raised in most of these cases, can this be further alleged more egregiously in this particular instance?

Another hurdle facing experts is the laundry list of stocks recommended by Merrill Lynch, more specifically Henry Blodgett and his "Internet Group," which were identified by New York Attorney General Elliot Spitzer as fraudulent representations to the retail investor. In cases containing these specific stocks in which the investor relied upon the Merrill Lynch broker's advice to his/her detriment, should rescissionary damages be included and/or appended to a basic damage calculation?

While significantly all of these cases will be grounded in a base methodology, consideration should be given to special circumstances, which may give rise to a tiered or stratified damage calculation. That said, Mr. Mason's interpretive treatise

of the *Daubert/Kumho* qualifications becomes more germane as tiering damages is certain to draw challenges at some point. Nonetheless, it is incumbent on the expert to consider various possible scenarios when zeroing in on these special circumstances and resulting damages. After all, these particular issues ultimately resulted in additional damages to an investor. Defending a respondent's challenge in these situations will require forethought and deftness but, stripping away the latent complexities, it should pose no greater problem than any other challenge provided the expert has ensured simple adherence to the principles mentioned above by Mr. Mason. In any event, disclosure of the methodology on direct examination will be tantamount to acceptance by any given panel. Consider the analogy of commission disgorgement in non-churning cases. *Davis v. Merrill Lynch*, 906 F.2d 1206 (8th Cir. 1990) provides case law support for requesting disgorgement of commissions and margin interest as well as out-of-pocket and/or market-adjusted damages even though this 'disgorgement' is already built into the calculation of out-of-pocket losses. Thus, the requested disgorgement of commissions and margin interest is counted twice; certainly unorthodox by any standard but one set in precedent. Again, constructing and supporting a methodology or tiered methodologies is the required standard all experts must meet.

The coming years in securities arbitration will be the stuff of future books, seminars and lectures about the exuberant and zealous actions resulting from the 'Internet Bubble.' With this new era, all participants in this morass of litigation will be faced with new issues, situations and challenges. While tried, tested and accepted fundamentals should continue to be the call, creative strategies founded upon sound principles will emerge and should be considered in each case. The grievances against the securities industry have created an abysmal chasm yet to be bridged. Many industry observers believe the SEC's punitive hammer was nothing more than a slap on the wrist. If this is accurate, at any level, damaged investors will be looking to securities attorneys to level the playing field. The role of the expert will be to craft an aggressive, supportable damages model to compensate these investors.

Recent Arbitration Awards

By Ryan Bakhtiari

***Anette Adams v. Salomon Smith Barney, Inc.*, NYSE Case No. 2002-010216**

Claimants asserted the following causes of action: lack of diversification, unsuitable trading in technology stocks, violation of NYSE Rule 405, breach of contract, misrepresentation, breach of fiduciary duty and failure to supervise for losses suffered in Claimant's IRA account. Claimant requested compensatory damages, interest, attorneys fees, costs and punitive damages.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of the Statement of Claim and costs.

1. The panel found Respondent Smith Barney liable and ordered Smith Barney to pay $600,000 in compensatory damages and $4,000 in forum fees.

This claim was based on the unsuitable trading of an IRA account. The Claimants used the measure of standard deviation to demonstrate to panel that the risk of the IRA account was not suitable for Claimant and exceeded the standard deviation of the model portfolio's on Smith Barney's web site pages.

Claimant's Counsel -
Maxwell Blecher, Esq. of Blecher & Collins, Kevin M. Kinne, Esq. of Cain Hibbard Myers & Cook, PC and Daniel R. Solin, Esq.
Respondent's Counsel -
Sean J. Coughlin, Esq. of Salomon Smith Barney and Dena L. Murphy, Esq. of Keesal Young & Logan
Claimant's Expert -
Edward S. O'Neal
Respondents' Expert - None
Hearing Situs -
Los Angeles, California
Arbitrators -
Gloria Brewer, Public
Richard Bryson, Public
Andrew J. Sorensen, Industry

***Abdul Afridi v. Morgan Stanley DW, Inc., Arun Sengupta and Adel Afridi,* NASD Case No. 01-03013**

Claimant asserted the following causes of action: inadequate supervision, negligence, unsuitability and breach of fiduciary duty. Claimant requested compensatory damages, interest, attorneys fees, costs, and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of the Statement of Claim and costs.

