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PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

Features And Columns

President's Message — by Charles W. Austin, Jr. — 1

ProfLipner's "I Love New York Law"
Some Old Cases on Damages That Might Just Apply Today — by Seth E. Lipner — 2

Practitioner's Corner
Mediation: Learning From The Hits and Misses — by David E. Robbins — 5

Expert's Corner
Confidentiality and the Doctrine of "Shared Discovery" in the Arbitration of Customer Claims Against Broker-Dealers — by Reagan D. Pratt — 12

Expert's Corner
Advanced Analytics-Effectively Portraying the Actual Risk and Return Profile of Your Client's Portfolio — by Jeffery & Michele Schaff — 20

Expert's Corner
Flat Fees or Fat Fees? Did Your Client Get a Wrap Account or a Bum Wrap? — by Douglas J. Schulz — 30

Expert's Corner
How To Conduct A Complex Financial Arbitration Part 1: Matters To Consider Prior To The Hearing* — by Richard Chernick and Rufus V. Rhoades — 35

Splintering Shareholder Groups and Mutual Funds Who's Mutual Fund Is It Anyway — by Max Rottersman — 42

Expert's Corner
Detecting Personal Trading Abuses — by Craig J. McCann — 52

Recent Arbitration Awards — by Ryan Bakhtiari — 60

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The Bar Journal of the Public Investors Arbitration Bar Association

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President's Message

Charles W. Austin, Jr.

Even as the tales of greed and corruption on Wall Street during the last decade continue to emerge, the "pushback" against the public investor has already begun. Members of the financial press who made a living the last few years bringing us salacious stories of excess and double-dealing are now calling for investors to quit whining and put it all behind them. Federal judges are rolling back the clock on 60 years of development of the federal securities laws to a time when it was every man for himself in a *caveat emptor* world. Powerful members of the U.S. Congress - who just 2 years ago took every good sound bite opportunity to denounce the financial services industry and the lax oversight of the regulators - have attempted to enact legislation which would all but gut the regulatory authority of state securities regulators; often at the instance of the industry itself and all in the name of more efficient regulation.

The financial services industry has begun to mount a "pushback" of its own of a far more arcane and subtle nature, but one which is potentially far more damaging to the public investor over the long term than those which come and go with the political winds and media fancy. It is for this reason that PIABA and its mission may be more important and relevant to the protection of the public investor than it has been in the last 10 years.

As it has done in the past when caught with its collective hand in the cookie jar with no plausible excuse, explanation, or defense for its behavior, the securities industry has set about to limit its exposure by focusing its efforts on the very system of dispute resolution that it imposes on its customers. These efforts are marked by systemic abuses of the process and attempts to limit the rights of investors to recover their losses by enacting seemingly arcane and innocuous rule changes under the radar screen. If left unchecked, the result will be a system whereby the public investor is deprived of any meaningful chance to recover that to which he is rightly entitled.

While PIABA may not yet be in a position to unilaterally demand and effect the changes necessary to make the arbitration process the fully equitable and relatively expeditious and efficient form of dispute resolution it is ideally intended to be, we are in a position to prevent things from happening which deprive the aggrieved public investor of a fair chance to recover his losses. To have come so far in such a short period of time is the real miracle of this organization.

PIABA would not find itself in the position it occupies today but for the tireless and relentless efforts of a lot of dedicated people. If the industry's efforts of the last year to distort and abuse the arbitration process are any indication, there will be much more work to do in the upcoming year. Fortunately, it is in just such environments that PIABA has always functioned best and served its most important role.

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ProfLipner's I Love New York Law Column – Some Old Cases on Damages That Might Just Apply Today

By: Seth E. Lipner

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The law of damages is pretty straightforward. In many states, where a securities act exists, damages are based on a formula. ***. Whether one adopts the so-called "out-of-pocket" method or the "benefit of the bargain" method seem to depend only on (a) market conditions and (b) which side you are on. And there is no question that as to attorneys fees, the "American Rule" (each side pays his own) predominates, although there are exceptions.

This article explores each of these subjects, focusing on two old cases which can be helpful to investors seeking to obtain full compensation.

HOTALING: "BUYING AND HOLDING"

An interesting, in some respects "leading" case on damages is *Hotaling v. Leach & Co.*, 247 N.Y. 84 (1928). Although a little long in the tooth, the case was decided by the New York Court of Appeals in the days when Benjamin Cardozo served on the Court; that Court's influence is still felt today, and no lawyer in New York would shy away from citing it. Indeed, the *Hotaling* case is still cited by courts on how to measure damages in securities fraud cases.

In *Hotaling*, the plaintiff was induced to buy and hold a bond as a result of a fraud committed by the defendant. Declaring the case not usual, the Court wrote that a

> seller's fraud is ordinarily complete and its effect exhausted at the sale. . . The buyer might [thereafter] sell or retain what he bought. Subsequent increase or decrease of value might bring profit or loss to the buyer, but such profit or loss would be the result of subsequent events and of choice by the buyer whether to hold or sell, [and thus not be attributable to the fraud].

Id. at 88.

But, the *Hotaling* Court observed, since the buyer in that case was induced by the fraud not only to buy but also to hold the bond (as an investment) for a period of years, the Court held it was wrong to limit damages to the bond's *ex-fraud* value on the purchase date. To do so, the Court explained, would exclude from the computation an important element of plaintiff's damage, *i.e.* the damage caused by plaintiff's holding of the security until a date when its value had all but disappeared.

As is often the case in "buy and hold" frauds, in *Hotaling* not all of the decline in value of the bond during the holding period could be attributed to the original fraud (i.e., there were other factors, including declining market conditions, which exacerbated the damages). That fact was

deemed irrelevant by the Court:

> if a complete and accurate picture had been given of the . . . company's position, an expectant investor might have hesitated and drawn back with a reasonable fear that any adverse change in business conditions would bring ruin to the company. That ruin came with a change of conditions. The effect of the [fraud] did not cease with plaintiff's purchase. He continued to hold the bond for investment in accordance with defendant's recommendation. Loss of his investment followed because of the weakness the company had been concealed from him by the defendant
>
> . . . **The loss proximately caused by the defendant's fraud is the difference between the price he paid and the value of what he received when put to the use contemplated by the parties.** In this case the value must be determined in light of subsequent events. As long as the fraud continued to operate and to induce the continued holding of the bond, all loss flowing naturally from that fraud may be regarded as its proximate result. . . .

Id. at 91-93 (emphasis added).

The Court thus held that, even in instances of declining markets, that the full measure of one's loss can be recovered in an investment fraud case where the fraud not only induced the purchase, but where it also induced "the holding".

The *Hotaling* reasoning is powerful. First, it recognizes the continuing influence of the broker on one whose intent was to buy and hold for growth. Since it is often presumed that all investors know that the value of all securities fluctuate with market conditions, a decline following a purchase can sometimes reasonably be expected even absent a fraud. Thus, one who was lead to believe he was buying for the "long-term" is less likely to be alerted to a fraud by a decline than one who expected to discover quickly the profitability of an investment. The *Hotaling* Court understood the difference. In "buy and hold" cases, subsequent losses can be recovered. the value must be determined in light of subsequent events. ("As long as the fraud continued to operate and to induce the continued holding of the bond, all loss flowing naturally from that fraud may be regarded as its proximate result. . . .")

Second, the decision recognizes that risky investments will, in bad times, decline more than safe investments, all other things being equal. ("Loss of his investment followed because of the weakness the company had been concealed from him by the defendant. . . .") The Court recognized that time played a part in exacerbating loss, but does not use that fact to limit the plaintiff's damages.

The brilliance of the Cardozo court, seen in this old case, still shines clearly. It applies as much today as it did then

***Schindler*: Recovering Attorneys Fees: An Unusual Case That Comes Up A Lot**

We all know that, as a general rule, the costs of litigation are not recoverable as damages in the absence of an agreement or a statutory mandate. Under New York law, only GBL 349 ("Deceptive Practices") can arguably apply to a securities case. But there are other exceptions to the general rule, which sometimes apply (where the proper facts exist)

For example, it has long been the law in this New York that if, through the wrongful acts of an adversary, a person is required to undertake or engage in other litigation with third persons to protect his or her interests, then such aggrieved party is entitled to recover those legal fees (and other expenses) incurred as a result of the transgressor's wrongful conduct. See, e.g. *Kinney v. Massachusetts*

Bonding & Ins. Co., 206 N.Y.S. 163, 170 (3rd Dept. 1924)(the legal fees, paid by the plaintiff to negotiate a substitute contract, were "directly occasioned and made necessary by the default of the [defendant].")

Notwithstanding the earlier decision in *Kinney*, the leading case on this subject is *Schindler v. Lamb*, 25 Msc.2d 810, 211 N.Y.S.2d 762 (Sup.Ct.N.Y.Co. 1959), *aff'd*, 10 A.D.2d 826, 200 N.Y.S.2d 346, *aff'd*, 210 N.Y.S.2d 226. *Schindler v. Lamb* involved a claim of fraud perpetrated by the defendant. The complaint sought damages for counsel fees and other expenses necessarily incurred in litigation with other parties which had to be undertaken as a result of the defendant's fraud.

The defendant in *Schindler* relied on the general rule against including attorneys fees as damages. The court, however, wrote:

> But there is a well-recognized exception to the rule. If, through the wrongful act of his present adversary, a person is involved in earlier litigation with a third person in bringing or defending an action to protect his interests, he is entitled to recover the reasonable value of attorney's fees and other expenses thereby suffered or incurred. [citations omitted].

Id. at 211 N.Y.S.2d 762. See also *Fugazy Travel Bureau, Inc. v. Ernst & Ernst*, 31 A.D.2d 924 (1st Dept. 1969); *City of Elmira v. Walter*, 546 N.Y.S.2d 183, 185 (3rd Dept. 1989).

Aside from the *Schindler* exception, it has been held that attorneys fees are recoverable in cases where the gravamen of an offense is "malice." *See e.g., Agostini v. State of New York*, 255 A.D. 264 (3rd Dept. 1938)(citing as examples of actions grounded in malice false imprisonment and malicious prosecution); *United Pickle Co. v. Omanoff*, 63 A.D.2d (1s Dept. 1978)(involving allegations of a malicious conspiracy to convert the plaintiff's property); *Mastic Fuel Services v. Cook*, 55 A.D.2d 599 (2nd Dept. 1976). Whether a case of invidious securities fraud or theft would qualify is up to an arbitration panel.