1. The panel found Respondent Morgan Stanley solely liable and ordered Respondent Morgan Stanley to pay Claimant $150,000 in

compensatory damages, $30,000 in interest and $40,000 in attorneys fees.

This award is significant because it involves a father suing his son the stock broker who admitted to making unauthorized trades in the account when his father was traveling in Pakistan. The son admitted to hiding the monthly statements from his father and represented himself at the hearing.

Claimant's Counsel -
Kim Juhase, Esq. and G. Alexander Novak, Esq. of Novak, Juhase & Stern
Respondents' Counsel -
Edward W. Larkin, Esq. of Morgan Stanley DW, Inc.
Claimant's Expert - None
Respondents' Expert - None
Hearing Situs -
New York, New York
Arbitrators -
Henry Tiffany, Public/Chairperson
Mary Lou McGanney, Ph.D, Public
George F. Janos, Industry

***John Alderice et al. v. Ferris, Baker Watts and Robert L. Butler,* NASD Case No. 01-05787**

Claimants asserted the following causes of action: violations of Virginia Securities Act, breach of fiduciary duty, actual and constructive common-law fraud, gross negligence, violations of NASD and NYSE rules involving the purchase and sale of securities. Claimants requested compensatory damages, interest, attorneys fees, costs, rescission and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of the Statement of Claim, attorneys fees and costs.

1. The panel found Respondents jointly and severally liable and ordered Respondents to pay Claimants $1,125,000 in compensatory damages and 6 percent interest from 45 days from the date the Award is served until paid in full.

Claimants requested compensatory damages of not less than $1,000,000. This award is significant for the size of the award in favor of the Claimants in relation to their losses.

Claimants' Counsel -
Charles W. Austin, Esq. of C.W. Austin, Jr., PC
Respondents' Counsel -
James C. Cosby, Esq. of Cantor Arkema & Edmonds, PC
Claimants' Expert -
Robert Lowry of RL Consulting
Respondents' Expert -
Charles Meyers of Economic Analysis Group
Hearing Situs -
Richmond, Virginia
Arbitrators -
Arnold Samuel Tesh, Public/Chairperson
Edward A. Dragon, Esq., Public
Paul F. Hood, Industry

***Craig S. Chalius et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* NASD Case No. 00-05231**

Claimants asserted the following causes of action: breach of contract, breach of fiduciary duty, negligence, suitability, negligent misrepresentations, improper margin calls, violation of the Consumer Protection Act, violation of NYSE Rule 405 and NASD Rule 2310 involving the trading in Primus common stock, Internet Strategies proprietary fund and the use of margin. Claimants requested compensatory damages, interest, attorneys fees, costs and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and filed a Counter Claim against Claimants requesting dismissal of the Statement of Claim, attorneys fees and compensatory damages.

1. The panel found in Claimants' favor on their claims of breach of fiduciary

duty, breach of contract and negligence, but also found Claimants negligent. The panel denied Claimants' Washington Consumer Protection Act claim, and Respondent Merrill Lynch's defenses of ratification, estoppel and laches. The panel found in favor of Respondent Merrill Lynch on its claim that Claimants failed to mitigate their damages.

2. Respondent Merrill Lynch's counter claim was denied.

3. Respondent Merrill Lynch was found liable and ordered to pay Claimants $1,541,857 in compensatory damages, interest at the rate of 9 percent from April 24, 2000 until the Award is paid in full, $11,932 in costs, $7,391 as sanctions for Merrill Lynch's failure to cooperate in the discovery process. The panel also awarded Claimants their $600 filing fee.

4. The panel awarded interest at 9 percent on the award of costs and sanctions from the date of the Award until paid in full.