The Practitioner's Corner – Mediation: Learning From The Hits and Misses

By: David E. Robbins

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Introduction

Learning from the real-life mistakes, successes and creativity of others can often have a lasting impact on the way you practice law. That is the hope of this article, which starts with a view from the trenches of mediation and then focuses on six constructive war stories.

Most arbitrators do not want to accept the possibility that the broker is a "bad guy" or that the customer is not telling the truth. The truth, many arbitrators believe, lies somewhere in between. If those are arbitrator perceptions, it may make sense to try to resolve the case in mediation, before presenting it to an arbitration panel. But to do so, the parties must have the proper mindset - namely, that a mediated settlement is a settlement and is not a win for one side.

Attorneys should be sensitive to the fact that in mediation, they are assuming two roles: advocate and advisor. If the attorney does not want his client to believe he has lost faith in the case (i.e., that he is less of an advocate than he should be), the attorney must rely on the mediator to provide an objective assessment or evaluation of the case. Such attorneys prefer the client to hear that assessment from the mediator rather than from the attorney.

It has been my experience that brokerage firms will often be motivated to settle if defense counsel honestly believes the following:

1. That the arbitrators could conclude that the customer's reliance on the broker's representations was reasonable, based on the customer's prior investment experience (if any);

2. That there will be a problem with the broker as a witness. For example, defense counsel will be concerned if it is likely the arbitrators will conclude that the broker's investment model for all his customers - no matter their unique circumstances - was that "one size fits all"; and,

3. That eventually, Claimant's counsel will figure out – if it is true – that the branch manager failed to reasonably and diligently supervise the broker.

There are many variations on these three factors. What follows are actual mediations - three which settled and three which did not - in which at least one of these three factors played a part. They

are offered with the hope that you, my PIABA colleagues, will benefit from the hits and misses of others. After each case presentation, there is a "lesson learned."

Successful Mediations

1. Alaska in December

It was alleged that before **Broker X** (a Respondent in the arbitration) left **Brokerage Firm Y** to join another firm, he took with him customer records of **Broker Z** (the Claimant in the arbitration, who worked with Broker X at Brokerage Firm Y). Thereafter, at his new brokerage firm (the other Respondent in the arbitration), it was alleged that Broker X solicited business from Broker Z's customers. Broker X denied participating in the purloining of Broker Z's customer records but a former sales assistant at the first brokerage firm told Broker Z's attorney that he and Broker X were involved in the misconduct. There was no documentary proof (e.g., office entry records, security video tapes, telephone records) to confirm what the former sales assistant asserted and Broker X vehemently denied engaging in the theft of Broker Z's customer records. He had a clean CRD.

A day before the mediation (conducted in Alaska in the winter), the mediator met separately with both brokers, as well as the former sales assistant. Based on those interviews, the mediator was able to uncover corroborating evidence that the arbitrators, eventually, would probably conclude that Broker X had participated in the theft of Broker Z's records. The mediator got the wife of the sales assistant to tell him how her husband and Broker X had gone to the office (of his former firm) late one night to obtain the records.

The attorney for the Respondent brokerage firm (where Broker X went to work) believed in Broker X's veracity, however. Therefore, after the first day of mediation, the mediator asked that defense counsel to speak directly with the corroborating witness (the sales assistant's wife). Thankfully, defense counsel had kept an open mind throughout the process and was willing to speak with the sales assistant's wife, despite his belief in Broker X's honesty. Defense counsel came to the conclusion, on his own, that the sales assistant's wife was probably telling the truth and would be a formidable witness against Broker X, and, thus, against the attorney's brokerage firm client. Outside of the mediator's presence, the mediator wanted that defense attorney to come to his own conclusion that his broker would not do well on the witness stand.

However, since Broker X had not signed up too many of Broker Z's clients as customers for the Respondent's brokerage firm, it was apparent that compensatory damages would be low. As a result, the Respondent brokerage firm initially offered only a nuisance value figure to settle the case. The brokerage firm eventually settled for a substantial amount of money based on the probability that Broker Z (the Claimant) would obtain punitive damages in the relatively small community in Alaska and that Broker X's career could be adversely affected in that community.

Lesson learned: Even if the compensatory damages that could be awarded by the arbitrators are likely to be small, it makes a great deal of sense for the parties to settle if the repercussions from an adverse Award – punitive damages - could far exceed those compensatory damages.

2. The Posthumous Arbitration

The last thing Dr. S, a California resident, did before killing himself was to sign the Uniform Submission Agreement to his Statement of Claim. However, before taking his life, he left many breadcrumbs behind. They consisted of e-mails, faxes, letters and taped telephone conversations in which he had discussed speculative trades that appeared to be arbitrary and inconsistent (but consistent with his bizarre personality). All he asked of his brokers in New York City – the Respondents in the

arbitration - was that they provide "best execution" on his orders and that when he entered his orders from California after the market closed in New York (for execution the following morning in New York), he, Dr. S., get the best prices at the market's opening that next morning.

Based on his eccentric personality, the brokerage firm had a due diligence report done of him (at the time his account was opened). The firm found (but apparently was not very influenced by the fact of) five lawsuits naming the customer as a defendant, as well as the fact that the customer's CPA license has been suspended because of dishonesty, fraud and gross negligence.

Prior to the mediation, Claimant's counsel gave the mediator access to two former brokerage firm employees who would, he said, testify on behalf of Dr. S's estate. The mediator spoke with them and found that they would be effective witnesses against their former brokerage firm. They told the mediator that Dr. S' broker in New York City rarely showed up to work until way after the stock market's opening; that he had a reputation for substance abuse; that he had been fired since the account closed; and, that Dr. S' account was usually handled by a 22 year old sales assistant who was completely out of his league for an account of this size. Whether this was entirely true, that is what they said would be their testimony at the arbitration.

In caucuses with defense counsel, the mediator told him of their anticipated testimony. The attorney said that the activities of that branch might give rise to a disciplinary investigation by the New York Stock Exchange or NASD Regulation. The potential testimony of the two former employees at the arbitration would not be of great assistance to the brokerage firm. Therefore, he convinced his client (the brokerage firm), that despite the permanent absence of the customer from the arbitration, it made more sense to settle with the late customer's estate.

Lesson learned: Sometimes there is a concern of defense counsel that a brokerage firm's former employees, in their testimony as witnesses called by the Claimant, will graphically testify about a failure to supervise the broker's trading in the Claimant's account. In this case, there was a justifiable concern about the poor executions received by the customer and a failure to supervise the aggressive, institutional-size trades of an eccentric retail customer.

3. Possible Hush Money Trumps Authorized Trading Activity

In this tech-wreck case brought by a very well-known tech-wreck customer attorney, the customers – both unemployed and one partially disabled – alleged that the broker over-concentrated their life savings in unsuitable, speculative Internet and telecom stocks and that while there was a great deal of trading, theirs was, in actuality, a de facto discretionary account because they agreed to buy or sell whatever the broker recommended. Not surprisingly, the account was profitable from the spring of 1997 to the spring of 2000, and then suffered substantial losses, incurring devastating margin debits and numerous margin calls.

Both sides agreed that the customers – husband and wife – became very close to the broker. The husband spoke with the broker daily, after checking the status of his account, online, each morning. The brokerage firm claimed that the husband entered numerous unsolicited orders, did his own research and wanted to purchase technology stocks. If those were all the main issues of the case, there would be nothing distinguishing it from the thousands of others that have been filed since the spring of 2000. However, there was a twist in this case which, after a day-long mediation, resulted in a settlement.

It seems that the broker, feeling bad about the losses incurred in the account, made many payments directly to the customers over a period of a year and half. During the mediation caucuses, the customers said that the broker gave them this money to stifle any complaints to management, in the hope that, in the mean time, the market would rebound. In caucuses with the broker, however, he told the mediator that he made these payments (of over $50,000) because he felt bad about the dire financial condition of the customers caused, he insisted, solely because of their authorized purchases of tech stocks in a lousy market. He said that he did not make the payments to forestall any complaints because, according to him, the customers had no reason to allege that he had engaged in any wrongdoing with respect to the trading in their account.

At the outset of the mediation, the mediator told the broker and his former firm (for the broker was "permitted to resign" after the firm received a copy of the Statement of Claim and learned, for the first time, of the payments) that there was a possibility that the arbitrators would infer an admission of liability from his payments and the fact that he was no longer employed by the Respondent brokerage firm because of those payments. The mediator told the parties that it was not his intention to try to convince the broker that the arbitrators would definitely conclude that he made the payments with the intention of keeping the customers quiet. That was because, said the mediator, he finds that it is never fruitful to tell someone that he is certain to lose the arbitration. There is, he told them, often a strong possibility that the arbitrators will accept the adversary's rendition of events. If there is that possibility, it makes more sense to try to settle the case in mediation. No one wants to believe arbitrators will conclude that they are not telling the truth. The case settled late that afternoon.

***Lesson learned*:** Sometimes mediations get settled if a defense attorney believes that admitted, tangential misconduct could overshadow the authorized trading that took place. The primary reason this case settled was because the experienced in-house and outside counsel for the brokerage firm and the broker realized that there was a distinct possibility that the arbitrators would see the payments as an admission of wrongdoing, despite the daily contact by the customers with the broker and their daily awareness of what was going on in their account.

Unsuccessful Mediations

1. Venting Can be Unhealthy

In this case, the customer was a successful hard-working oncologist in his mid-60s. He asserted that since he had made so much money in the stock market through self-directed trading; since he wanted to retire within a year; and, since he did not want to trade equities any longer, he wished to hand over his sizable portfolio to experienced money managers to reallocate his portfolio of equities and mutual funds to bonds, which he knew nothing about. He did this shortly before the stock market began to implode in the spring of 2000.

Instead, what little trading took place was to sell equities to purchase equities. No bonds were purchased and no mutual funds were sold, and for most of the time, no trading at all took place. All the while, the doctors' accounts dropped dramatically in value, despite repeated requests from the doctor and his wife for the broker to do something. This inaction and apparent inexperience in bonds on the part of the broker led the doctor to close his pension account in just a few months. He sought as damages the drop in the value of his account during that period of alleged incompetence.

The brokerage firm and the broker – while agreeing that the doctor told them that he wanted to retire early and replace his growth-oriented equity holdings with a fixed

income portfolio – said, nevertheless, that it was the doctor's decision alone not to sell those aggressive tech stocks and mutual funds because he wanted to wait until they rebounded in price, before selling them and buying bonds.

Neither side had contemporaneous correspondence or notes that supported their respective positions. Therefore, instead of leaving the resolution of the case to the unpredictability of arbitrators, we tried to see if we could successfully mediate the dispute.

A few days before the mediation, the mediator was telling the customer's attorney that he did not have a clear picture of the Claimant. The mediator asked if he could have a teleconference with the attorney and his client before the mediation session. The attorney told the mediator that his client was taciturn and unemotional and that he, too, was having difficulty getting through to his client. In that pre-mediation teleconference, the mediator suggested to the customer that after the "mediator presentation" of the issues and facts, he – the doctor - might want to tell the brokerage firm attorney and the broker why he brought this case, in his own words. He listened quietly to this suggestion and said that he would take it under advisement, all the while coming across as a highly intelligent person.

At the mediation, the mediator asked Claimant's counsel if he wished to make a statement. Counsel deferred to his client, who, until then, had sat passively, studiously taking notes. The doctor put down his pen, looked at the mediator and then looked across the table to the broker and to the brokerage firm's attorney.

"He's an idiot," said the doctor in a highly emotional voice. "He never could understand the goals of my account. He was completely unqualified to take my account. He's an idiot." The doctor augmented his outbursts with a great deal of finger pointing towards the broker, who, with the brokerage firm attorney, sat aghast and ashen faced.

After order was restored, we broke up into caucuses. The first thing the brokerage firm attorney said to the mediator was, "Now this case is going to be tougher to settle. My broker is extremely offended by the doctor's outbursts." While the Claimant felt better by leveling his verbal charges against the broker, he was unable to substantiate his assertions with any documents and, therefore, the brokerage firm felt emboldened to make a relatively small settlement offer (which was rejected).

***Lesson learned*:** They say that customers often want to just "get it off their chest" at mediations and that once they do, they will be more amenable to settling. That is not always the case. Catharsis does not always lead to redemption. Such venting can greatly offend a broker. The venting in this case should have been in the private caucuses and not in the open session.

2. The Claimant Who Was Still Working for the Brokerage Firm

At the time of the mediation, Ms. L was a director and manager of a well-known brokerage firm's municipal sales department. She claimed, in her Statement of Claim, that that brokerage firm failed to compensate her at the same level it paid comparable male employees; that it refused to promote her to managing director; that it engaged in a pervasive pattern and practice of sex discrimination; and, that the firm reduced her management duties and responsibilities. However, because she had an employment contract, she remained on the job after filing the Claim and, because the brokerage firm did not want to be accused of retaliatory discharge, she still went to work everyday, where she encountered cold-shoulder after cold-shoulder.

It was the position of the brokerage firm that new management directives that affected the Claimant's department were non-discriminatory and universally applied and that at no time was she discriminated against due to her gender or any

other reason. While she may have been paid less than others in her department, her compensation was, said the brokerage firm, consistent with industry pay scales.

As the mediation progressed, it was clear that the Claimant would come across very sympathetically to an arbitration panel (as opposed to way in which the brokerage firm's witnesses would be perceived) but that she would have difficulty quantifying and obtaining substantial compensatory damages. So, the mediator came up with the proposal that in exchange for her leaving the firm, the Claimant would settle the case for a reasonable severance package. Her very presence at the brokerage firm was uncomfortable for all concerned but outside defense counsel, hammering on the law (which is quite favorable to employers in almost all cases with employees), was unwilling to accept the reality that the Claimant's daily presence at the brokerage firm was adversely affecting the department's production and morale. The law was the law, she said to the in-house attorney, who was dependent on the outside counsel for guidance.

***Lesson learned*:** When an outside defense attorney is unwilling to disassociate her legal analysis of a case in order to please in-house counsel, and when she wants to prove she can beat her male adversary, it is difficult if not impossible to settle a case.

3. Some Cases Should Just be Arbitrated

Mr. A was a Managing Director and Co-Head of the Mortgage-Backed Securities Trading Department of a well-known brokerage firm. In his arbitration, Mr. A claimed that corporate decisions were made that affected his and others in that department, decisions that drastically altered his responsibilities. He argued that the significant reduction of professional staff, trading limits and risk capital and "the material change in his duties" justified his resignation from the firm. The firm's actions, he said, amounted to constructive discharge – as if he were fired without cause. In the arbitration, he was seeking the trading bonus he would have received had he not "been forced to resign."

The brokerage firm argued that Mr. A was not singled out and that disastrous financial conditions in that department called for a sea change. The firm asserted that a change or reduction in his responsibilities, based solely on those terrible financial conditions, did not amount to "intolerable working conditions" that would justify a arbitration panel finding of constructive discharge.

Thus, in a nutshell, the former employee was asking the arbitrators to view the brokerage firm's conduct by one standard and the brokerage firm was asking the arbitrators to judge its conduct by another standard. That is, the former employee claimed that there had been a "material change" in his duties, justifying his resignation and the brokerage firm argued that he had to be able to prove "intolerable working conditions" to satisfy a claim of constructive discharge. Since the parties and their attorneys did not know which of the two standards the arbitrators would apply, it made sense to mediate the case. Or, at least, that was the thought of the mediator.

In employment cases especially, the way in which the former employee comes across as a person is often determinative of the case's outcome. If he or she comes across as an egocentric wise guy who made hundreds of thousands of dollars in "discretionary bonuses", he or she will have a tough time prevailing in arbitration even if he or she was treated improperly by the brokerage firm. In this case, Mr. A came across as a really nice guy who had worked hard at the brokerage firm and who, he believed, had no choice but to leave the firm to preserve his sanity. He did not even go to another employer.

As the mediation session progressed, the brokerage firm's attorney realized that Mr. A would come across quite well. However, she said,

she would rather lose the case in arbitration than set a "bad precedent" - for there were other arbitrations that had been filed by the same law firm for other former employees of the brokerage firm - by settling this case in mediation.

***Lesson learned*:** Sometimes a mediator's detailed analysis of the case gives both sides justification for going forward with the arbitration. In this case, the attorneys agreed to disagree on the theory or standard of liability the arbitrators would impose. The brokerage firm ultimately was correct in its decision not to settle, for the arbitrators accepted its defense and dismissed the claim in its entirely (showing, again, how difficult it is for brokers to prevail in constructive discharge cases).

Conclusion

Still in its infancy, securities mediation is evolving at a rapid pace. A number of our PIABA colleagues have expressed frustration with the process, primarily when it appears that the brokerage firm is not approaching it in good faith or is just looking for some "free" discovery.

Mediations will only result in settlements if both parties want them to settle. Just as you can't force your teenager to clean his room or that stunning member of the opposite sex to fall in love with you, parties have to want to settle. No matter how high the mediator's professed "success rate", if the parties are not self-motivated to control the outcome of the dispute, the controversy will be left to the unpredictability of arbitrators, who sometimes get it wrong. Learn from the experiences of others. Keep an open mind; recognize that cases often settle for reasons unrelated to the merits of a case; and, accept the fact that even in arbitration, perception can become reality.

Confidentiality and the Doctrine of "Shared Discovery" in the Arbitration of Customer Claims Against Broker-Dealers

Reagan D. Pratt

The doctrine of "shared discovery," which permits litigants to share otherwise-confidential documents produced in discovery by a common adversary, is a well-established rule of procedure in this state. In the context of securities arbitration, however, broker-dealers facing similar customer complaints often deny the applicability of this doctrine, and of even the general premise that judicial proceedings should be open to public scrutiny. If accepted, such a procedural rule would significantly limit customers' ability to efficiently and effectively prepare claims based on wide-spread misconduct, such as the conflicts of interests exposed by recent investigations into firms' recommendations of the stocks of their investment banking clients. This article explores whether efforts to construct such roadblocks to effective discovery, or to cloak the process with a veil of secrecy, further any legitimate goals of securities arbitrations.

Introduction

Virtually every claim between securities broker-dealers and their individual customers are subject to mandatory arbitration, as a result of the industry-standard use of pre-dispute arbitration provisions in their form account opening agreements. Such arbitration clauses are enforced to compel every type of complaint about broker-dealer misconduct – whether asserted under the common law of fraud and breach of contract, or pursuant to the private rights granted under the anti-fraud and registration provisions of the state and federal securities acts – to arbitrations governed by procedures that the securities industry itself largely crafted. [1]

The vast majority of these arbitrations are administered by the National Association of Securities Dealers (NASD). In 2002, the NASD received 7,704 arbitration claims, and the filing rate through August of 2003 reflects a 23% increase over the same period of the previous year. [2] Another 1315 claims were filed last year with the arbitration forum administered by the New York Stock Exchange ("NYSE"). [3] Hence an entire body of law and procedure, for a large class of disputes concerning the conduct of a nation-wide industry, is decided by this private corporate judicial

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[1] *See Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220 (1987).

[2] *See* "NASD Dispute Resolution Statistics," at http://www.nasdadr.com/statistics.asp.

[3] *See* http://www.nyse.com/pdfs/arbstats090503.pdf.

system administered by the industry's own trade associations.

Unlike ordinary court cases, these proceedings occur largely behind closed doors. A party investigating a broker or firm cannot look at the NASD or NYSE's docket to examine pleadings filed in related arbitrations. The arbitration hearings themselves are not held in public forums open to scrutiny. In addition to such secrecy, the industry respondents in these matters routinely ask arbitration panels to enter blanket confidentiality orders to limit the distribution of information about the process. Some broker-dealers do not, however, simply seek to limit access of the press. Rather, they further seek to prevent customers' counsel from using the discovery products from a given arbitration in other arbitrations against the firm, or from sharing such documents with other customer-claimants and counsel – even if those other customers have cases involving the same broker, the same investments, the same fact pattern, and the same legal claims.