5. Respondents were found not liable for Claimant's capital gains taxes incurred in the sale of the suitable securities.

This claim was based on the exercise of stock options and holding of securities on margin. The panel found that the Claimants were partially responsible and failed to mitigate their damages. The award is significant in that Mr. Chalius was a series 7 licensed stock broker and had worked for Merrill Lynch for three years prior to embarking on a new career wherein he was granted the stock options that formed the basis for the dispute.

Claimants' Counsel -
    Fred Hubner, Esq. and Lawrence R. Cock, Esq. of Cabie, Langebach, Kinerk & Bauer, LLP
Respondent's Counsel -
    Eric D. Lansverk, Esq. of Hillis Clark Martin & Peterson
Claimant's Expert - None
Respondents' Expert - None
Hearing Situs -
    Seattle, Washington
Arbitrators -
    Larry T. Coady, Esq., Public/Chairman
    Laurie E. Law, Esq., Public
    John F. Robbins, CFA, Industry

***Craig S. Chalius et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* NASD Case No. 00-05231**

Claimants asserted the following causes of action: breach of contract, breach of fiduciary duty, negligence, suitability, negligent misrepresentations, improper margin calls, violation of the Consumer Protection Act, violation of NYSE Rule 405 and NASD Rule 2310 involving the trading in Primus common stock, Internet Strategies proprietary fund and the use of margin. Claimants requested compensatory damages, interest, attorneys fees, costs and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and filed a Counter Claim against Claimants requesting dismissal of the Statement of Claim, attorneys fees and compensatory damages.

1. The panel found in Claimants' favor on their claims of breach of fiduciary duty, breach of contract and negligence, but also found Claimants negligent. The panel denied Claimants' Washington Consumer Protection Act claim, and Respondent Merrill Lynch's defenses of ratification, estoppel and laches. The panel found in favor of Respondent Merrill Lynch on its claim that Claimants failed to mitigate their damages.

2. Respondent Merrill Lynch's counter claim was denied.

3. Respondent Merrill Lynch was found liable and ordered to pay Claimants $1,541,857 in compensatory damages, interest at the rate of 9 percent from April 24, 2000 until the

Award is paid in full, $11,932 in costs, $7,391 as sanctions for Merrill Lynch's failure to cooperate in the discovery process. The panel also awarded Claimants their $600 filing fee.

4. The panel awarded interest at 9 percent on the award of costs and sanctions from the date of the Award until paid in full.

5. Respondents were found not liable for Claimant's capital gains taxes incurred in the sale of the suitable securities.

This claim was based on the exercise of stock options and holding of securities on margin. The panel found that the Claimants were partially responsible and failed to mitigate their damages. The award is significant in that Mr. Chalius was a series 7 licensed stock broker and had worked for Merrill Lynch for three years prior to embarking on a new career wherein he was granted the stock options that formed the basis for the dispute.

Claimants' Counsel -
Fred Hubner, Esq. and Lawrence R. Cock, Esq. of Cabie, Langebach, Kinerk & Bauer, LLP
Respondent's Counsel -
Eric D. Lansverk, Esq. of Hillis Clark Martin & Peterson
Claimant's Expert - None
Respondents' Expert - None
Hearing Situs -
Seattle, Washington
Arbitrators -
Larry T. Coady, Esq., Public/Chairman
Laurie E. Law, Esq., Public
John F. Robbins, CFA, Industry

Don E. McLoed v. Josephthal & Co., Inc. and its successor Fahnestock & Co., Inc., et al.
NASD Case No. 01-06296

Claimant asserted the following causes of action: unauthorized trading, breach of fiduciary duty, securities fraud, unsuitability, negligence and churning based on the purchase and sale of Critical Path and I-2Technologies securities. Claimants requested compensatory damages, interest, attorney's fees, costs and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of the Statement of Claim and costs. Respondent Fahnestock adopted the answer of Respondents Josepthal and the broker Respondent Christopher K. Somers.

1. The panel found Respondents jointly and severally liable and ordered Respondents to pay Claimant $1,003,725.20 in compensatory damages and 6 percent interest from July 18, 2000 until payment in full of the Award.