In the Texas judicial system, of course, courts generally have no discretion to prohibit the sharing of documents or other matters simply because the press or other parties might discover it. Instead, open scrutiny of the judicial process is considered a vital shield to corruption and an important means of assuring the public's confidence in the enforcement of the laws of our society. Even when truly confidential information is at stake – such as legitimate trade secrets – the doctrine of "shared discovery" typically dictates that parties who obtain confidential information in one suit against a defendant may share that information for use in other suits, so long as the party receiving that information agrees not to disclose it to the defendants' competitors.

Both of these premises, considered so fundamental to the efficient and honest functioning of the judicial process in almost every state and federal court, are equally compelling in the context of industry-sponsored securities arbitrations. Unfortunately, the rules governing securities arbitration do not address the permissible scope or use of protective orders. And arbitrators have scant guidance from prior decisions, because (a) arbitrators are trained to avoid disclosing their reasons for their actions, and (b) the lack of meaningful appellate review of arbitration decisions has the collateral effect that no developing body of precedent guides future panels on procedural (or even substantive) questions. Accordingly, like most other procedural and substantive issues in the realm of broker-dealer liability, requests for confidentiality present battles that practitioners in this field can expect to fight over and over again until the SEC mandates written arbitration rules limiting the use of global confidentiality orders.

Discovery in Securities Arbitration – An Overview

Documents are generally the beginning and end of meaningful discovery in securities arbitrations. Depositions are rarely permitted, and standard interrogatories are expressly discouraged. Documents, on the other hand, abound. Broker-dealers are required, by extensive federal regulations and rules of the NASD and NYSE, to maintain detailed records of almost every aspect of their dealings with their customers and their employees. [4] Firms are required to maintain written supervisory procedures (generically referred to as "compliance manuals")

[4] *See, e.g.,* SEC Rules 17a-3 and 17a-4, promulgated under the Securities Exchange Act of 1934. 17 C.F.R. §§ 240.17a-3 and 240.17a-4 (2003).

describing the steps that they agree to undertake to ensure compliance with regulatory obligations and to "detect and prevent" violations of the securities laws. They are required to record the fact of, and basis for, the recommendations that they make to customers; they are required to review and maintain copies of all pertinent communications, including e-mails; they are required to document their reviews of accounts that reflect unusual or unwise activity; they are required to keep records of their internal audits (conducted at least annually) of the operations of every branch office. These documents can paint a vivid picture of the dealings between a customer, the "financial advisor," and his firm.

Accordingly, attorneys representing customers request the same categories of documents in connection with every "routine" customer claim (such as those for churning, unsuitability, unauthorized trading, failure to supervise, and other fraudulent conduct). [5] Recognizing this, in 1999 the NASD promulgated Notice to Members 99-90, commonly referred to as the "Discovery Guide." [6] This guidance includes a series of document lists that parties are expected to exchange "without arbitrator or staff intervention," and states that the documents on these lists are considered "presumptively discoverable" absent a showing of "good cause not to order production." In addition to account statements, agreements, confirmations, and customer communications, these lists call for the production of documents such as compliance manuals, exception reports, branch audits, disciplinary records, the basis for recommendations, and commission runs and other documents reflecting compensation received by the firm or broker.

The NASD promulgated the Discovery Guide to reduce discovery delays, based on its stated observation that: "Discovery disputes have become more numerous and more time consuming. The same discovery issues repeatedly arise." Unfortunately, the Discovery Guide has not lived up to its promise. Respondent firms routinely refuse to produce "presumptively discoverable" documents, forcing claimants to file and argue motions asking arbitration panels to compel the firm to produce documents listed in the Discovery Guide. [7]

A tactic that some firms employ to delay production of these documents is an insistence, prior to production, upon a "confidentiality" agreement or order barring the claimants from retaining discovery products after completion of the matter, or from sharing these materials with other parties. Brokerage firms typically argue that such confidentiality orders are necessary to (1) protect their

[5] Likewise, Respondent firms will ask the customer-claimants to produce a list of "standard" items. Since customers are not generally the type of repeat litigants whose personal documents might be relevant in other disputes, however, their document productions do not raise the type of "shared discovery" issues addressed in this article.

[6] NASD Discovery Guide, printed in NASD Notice to Members 99-90 (November 1999), at http://www.nasdr.com/pdf-text/9990ntm.com.

[7] Firms engage in such conduct with apparently little fear of consequence, due to the structural deficiencies inherent in any arbitration forum that routinely serves a single industry in its disputes with individual claimants, a circumstance which makes it impossible for arbitrators to hold the industry fully accountable if they wish to obtain future appointments. A full discussion of the evils of such a system is far beyond the scope of this article.

trade secrets; (2) prevent the press from reporting on the matters at issue; and (3) protect themselves from future litigation.

Arbitrators are given no written guidance by their sponsoring forums for responding to such requests. The NASD's Code of Arbitration Procedure is silent on the issue. The Discovery Guide obliquely states:

> If a party objects to document production on grounds of privacy or confidentiality, the arbitrator(s) or one of the parties may suggest a stipulation between the parties that the document(s) in question will not be disclosed or used in any manner outside of the arbitration of the particular case, or the arbitrator(s) may issue a confidentiality order.

Nothing in the rules or guidance, however, suggests which documents might qualify for such broad secrecy, or the standards that an arbitrator should apply to make this determination.

On the other hand, the NASD and NYSE have, through their congressional testimony and their conduct relating to their organizations' investigation of widespread analyst fraud, acknowledged the importance of shared discovery in exposing the truth and in permitting arbitration to serve its purported goals of equity and efficiency. Specifically, after exposing the pattern of compromised and outright fraudulent "research" recommendations issued by some firms, every regulator involved disclosed key evidence of the schemes for public view. The head of the NASD then explicitly stated his expectation that the documents so exposed will be used in arbitrations by, and lead to further discovery by, the thousands of retail investors who suffered losses after relying on their broker-dealers for honest stock recommendations.

Openness and The Shared Discovery Doctrine: The Legal Framework

When arbitrators look to case law for guidance, they find clear authority condemning broad confidentiality orders. The courts of every jurisdiction in this country view unwarranted requests for secrecy with extreme disdain. And the widely-accepted "shared discovery" doctrine protects the rights of individuals to share the fruits of discovery produced by repeat defendants.

As a general principle, there is a reason that the term "star chamber" is derogatory. The courts of every jurisdiction in this land recognize that secrecy for its own sake generally protects nothing but corruption, falsehoods, and inequity. A presumption of openness applies to all court proceedings in this country, criminal and civil, because "secrecy insulates the participants, masking impropriety, obscuring incompetence, and concealing corruption." [8] The U.S. Supreme Court holds that this presumption of openness "may be overcome only by an overriding interest based on findings that closure [of proceedings from public scrutiny] is essential to preserve higher values. [9]

The Ninth Circuit recently held that this same policy applies to arbitrations, and that attempts to make consumer arbitration proceedings confidential are void as an unconscionable violation of public policy. [10] The court reasoned that "confidentiality provisions usually favor companies over

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[8] *Brown & Williamson Tobacco Corp. v. FTC,* 710 F.2d 1165, 1179 (6th Cir. 1983), *quoted in Kelli Sager & Matthew Leish, In Defense of Public Trials,* 29 LITIGATION 54, 58 (2003).

[9] *Press-Enterprise v. Superior Court,* 464 U.S. 501, 510 (1984).

[10] *Ting v. AT&T,* 319 F.3d 1126, 1151-52 (9th Cir.), *cert denied,* 2003 U.S. Lexis 5506 (2003).

individuals," and fairness requires openness so that claimants will have access to the same body of knowledge and experience that the "repeat player" corporation gains from multiple arbitrations.

Even when evidence is entitled to confidentiality because it contains trade secrets or other sensitive information, the doctrine of shared discovery dictates that a plaintiff who obtains documents from a defendant in one case is generally permitted to share those documents with a similarly situated plaintiff who is also adverse to the same defendant. The party with whom the discovery is shared is, of course, prohibited from disseminating trade secrets to competitors of the producing party, and the producing party is typically entitled to the names of all such parties with whom information is shared. Subject to these caveats, however, even truly confidential information is free for use in other litigation against the producing party.

In Texas, courts generally have no discretion to prohibit the sharing of discovery products. At least two goals justify this doctrine: (1) full disclosure of the truth; and (2) efficiency. As the Texas Supreme Court observed in *Garcia v. Peeples*:

> Shared discovery is an effective means to insure full and fair disclosure. Parties subject to a number of suits concerning the same subject matter are forced to be consistent in their responses by the knowledge that their opponents can compare those responses.
>
> In addition to making discovery more truthful, shared discovery makes the system itself more efficient. [Without it, the system] forces similarly situated parties to go through the same discovery process time and time again, even though the issues involved are virtually identical.[11]

The court further noted that both state and Federal courts across the country have adopted this doctrine to help streamline discovery, to reduce costs for parties seeking it, and to improve judicial economy.[12] The alternative offers nothing but waste and expense, as "one party facing a number of adversaries can require his opponents to duplicate another's discovery efforts, even though the opponents will share similar discovery needs and will litigate similar issues."[13] Accordingly, shared discovery is the controlling premise in virtually every jurisdiction to have considered the issue.[14]

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[11] 734 S.W.2d 343, 347 (Tex. 1987) (multiple citations omitted).

[12] *Id. (citing Wilk v. American Medical Ass'n,* 635 F.2d 1295, 1299 (7th Cir. 1980); *American Telephone and Telegraph Co. v. Grady,* 594 F.2d 594, 597 (7th Cir. 1979); *Phillips Petroleum Co. v. Pickens,* 105 F.R.D. 545, 551 (N.D. Tex. 1985); *Ward v. Ford Motor Co.,* 93 F.R.D. 579, 580 (D. Colo. 1982); *Carter-Wallace v. Hartz Mountain Industries,* 92 F.R.D. 67, 70 (S.D.N.Y. 1981); *Patterson v. Ford Motor Co.,* 85 F.R.D. 152, 154 (W.D. Tex. 1980); *Parsons v. General Motors Corp.,* 85 F.R.D. 724, 726 (N.D. Ga. 1980)). Moreover, the *Garcia* court also observed that the Federal Judicial Center's Manual for Complex Litigation recommends sharing discovery in order to avoid duplicate efforts. *Id. (citing Manual for Complex Litigation,* Pt. I, § 3.11 (5th ed. 1982)).