2. The panel found Respondents jointly and severally liable and ordered Respondents to pay Claimant $1,300,000 in punitive damages pursuant to *Diaz Vicente v. Obenauer*, 736 F. Supp. 679, 695 (E.D. Va. 1990).

3. Respondents were ordered to pay Claimant $774,863 in attorneys fees, $500 for the filing fee and all forum fees totaling $12,000.

This award is significant for its size and the fact that the panel awarded attorneys fees totaling approximately one-third of the overall award which includes punitive damages. Claimants counsel reports that no settlement offer was made by Respondents prior to the Award.

Claimant's Counsel -
W. Scott Greco, Esq. and Frederick D. Greco, Esq. of Greco & Greco
Respondents' Counsel -
John M. Myers, Esq. of Montgomery, McCracken, Walker & Rhoads
Claimant's Expert -
Robert Lowry of RL Consulting
Respondents' Expert - None

Hearing Situs -
Washington, DC
Arbitrators -
Staci Williams, Public/Chairperson
Diane S. Gold, Public
Patricia J. Randolph, Industry

***Charles and William Piscitello as Trustees on behalf of the Anne Piscitello Trust v. Securities America, Inc. and William Utes,* NASD Case No. 01-06444**

Claimants asserted the following causes of action: violation of Illinois Securities Law of 1953, violation of Illinois Consumer Fraud and Deceptive Business Practices Act, breach of fiduciary duty, negligence, breach of contract, respondeat superior and failure to supervise for the sale of suitable securities which incurred capital gains taxes and subsequent purchase of an unsuitable MFS Massachusetts Investment Growth Fund. Claimants requested compensatory damages, interest, attorney's fees, costs and reimbursement of capital gains taxes.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims and costs.

1. The panel found Respondent William Utes failed to recommend suitable investments and Respondent Securities America, Inc. failed to exercise reasonable supervision. The panel found Respondents jointly and severally liable and ordered them to pay $207,000 in compensatory damages and return $9,000 in commissions.

2. Respondents were found not liable for Claimants' capital gains taxes incurred in the sale of the suitable securities.

This claim was based on the sale of suitable securities for the Claimants' trust and purchase of an unsuitable mutual fund. The panel found that the broker, Utes, who did not file a properly executed submission agreement and who appeared and testified at the hearing, was bound to the arbitrators determination on all issues.

Claimants' Counsel -
James J. Eccleston, Esq. and Stephen Berkeley, Esq. of Shaheen Novoselsky Staat & Filipowski, PC
Respondents' Counsel -
Michael Grimm, Esq. and Harvey Herman, Esq. of Clausen Miller, PC
Claimants' Expert -
Jeffrey Schaff
Respondents' Expert - None
Hearing Situs -
Chicago, Illinois
Arbitrators -
Professor William Mock, Esq., Public/Chairman
Sheila A. Reilly, Esq., Public
Carmen P. Michelotti, Industry

***Marilyn Raines v. Sentra Securities Corporation,* NASD Case No. 02-00598**

Claimant asserted the following causes of action: breach of fiduciary duty, failure to supervise, fraud, violation of federal and state securities laws, NASD Rules of Fair Practice and NYSE Rules in the investment of Claimant's retirement account in a Jackson National Life variable annuity and Putnam Voyager Fund. Claimant requested compensatory damages, interest, attorneys fees, costs, rescission and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim requested dismissal of the Statement of Claim, attorneys fees and costs.

1. The panel found Respondent liable and ordered Respondent to pay Claimant $87,696 in compensatory damages, $28,000 in attorneys fees pursuant to case law presented by Claimant in the closing argument which were the cases of *First Interregional Equity Corp. v. Haughton*, 842 F. Supp. 105 (S.D.N.Y. 1994)

and *In re US Offshore, Inc.*, 753 F. Supp. 86 (S.D.N.Y. 1990). The panel also awarded $4,500 in expert witness costs and assessed Respondent $7,875 in forum fees.