[13] *Id.*

[14] *See Wolhar v. General Motors Corp.,* 172 A.2d. 464, 467 & n.8 (Del. Super. Ct. 1997) ("The great weight of authority in other jurisdictions holds that such sharing is not only theoretically sound but also justified as an efficient use of the resources of the courts and parties.").

Application of the Shared Discovery Doctrine to Securities Arbitrations

The core justifications for the shared-doctrine apply squarely to the vast majority of garden-variety securities arbitrations. Lamentably, the *Peeples* court described an alternative which fairly portrays the state of discovery in securities arbitration today:

> [T]he ultimate purpose of discovery is to seek the truth, so that disputes may be decided by what facts reveal, not by what facts are concealed. Unfortunately, this goal of the discovery process is often frustrated … The "rules of the game" encourage parties to hinder opponents by forcing them to utilize repetitive and expensive methods to find out the facts.
> The truth about relevant matters is often kept submerged beneath the surface of glossy denials and formal challenges to requests until an opponent unknowingly utters some magic phrase to cause the facts to rise. Courts across the country have commented on the lack of candor during discovery in complicated litigation. [15]

A routine example of such skullduggery in securities arbitrations is the production of a firm's "compliance manual," an item that the NASD's Discovery Guide declares "presumptively discoverable" in every customer case. Some firms assert that their manuals are "trade secrets" entitled to special protections. [16] These firms would have claimants' counsel return the manuals at the conclusion of each matter, even if that counsel repeatedly represents customers against that firm and would be required thereby to repeatedly fight for possession of the same documents that he used in the last case.

Inefficiency, however, is the lesser of the evils promoted by this game. More than one brokerage firm, for example, has been known to claim in discovery that it has only one "compliance manual," when in fact its supervisory procedures are spread through a variety of additional documents with names like "Compliance Department Procedure Manual," "Account Executive Compliance Manual," and "Branch Manager's Operations Manual." Or a firm will produce the 1995 version of a manual, when in fact a 1997 revision was the operative document. Without shared information about these documents, the unwary practitioner would never know that the cloak of confidentiality has been used to conceal the truth.

Supervisory procedures are not the only documents for which shared discovery is a practical necessity, moreover, because it is not unusual for a firm's conduct in a particular circumstance to generate multiple claims. A broker or firm intent on committing fraud will rarely focus their efforts on just customer. There are countless examples of individual brokers whose activities have spawned several, and even dozens or hundreds of claims. Each of those customers will need discovery of all of the firm's communications with

[15] *734 S.W.2d at 347.*

[16] *This claim is dubious because the contents of the manuals are required by federal law. Numerous arbitration panels, and the only two courts known to have addressed the issue, have determined that compliance manuals are not confidential trade secrets. See Miller v. Smith, Barney, Harris Upham, 85-86 Fed. Sec. L. Rep. ¶ 92,498 (S.D.N.Y. 1986); Galucci v. Fleet Nat'l Bank, Case No. PC02-6837, Sup. Ct. of R.I. (Order of July 16, 2003) (unpublished).*

that broker, his employment file, his trade-by-trade compensation, his exception reports and audits, and every other documents pertaining to (or failing to pertain to) the scheme at issue. No system intent on exposing the truth and promoting equitable results would permit the firm to force every customer to go through the same discovery battles in one matter to obtain documents that the firm had already been ordered to produce in another.

The importance of the shared discovery doctrine is particularly highlighted by the mounting wave of customer arbitrations being filed in response to the exposure of the widespread fraud that culminated in the April 2003 conflict-of-interest "Global Settlement" between most of the major Wall Street brokerage firms and the SEC, NASD, NYSE, and various state regulators. The Global Settlement investigations revealed that analysts at many brokerage firms placed "buy" ratings on the securities of their employers' investment banking clients, while privately those same analysts admitted (often in casual e-mails) that those ratings resulted solely *because* of the investment-banking relationship, and that the recommendations were without merit or outright false.

In exposing these systematic misrepresentations, all of the various regulators acknowledged the importance of shared discovery by publicly disclosing some of the most damaging documents. The regulators expressly refused firms' requests for confidential treatment of those documents. In addition to excerpts from the firms' relevant compliance manuals, these "smoking guns" included numerous categories of documents that the firms claimed were confidential, such as personnel reviews, sales pitches, and internal profitability reports. Copies of many of these are now publicly available on the web pages of various regulators.

In Senate testimony earlier this year, NASD Chairman Robert Glauber explicitly encouraged defrauded investors to use these published documents as a "roadmap" for their actions against particular firms. He stated that the NASD is "hopeful" that these documents "make it easier for investors to recover their losses through arbitration … as evidence from the settlement can and does become used to make the case for recovery of investor losses." [17] In light of this testimony, it appears that Mr. Glauber would strongly disagree with the assertion of NASD member firms that his arbitration forum should participate in efforts to obstruct shared discovery of further evidence in these cases.

Mr. Glauber's testimony reflects a recognition that the NASD and NYSE cannot permit their arbitrators to impose blanket secrecy orders over the products of discovery from their forums, without grave consequences for the public's confidence in industry-sponsored arbitration and the securities markets that the NASD and NYSE are required to regulate. Even Senator Jon Corzine, the former Chairman of Wall Street powerhouse Goldman Sachs, Inc., has questioned the ability of industry-

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[17] *See* "Investment Banking Practices," May 7, 2003 Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs (Chairman Richard Shelby, R-Alabama). Chairman Glauber further testified that:

> We are gearing up for a large arbitration load. We believe there will be a lot of actions brought, as there should be.

http://banking.senate.gov/03_05hrg/050703/live.ram [time 2:47:35-:57; 3:39:52-:08].

controlled arbitration fora to fairly and transparently decide claims based on such wide-spread conduct. In questioning SEC Chairman William Donaldson about the Global Settlement, Senator Corzine observed:

> This arbitration process is going to be very much one of those areas where the public is going to look for the fairness that will be tied to whether there is a restoration of public confidence in the process. If it is not one that is both transparent, fair minded for those that participate, if they feel like the process doesn't come out, in aggregate, with fair response to investors' complaints, I think we will not have had all the benefits that were intended by the efforts of the global settlement. [18]

Senator Corzine echoed the principle of openness that has, for ages, governed the conduct of every other judicial forum in this country. At a time when Wall Street has systematically undermined the confidence of individual investors in the lawful functioning of our securities markets, this need for transparency – for open proceedings that expose for scrutiny the alleged efficiency and fairness of the private judicial systems administered by the NASD and NYSE – is more apparent than ever.

Conclusion

Broker-dealer requests for secrecy, and objections to shared discovery, enjoy no support in reason or jurisprudence. These requests, if honored, foster nothing but concealment of the truth and needless increases in the cost and burden of discovery. The heads of the NASD and NYSE have both expressly and, through their actions in publishing documents as "roadmaps" to investor claims arising from analyst fraud, implicitly rejected their member firms' ad hoc proposal for rules permitting them to conceal their conduct. Until the NASD and NYSE explicitly incorporate this concept into their official rules of procedure, however, practitioners will be required to repeatedly remind arbitrators that they cannot, consistent with this "roadmap" concept and decades-old state and federal practice, prohibit individual customers from sharing information about their claims with the public, or from sharing with other customers the documents pertaining to those claims.

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[18] http://banking.senate.gov/03_05hrg/050703/live.ram [time 2:47:35-:57; 3:39:52-:08].

Expert's Corner: Advanced Analytics-Effectively Portraying the Actual Risk and Return Profile of Your Client's Portfolio

by Jeffery & Michele Schaff

Jeffery and Michele Schaff provide expert consulting, expert witness and testimonial services with respect to cases being litigated or potentially litigated and to parties wanting to adopt practices aimed at mitigating the risk of potential litigation. The Schaffs founded Ardor Fiduciary Services to serve the needs of attorneys and fiduciaries. Both have earned the Certified Investment Management Consultant accreditation and are two of approximately thirty Certified Fiduciary Auditors in the United States. Jeffery's professional history includes extensive brokerage experience as both a registered representative and principal.

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An elderly widow walks into your office, distraught by how her investments could have lost 80% in three years. When you discover that her portfolio was supposed to be conservatively invested in a diversified portfolio largely comprised of income securities and that she relied on the income to pay for her living expenses, it is immediately apparent that her assets were invested well beyond her risk tolerance. But how can you demonstrate the level of risk taken and its impact on your client's portfolio? What about the case in which the claimant's losses are less dramatic or the unsuitability less apparent? How do you determine the underlying risk or later substantiate the financial impact of excess risk on your client's wealth? More importantly, is it not best to be able to objectively quantify the degree of unsuitability even if the portfolio has been clearly inappropriately invested?

By reviewing your claimant's account statements, you will certainly develop a sense for the story behind the losses. But the appearances given by these brokerage statements can be misleading. Is a portfolio safe because it owns GE instead of the latest .com? Does holding several bonds make it safe? Is an all mutual fund portfolio categorically safe? Making a proper determination as to the suitability of a portfolio for an investor necessitates further examination. The first step usually involves determining the degree of loss experienced by the claimant, under the presumption that large losses are generally indicative of large risks.

However useful for quantifying dollars lost on investments, profit and loss reports do not make evident the total risk and return characteristics of a portfolio. In a volatile portfolio, a period return may indeed be more correlated to the happenstance of investment buys and/or sells or the timing of an account's opening and/or closing than suggestive of a portfolio's true risk and return profile. To wit, if an investor happened to close his account after the portfolio had rebounded, the period return on a risky portfolio might not seem at all indicative of its riskiness. Seldom does the period end at the point of worst possible return, and seldom does the period begin at the point that would allow for the best possible return. Yet only in cases where the period ended at the former could a period return computation alone demonstrate the full downside risk actually experienced in a portfolio.

Consider an all equity investor who closed his account December 31st 2002. If he had a conservative investing profile, how well could his profit and loss report

alone portray whether or not a 100% equity allocation was unsuitably risky? Not well. In fact, the amount of loss may entirely depend on how long the investor's account had been open or when the investments were purchased. If the investor had held the account for only one year, at which time the investments were made, the profit and loss report would reflect a loss of over 22% using the S&P 500 as a proxy. In this case, the profit and loss report would indicate that the strategy was unsuitably risky. If, however, the investor had held the account for five years, the profit and loss report would show an aggregate loss of less than 3%, which might not seem unsuitable when considered alone. Even though the investor in these two scenarios would have experienced the same extreme volatility and losses in 2002, the profit and loss report could lead one to draw different conclusions about the same portfolio's risk, depending on the happenstance of the holding period. As this example clearly illustrates, profit and loss reports alone cannot be relied upon to demonstrate unsuitable investing.

Fortunately, Modern Portfolio Theory computations allow for the proper and effective calculation and demonstration of a portfolio's true risk and return profile. These methods are objective and extremely useful for clearly and effectively exhibiting the extent of risk in a portfolio.

Establishing Portfolio Performance

The first step in evaluating a portfolio's risk and return involves the calculation of its series of sub-period returns. These calculations require raw data from the client's brokerage statements; and the specificity of your results will vary with the frequency of your data, so use monthly statements where possible. The relevant data to gather includes the portfolio's value, net of any margin, at the beginning and end of every sub-period (i.e. month), along with deposits and withdrawals. From this point, the process of calculating sub-period returns is straightforward and intuitive.

Where monthly statements can be used, for instance, each month's return is calculated by measuring the change in the portfolio's net value from one month to the next when there are no contributions or withdrawals. For example, if a portfolio was worth $100,000 at the beginning of a month and $99,000 at the end, it lost 1% in that month. If the client deposited funds into his portfolio or received a distribution from it, the monthly return would need to be adjusted for its cashflows. For example, if the portfolio was worth $100,000 at the beginning of a month and $99,000 at the end, and the client withdrew $1,000 at the end of that month, the portfolio return would be 0%. Cashflows rarely occur at the beginning or end of a period, however, and it is not practical (or in some cases possible) to adjust for cashflows that occur during the middle of a period. This problem can be easily resolved by adopting conservative cashflow assumptions – account for distributions at the beginning of the month in which they took place and contributions at the end.

Once the complete series of monthly returns is established for the entirety of the period under examination, you have the data necessary to determine the overall period return as well as the annualized averages and rolling period returns, including best and worst twelve-month returns. The sub-period returns also provide you with the data necessary to compute the portfolio's beta and standard deviation, useful expressions of risk. Although it is possible to make these computations manually, doing so increases the chances of error. We find that loading the sets of sub-period returns into specialized software provides quick and precise Modern Portfolio Theory statistics that are easily conveyed in compelling user-friendly graphics.

Average vs. Compound Returns

Before addressing measures

of portfolio risk, it is appropriate to explain the two basic measures of annualized investment return: the simple average or arithmetic mean return and the compound or geometric mean return. Each is important in its own way and useful in calculating and demonstrating different measurements of risk.

The simple average return is calculated by summing the annual return for each period under consideration and dividing it by the number of periods. For example, a 10% return in 19X1 and a 20% return in 19X2 would net a 15% arithmetic mean return for the two year period. This return measure is necessary in the calculation of standard deviation, a risk measure that will be addressed later in this article. However, if you look simply at the arithmetic mean, you will gain no understanding of the impact of volatility on the portfolio's returns over time. The more volatile the portfolio, the more deflated the investor's true return will be relative to its simple average.

The compound return shows the true return that an investor received and demonstrates the impact of volatility on portfolio returns. Using the figures from the previous example, the geometric mean return is 14.9%. As you can see, variability of returns, or volatility, reduced the geometric mean return relative to the arithmetic mean.

Think of it this way: if an investor lost 50% in one year and gained 50% the next year, his arithmetic mean return would be 0% even though he would still be down 25% overall! If he started with $1, he would only have 50¢ at the end of the first year and 75¢ at the end of the second. In this example, the geometric mean return is actually -13.4%. For that investor to get back to breakeven, he would need to gain 100% in the second year to make up the initial 50% loss. The investor who does not understand the difference between arithmetic and geometric mean returns may become convinced to take on more risk than suitable, unaware of the negative impact and potentially permanent damage that volatility can have on a portfolio.

Measuring Risk

There are many measures of risk in a portfolio. But what measure of risk is appropriate for your cases? The answer depends on the type of claim that you have.

If the portfolio or investment is highly correlated to the S&P 500, the common measure of beta may offer a handy comparison point for risk. This could be the case if the claim of unsuitability is on a single stock, a mutual fund or a diverse group of securities in the same asset class.

The beta calculation expresses how volatile a portfolio or investment vehicle is relative to a given benchmark. If an investment has a beta of 1.0, it has moved in lock step with its benchmark and is therefore said to have a risk equal to its benchmark. A portfolio with a beta of 0.75 moved 75 cents for every dollar the benchmark moved and is thus 25% less volatile. And a beta of 1.25 indicates that a portfolio is 25% more volatile than its benchmark.

Whether beta is a useful measurement or not depends on how highly a portfolio or investment is correlated to its benchmark. Correlation is the propensity of an asset or group of assets to rise or fall in tandem with another asset or group of assets. Assets that rise and fall in tandem are highly correlated; those that rise and fall as mirror opposites are negatively correlated; and assets that rise and fall irrespective of each other are non-correlated. The Modern Portfolio Theory measure for correlation is r-squared. When the r-squared computation is 0.8 or greater, the correlation of an asset to a benchmark is strong enough for the comparison to be considered reliable. The bottom line is that beta is only useful in apples-to-apples comparisons, and if the r-squared of the portfolio is less than 0.8, the beta statistic is simply not an appropriate risk measure.

The best measure of risk in a portfolio is standard deviation. It is even useful for demonstrating the risk of portfolios that are not highly correlated to any single benchmark. In fact, it is so useful at measuring risk that it is broadly accepted by the investment community as the standard for risk measurement in investment portfolios.

What is standard deviation? As you may recall from your college statistics course, standard deviation is the measure of the extent to which returns vary from their arithmetic mean return. It describes the normal range of returns expectable by a given portfolio two-thirds of the time.

Think of standard deviation as a 'plus or minus' number: to say that the S&P 500 has delivered a 12% simple average return with a standard deviation of 20% since 1925 is to say that in any given year it returned 12%, plus or minus 20%. Therefore, the S&P 500's normal range of returns for two-thirds of the years since 1925 is between –8% and 32%.

To investors, standard deviation means risk. The higher the standard deviation, the greater the risk. If you see two portfolios, one with a standard deviation of 10% and the other with a standard deviation of 20%, you know that the latter is twice as volatile (read "risky") as the former.

What is a "good" standard deviation? What standard deviation figure is too risky for a conservative investor? Those answers are relative and depend on the period of time under consideration. Whatever the standard deviation of the claimant's portfolio over the period of the claim, it may need to be compared to the standard deviation of a representative benchmark over the same timeframe in order for the portfolio's standard deviation to have meaning, especially if the period in question involved unusual market behavior. Short-term aberrations aside, the long-term standard deviation of the S&P 500 is around 20%, with small and mid capitalization domestic stock indices and foreign stock indices between 20% and 30%. Diversified bond portfolios typically have long-term standard deviations of less than 10%, and balanced portfolios fall in the mid-teens.

Standard deviation is particularly useful in a suitability claim because the financial services industry widely accepts it as the preferred measure of risk, because it is objective, and, most importantly, because the specific volatility of an investment or portfolio is highly predictive of the likelihood that an investor will permanently damage his portfolio by selling after a drop in the value of his holdings. Investors are enormously concerned that their respective portfolios may drop and cause them to lose their hard earned money. The greater the volatility of an investment or portfolio, the greater the chance that an investor will cash out at a low and lock in large losses.

Benchmarking

Now that you or your expert has calculated the return and standard deviation of your client's portfolio, what is next? How do you make sense of the data and effectively use it to make your case? The answer lies in context. You need to compare the risk and return profile of your claimant's portfolio to one or more of its closest benchmarks.

You should include as a benchmark a model portfolio that reflects the investor's actual suitability and investment objectives, with the model based on information available at the time the investment decisions were made, so as to prevent cherry picking in hindsight. Doing so is possible through the use of sophisticated Modern Portfolio Theory software that limits data to what would have been available at the time of decision making. Another benchmark that you should include is the actual portfolio's

asset allocation mapped with appropriate benchmarks for each asset class. Benchmarking against a model portfolio demonstrates the degree to which the actual portfolio reflected or conflicted with the claimant's true risk profile. You benefit by benchmarking against the actual portfolio's asset allocation because the actual portfolio is typically not only riskier than appropriate given the claimant's suitability profile, but also riskier that its representative asset allocation would suggest.

The simplest way to establish a blended portfolio benchmark that represents the claimant's true suitability is to generalize an overall allocation of stocks to bonds that would be appropriate for his investment objectives and risk tolerance. Once you have established this ratio, compare it to an identical proportion of an appropriate stock index to an appropriate bond index. For instance, a portfolio comprised of 60% blue chip stocks and 40% bonds might represent a benchmark suitable for a hypothetical investor's investment objectives and risk tolerance. You could compare this ratio to representative indices. In this case, it would be reasonable to use the S&P 500 Index for the 60% blue chip portion and the Lehman Brothers Aggregate Bond Index for the 40% bond portion. To compare an actual portfolio to its representative blended benchmark, begin by classifying each investment into an appropriate asset class. Every investment belongs to an asset class. IBM, for instance, is a large capitalization domestic stock. Likewise, every asset class is represented by at least one index. Appropriate indices to which one could reasonably compare IBM would include the S&P 500 or the Dow Jones Industrial Average. If you associate every asset in a portfolio to its most appropriate asset class, you will uncover the portfolio's asset allocation – what percentage of the portfolio is large cap domestic stocks, small cap domestic stocks, foreign stocks, domestic bonds, etcetera. One you have the asset allocation, you can map to each asset class a representative benchmark. By mapping benchmarks to the allocation in this manner, you can generate performance statistics that show how those benchmarks would have performed in the period of the claimant's complaint when blended in the portfolio's specific allocation. Securities classification can be done manually, but in order to avoid arguments of subjectivity, specialized software can be used. Furthermore, although this description appears both simple and straightforward, the processes of objectively classifying the securities in a portfolio and developing a blended benchmark have complex facets and require skill and experience.