This claim is significant because it represents a make whole award. Claimant was awarded her complete out of pocket loss, surrender charges for the variable annuity, interest, attorneys fees and expert witness costs.

Claimant's Counsel -
Ryan K. Bakhtiari, Esq. of Aidikoff & Uhl
Respondent's Counsel -
Michael R. Hall, Esq. of Hall, Jaffe & Clayton
Claimant's Expert -
Robert Maloney
Respondents' Expert - None
Hearing Situs -
Las Vegas, Nevada
Arbitrators -
Mandel E. Himelstein, Esq., Public/Chairperson
Douglas Edwards, Esq., Public
Curtis H. Baer, Industry

***Patricia B. Williams et al. v. J.P. Turner & Co. LLC and Daniel Dellarosa,* NASD Case No. 02-00590**

Claimants asserted the following causes of action: violation of Chapter 517 of the Florida Statutes, negligence, breach of fiduciary duty and fraud. Claimants requested compensatory damages, interest, attorneys fees, costs, rescission and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and filed a Counter Claim for the debit balance in Claimants' account. Respondents requested dismissal of the Statement of Claim and costs.

1. The panel found Respondents jointly and severally liable and ordered Respondents to pay Claimants $144,000. Respondent Dellaros was ordered to pay Claimants and additional $6,000.

Existence of tape recorded conversations between the broker and the customer were not disclosed until approximately 30 days prior to the hearing. Claimants used the tapes to demonstrate that the trading in the account was solicited since the broker had marked the trade tickets "unsolicited". Respondents argued that because Claimant had attended a 3 day Wade Cook Seminar prior to opening the account that Claimant was a "sophisticated investor." The result is significant and demonstrates that all investors are entitled to the protection of the law whether or not they are arguablely sophisticated.

Claimants' Counsel -
Eric E. Ludin, Esq. of Piper, Ludin, Howie & Werner, PA
Respondents' Counsel -
S. Lawrence Polk, Esq. and Amy Hass, Esq. of Sutherland, Asbill & Brennan, LLP
Claimants' Expert -
John Reven and John Lyman
Respondents' Expert - None
Hearing Situs -
Tampa, Florida
Arbitrators -
Maurice M. Feller, Esq., Public/Chairperson
Edward M. Panzica, Public
Albert Roberts, Industry

***Thad Wong v. Morgan Stanley, DW, Inc. and John Spillane,* NASD Case No. 01-03978**

Claimant asserted the following causes of action: violation of state securities laws, violation of NASD Conduct Rules, breach of contract, common law fraud and misrepresentation, breach of fiduciary duty, constructive fraud, respondeat superior, negligence and negligent supervision involving the purchase of high tech stocks Ariba, Covad Communications, Sycamore Networks and Entrust Technologies among others. Claimant requested compensatory damages, interest, attorneys fees, costs, and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of the Statement of Claim, expungement of Spillane's CRD and costs.

1. The panel found Respondents jointly and severally liable and ordered Respondents to pay Claimant $334,280 in compensatory damages plus 10 percent interest from July 12, 2001 until the Award is paid in full.

2. Respondents were found jointly and severally liable and ordered to pay $25,000 in attorneys fees, $6,578 in costs, $500 for Claimant's filing fee.

3. The panel also ordered the expungement of the claim from Spillane's CRD to all claims except for Claimant's negligence cause of action.

This claim is significant because the Claimant, Wong, was a former Charles Schwab day trader who transferred his portfolio to Morgan Stanely who committed wrongful conduct in his account.

Claimant's Counsel -
  Andrew Stoltmann, Esq. of Koeller Hargett & Caruso
Respondents' Counsel -
  Eric Chial, Esq. of Lewitas & Associates and Ronald Wood, Esq. of Morgan Stanley DW, Inc.
Claimant's Expert - None
Respondents' Expert - None
Hearing Situs -
  Chicago, Illinois
Arbitrators -
  Anita M. Rowe, Esq., Public/Chairperson
  Rev. David J. Langseth, Public
  Carmen P. Michelotti, Industry

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Website: www.PIABA.org

Upcoming Events:

PIABA 12th Annual Meeting and *Securities Law Update*, October 22 - 26, 2003. La Quinta Resort, La Quinta, California.