There are four major types of benchmarks available for generating these comparisons to the claimant's true suitability and actual portfolio: major indices, generic index blends, peer averages and theoretical "well-managed" portfolios.

The evening news you watch most likely quotes the S&P 500, Dow Jones Industrial Average and/or NASDAQ Composite as proxies for how the stock market has performed on a specific day. The bond market is typically compared to the Lehman Brothers Aggregate Bond index and foreign stocks are generally benchmarked against the Morgan Stanley Europe, Australia, Far East (EAFE) index. These are all examples of major indices. Each tracks the performance of specific securities in a single asset class and is deemed to represent the asset class of those securities. For instance, the S&P 500 is a proprietary capitalization weighted benchmark of 500 domestic blue chip stocks. These indices are useful for benchmarking portfolios that are highly correlated to a given index. Generally speaking, if your claimant has an all equity portfolio with a diverse group of domestic large capitalization stocks, it would be reasonable to benchmark it against the S&P 500.

A generic index blend is generated by mixing fixed portions of major index benchmarks. The most prevalent blend, the 60:40, is simply a portfolio comprised of 60% S&P 500 and 40% Lehman Brothers Aggregate Bond index. The 60:40 blend is a generic representation of a benchmark for a balanced domestic investment portfolio. Its cousin, the 40:20:40 can be used as a benchmark for a balanced global investment portfolio, and is comprised of 40% S&P 500, 20% EAFE and 40% Lehman Brothers Aggregate Bond index. Generic blended index benchmarks can be useful as points of reference.

Peer benchmarks are created by segregating the universe of money manager according to investment style, so all managers investing in a similar style are grouped together. For instance, the peer group for a small capitalization stock mutual fund manager is the universe of all funds with investments that are primarily concentrated in small capitalization stocks. This benchmark is particularly useful for evaluating the performance of a single investment or money manager. For instance, a particular mutual fund could be compared to the performance of its peer group to see how its manager performed relative to others with similar objectives. Peer benchmarks can also be used to compare entire portfolios. For instance, a balanced portfolio could be compared to the performance of the average balanced mutual fund.

Finally, portfolios can be compared against custom blends of theoretical "well-managed" portfolios. For instance, the generic 60:40 index blend could be modified to a 70:30 or 50:50 blend to better reflect the true suitability of a particular claimant's investment objectives and risk tolerance. Another type of theoretical "well-managed" portfolio is the model portfolio, which involves an expert customizing an asset allocation and a corresponding blend of specific asset class benchmarks to better reflect an investor's investment suitability profile, such as a portfolio comprised of 15% large cap growth, 10% large cap value, 10% mid cap, 10% foreign bonds, etcetera. More specific still, the custom blend could use actual money managers (i.e. mutual funds) to represent each asset class. A word of caution: the more specific the theoretical "well-managed" portfolio, the more arguable it becomes.

Which benchmark is best? Again, that is largely dependent on the circumstances of your case. Whenever possible, reference multiple benchmarks. Referencing assorted benchmarks that are appropriate to your case is a good way to objectively establish a range of reasonable performance expectations. Whether you use one benchmark that you feel is the best fit, or average several different ones, incorporating them in your case can make it much more persuasive.

Performance Variance

If your claimant's risk and return profile do not match those of the portfolio's closest benchmarks, there must be a reason why. A portfolio's performance will only deviate from its benchmarks if there is an attributable reason. That reason may well be the basis for substantiating your suitability claim, and the portfolio's variance can provide you with a means of expressing the damage caused by the unsuitable investing.

How closely should the claimant's portfolio performance match its benchmark? That depends on a number of factors, including how well the benchmark represents the portfolio and the portfolio's expenses relative to its benchmark. Assuming that the benchmark exactly mirrored the portfolio, the only variance would be investment expense. For instance, if the portfolio compared to the traditional 60:40 blend actually owned the same securities represented by the blend (i.e. all 500 of the S&P

500, in proportion) and paid an average of 1% in annual investment fees, the portfolio would realize a net return equal to 1% less than the benchmark.

However, these authors have never seen a portfolio that was a perfect match for its benchmark. In the real world, portfolios are comprised of stocks, bonds, mutual funds, ETFs, unit investment trusts, variable annuities, etcetera. To demonstrate, consider a few popular holdings that are commonly benchmarked against the S&P 500. Fidelity categorizes its Magellan fund as a domestic large-cap stock fund, but its holdings are different than those in the Vanguard 500 stock index fund; and both of these funds' holdings are different than those of the S&P 500 ETF (symbol SPY). The ETF holdings will match the S&P 500 index precisely; while the Vanguard 500 stock index fund holdings will be only substantially analogous to the index; and the Fidelity Magellan fund holdings will meaningfully differ. In similar fashion, an investor's overall portfolio will rarely match a simple benchmark. And the greater the differences between a portfolio and its benchmark, the greater is the likelihood of disparate performance.

The most common cause of variation of returns from a corresponding benchmark is the lack of diversification. This diversification problem comes in two forms: too few securities and too few asset classes.

Having too few securities in a portfolio increases the portfolio's specific risk, which is the risk specifically related to an individual security. To depict this risk, consider what would happen if Michael Dell died today. The share price of Dell stock would plummet for reasons totally unrelated to the rest of the stock market or even technology stocks generally. Studies have shown that it takes between 20 and 40 individual securities in a given asset class to substantially diversify away the level of specific risk of a group of securities.

Too few securities can also cause concentration, which occurs when the individual securities in a portfolio are limited in scope to those of particular industry sector or when one or more issues of securities dominate the portfolio or have excessive influence upon it. A portfolio could be described as concentrated if, for example, technology stocks comprised 50% or if a single issue (e.g. DELL) accounted for over 25% of the equity portion of the portfolio. Concentrating securities in these manners needlessly increases the risk to a portfolio.

Having too few asset classes in a portfolio needlessly increases the portfolio's market risk, which is the general risk of the market. Market risk cannot be avoided altogether, but it can be reduced by combining asset classes that are not perfectly correlated to each other. Market risk typically affects asset classes at different times and to varying degrees. For instance, small stocks might rise at the tail end of a recession, while large cap stocks languish in comparison. By holding a broad variety of asset classes, a portfolio has less exposure to the risk of any single asset class. The process of intentionally allocating a portfolio between specific proportions of varied asset classes is known as strategic asset allocation.

Another likely culprit of performance variance relative to an appropriate benchmark is risk. If the portfolio does not exhibit the same standard deviation as its benchmark, it should not be expected to deliver the same return. For instance, if a portfolio is comprised of 60% blue chip stocks and 40% intermediate term bonds, but has a standard deviation of 20% while the generic 60:40 blend has a standard deviation of 15%, the portfolio should be reasonably expected to deliver commensurately higher investment returns to compensate for the increased risk taken. In cases where a claimant's portfolio delivered market returns while taking significantly greater risk, demonstrating the impact of the additional risk taken can be useful in supporting your

unsuitability claim. If the issue is degree of profitability, it is also possible to calculate the greater return that would have been expectable for the incrementally greater risk taken.

The use of poor money managers can also result in performance variation. While it is true that no money manager consistently performs in the top decile or even the top quartile over the long term, it is also true that some money managers manage to consistently underperform their peer group. There are a wide variety of reasons why some mutual fund money managers underperform their peers over extended periods. Regardless of the reason for this phenomenon, selecting and retaining such a fund on the part of a financial advisor is a sign of poor due diligence and/or neglect.

The above description of causes for performance variance is not intended to be exhaustive. It is intended to be instructive. The key concept is that there is at least one cause for every variance of return. An underlying cause may provide you with support for your claim if your claimant's portfolio has been unsuitably invested. So whenever you find a variance of return from a reasonable benchmark, it is important to attribute the cause of the variance.

Expressing Your Findings

Now that you have established the performance behavior of your client's portfolio and have compared it to his suitability profile using appropriate benchmarks, you must decide how to describe your case and structure your arguments. You have at your disposal benchmark comparisons and numerous performance statistics, such as annualized compound return, standard deviation, period return, Sharpe ratio, number of positive/negative returning sub-periods (i.e. months) and highest/lowest returning sub-periods (i.e. months).

So how do you best express your findings? Use the numbers to paint a picture. Visually expressing your statistics will certainly be more compelling than offering the numbers alone. Charts and graphs are far more attention grabbing and demonstrate complex points better than computations alone. Such graphics can be used in your statement of claim, in a written expert's report or as enlarged exhibits for use at arbitration.

The most effective graphic for demonstrating risk and return is the scatterchart. This chart effectively portrays the risk and return of your client's portfolio against selected benchmarks. [See Figure 1.] Even a lay person with only average investment knowledge and intelligence can grasp that the risk level of the claimant's portfolio in the sample graph was about four times that of the S&P 500 and incurred losses that were over four times greater than the S&P 500.

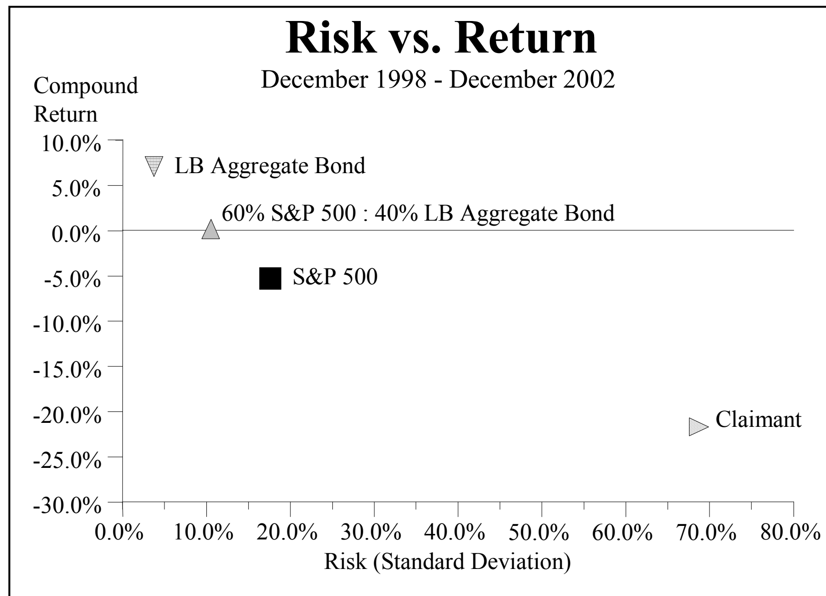


Figure 1. Source: Ibbotson Associates software

Another handy graphic is the mountain chart, which portrays the time line of a portfolio's performance vis-à-vis selected benchmarks. [See Figure 2.] It is often expressed as the 'Growth of $1' chart. A mountain chart is particularly useful at demonstrating whether or not a portfolio's losses were primarily caused by broad stock market losses. If the claimant's performance meaningfully deviates from that of the stock market, the losses cannot simply be blamed on the market.