Annual Business Meeting, October 23, 2003 from 11:45 a.m. - 1:45 p.m. La Quinta, Resort, La Quinta, California.

PIABA Board of Directors Meeting, October 26, 2003. La Quinta Resort, La Quinta, California.

California Mid-Year Meeting, February 21, 2004. Location to be Announced.

PIABA Board of Directors Meeting, March 13-14, 2004. Location to Be Announced.

For more information pertaining to upcoming PIABA meetings, contact the PIABA office or visit the PIABA website at www.PIABA.org.

New Members:

(since publication of Spring 2003 issue of *PIABA Bar Journal*)

John G. Appel, Jr.	(619) 232-1200
V. Michael Arias	(305) 357-9011
Daniel Arshack	(212) 267-3700
Daniel E. Bacine	(215) 963-0600
John Baker	(512) 703-2300
William Bankston	(907) 276-1711
Eric J. Berger	(212) 265-6888
Susan Bernhardt	(303) 864-1000
Michael Betts	(412) 826-8550
Dan Bishop	(704) 716-1200
Samuel T. Brannan	(770) 673-0047
Orousha Brocious	(310) 274-0666
Steven G. Calamusa	(561) 799-5070
John S. Chapman	(216) 241-8172
Dennis M. Charney	(208) 938-9500
Walter Clark	(760) 568-5661
David Cutler	(847) 765-8000
Michael Dennison	(203) 624-9500
Richard Dodd	(254) 697-4965
Thomas Donahoe	(412) 394-5399
Christopher Dorsey	(713) 654-7654
Thomas T. Dunbar	(601) 949-8900
Sheryl Falk	(713) 654-7615
Joel Finkelstein	(845) 562-0203
Craig Follis	(804) 648-1551
David M. Foster	(248) 855-0940
Richard S. Frankowski	(205) 328-9576
William Fynes	(214) 231-0547
Peter S. Gersten	(860) 561-5313
Steven R. Griffin	(850) 432-2451
Paxton R. Guymon	(801) 363-5600
Kenneth Hardison	(919) 829-0449
Jesse Harrington	(601) 605-3501
JoAnn Hoffman	(954) 772-2644
James Jackman	(941) 747-9191
James S. Jones	(330) 757-7700
Gerald D. Jowers, Jr.	(803) 256-7550
Gregory W. Kehoe	(813) 286-4100
T. Michael Kennedy	(972) 281-5888
Deokyoung Ko	(317) 598-2046
Frederick C. Kramer	(239) 394-3900
Scott Lane	(412) 394-4406
David Leacock	(561) 655-1901
Amy Leonetti	(651) 209-1170
Ted Machi	(817) 335-8880
Michael Malarney	(585) 263-2608
Richard Manger	(336) 889-4334
Gary Mason	(202) 429-2290
Greg May	(214) 443-7500
James McGowan	(630) 262-0366
Frank R. Mead	(602) 255-6012
James Mentkowski	(414) 278-8759
Jim Murphy	(248) 737-8400
Salvador Ongaro	(602) 255-6000
J. Boyd Page	(770) 673-0047
Gary Paige	(239) 277-1979
Lorraine Powers	(954) 772-2644
Carlos A. Prietto, III	(949) 720-1288
Adam Rabin	(561) 838-4100
Jose Riguera	(305) 856-2444
Arnold Rosenblatt	(603) 621-7102
Edward Russey	(949) 770-7004
Charles Schwager	(713) 222-2700
Thomas St. Germain	(337) 291-1925
Michael J. Stanton	(813) 286-4100
James C. Steffl	(248) 648-8600
David Sternberg	(215) 569-0900
Willard P. Techmeier	(414) 223-1050
Eugene L. Trope	(310) 207-8228
Steven Wigrizer	(215) 569-0900
Daniel G. Williams	(561) 799-5070