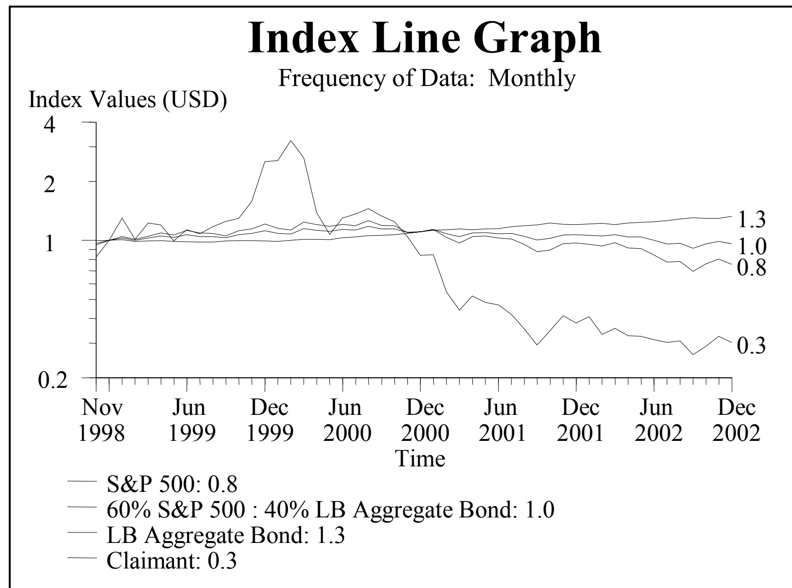
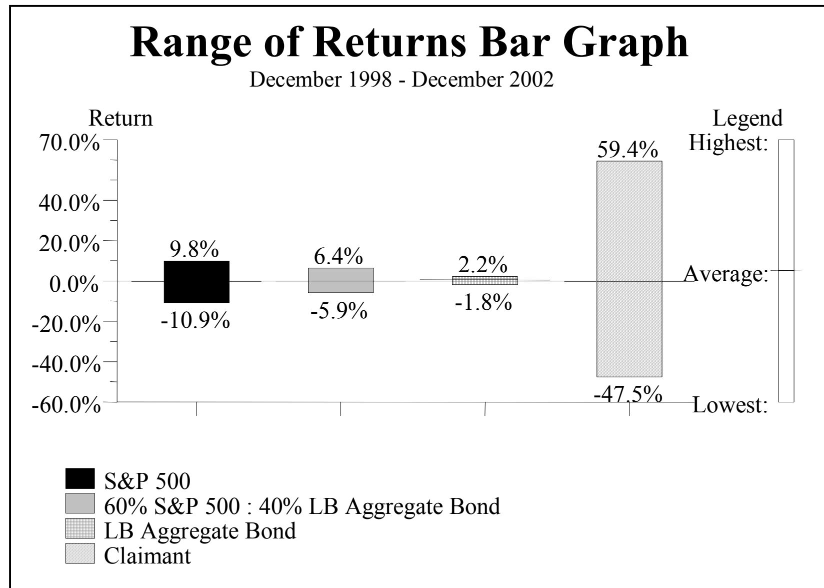


Figure 2. Source: Ibbotson Associates software

Finally, the range of returns chart demonstrates a portfolio's highest and lowest rolling twelve-month period returns versus selected benchmarks. [See Figure 3.] This graphic is particularly useful for showing when a portfolio has exceeded an investor's maximum threshold of loss, the greatest amount the investor is capable of withstanding. Over the past five to ten years, it has become quite common for financial consultants to use financial planning software to create portfolios and include in their presentation the investor's stated maximum threshold for loss. And even lacking such a document in your file, the visual comparison to the benchmarks provides an effective aid to support the argument that a claimant's portfolio exceeded his specific suitability profile.



Each and every case is a story unto itself, and the details of each story vary. As with the causes of performance variance, this explanation of useful graphics is intended to be instructive and not exhaustive. Dozens of various charts and graphs can effectively portray various aspects of the risk and return profile of a client's portfolio, but only certain ones will be useful in depicting the issues relevant to a particular client's claim. The greatest challenge may lie in identifying the graphics you need to best make your case.

Conclusion

Clearly demonstrating the true risk and return characteristics of your client's portfolio using the analytics described herein can be fundamental to identifying and substantiating allegations of unsuitability. Using the advanced analytics and techniques suggested in this article, you can fully and objectively demonstrate the actuality of a portfolio's performance and do so in a compelling manner. And expressing your findings with visual aids can be an important aspect of clearly presenting your claimant's complaint.

Expert's Corner - Flat Fees or Fat Fees? Did Your Client Get a Wrap Account or a Bum Wrap?

By Douglas J. Schulz, CRCP, RIA

Flat fee or wrap fee accounts are all the rage these days. Each brokerage firm has its own special title for these kinds of accounts, but they all have one similarity - the investor is charged a flat percentage per year on the total assets in the account. Flat fee or wrap fee accounts are not totally new. In one format or another they have been around for several decades.

One of the main questions that need be asked is why these types of accounts have become so popular in just the last few years. The answer is that it's not necessarily the investing public that has demanded these accounts but rather they have been pushed by the brokerage industry and by the stockbrokers themselves. Article after article in publications such as Registered Representative magazine has alluded to the increasing pressure by brokerage houses on their stockbrokers to convert more of their accounts to flat fees. One way that firms lure brokers to the flat fee account is to pay them a higher payout on flat fee accounts. Firms conversely penalize the commission broker by paying a lower payout on the traditional account.

There are industry professionals that feel that within the next 10 years, some of the major brokerage firms will have totally phased out commission stockbrokers. At that point stockbrokers at larger firms will either be salaried individuals, or like institutional portfolio managers, the brokers will receive a percentage of the fee being charged by the brokerage firms. It is easy to understand why big brokerage firms would like to go in this direction. Even though the major brokerage wire houses have some of the lowest commission payout percentages in the industry, they still pay out to brokers somewhere between 30 to 50% of gross commissions. This payout structure has always made stockbrokers one of the highest-paid professions in the United States. If large brokerage firms can retain a much higher percentage of the commissions and fees, that clearly puts a lot more money to their bottom line.

In addition to the reasons listed above, there are other reasons that brokerage houses have increased the pressure on their brokers to convert their accounts to flat fees in the last few years. The three year bear market that started in the spring of 2000 has put enormous pressure on the bottom lines of the major brokerage firms.

- Trading activity is down.
- Commission income is down.
- Mark ups, mark downs, and spreads are down.

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- Margin borrowing is down.

These are all tremendous profit centers for brokerage firms. So what is one of the solutions? Convert everyone to flat fees. Let's face it - with billions and billions in brokerage accounts, making 1% to 2% a year, on even otherwise inactive accounts, is a very lucrative business plan for the brokerage houses.

There is little doubt that converting millions of investors and millions of accounts to flat fees or wrap fee accounts is definitely in the best interest of the brokerage firms. As I pointed out in the book Brokerage Fraud – What Wall Street Doesn't Want You to Know, this flat fee pitch is in many ways a scam. For millions of investors, this compensation setup is not in their best interest. The remainder of this article addresses why and when flat fee accounts may not be in your client's best interest.

Flat Fee Accounts Marketed as a Commission/Fee Saver

Let me touch upon the marketing of these flat fee accounts. One of the biggest hypocrisies relating to these flat fee or wrap fee accounts is how they are being marketed to many investors. The brokerage industry and their brokers are telling many investors that these flat fee type accounts are in the best interest of the investor because there no longer will be a conflict of interest as it relates to commissions. Second, they are often marketed as a commission savings to the client. As you will see below, far too often these claims are just patently false.

For a large percentage of investors, their accounts have never generated 1% to 2% in commissions in the first place. So when a broker and his firm talks a client into converting to a flat fee account charging 1% or 2% a year, this is not only not a cost savings, it is a cost increase!

Should an Investor be Paying 1% to 2% a year to a Broker?

Even if an investor's account was producing 1% to 2% a year in commissions, it probably shouldn't have been. Even in the boom-boom years, it never made sense for investors to be paying 1% to 2% in commissions and fees on an annualized basis. There are a myriad of options and opportunities for investors to have their money managed or even to trade on their own for a lot less than 1% to 2% a year in commissions and fees. Mutual funds, professional investment advisers, index funds, and the various exchange traded funds are just a few examples of how many investors can have their money managed or invested for a lot less than 1% or 2% a year.

Or think of it this way. To some degree the cream rises to the top in the securities industry. If there is a stockbroker who has a proven track record of making above average returns for individuals, he will eventually be making millions of dollars in running his own mutual fund or his own hedge fund, or he'll be a very high paid individual managing money on a professional basis. The most successful, most experienced, most seasoned individuals are running billion-dollar mutual funds or similar products. Investors can invest their money with these folks and the vast majority of the time, the client's average management fee is going to be somewhere around 1% and the maximum fee would be 2%. So it's not difficult to question the advisability of an investor paying the same 1% to 2% to a local stockbroker. Has this local stock broker been managing money on a discretionary basis for 20 years? Does he have a documented, proven track record in good and bad markets? Are his management style and investment parameters formalized and in writing for your review? Probably not. So why should an investor pay the same amount of annual fees when there is truly little comparison?

1% to 2% for Fixed Income Accounts

My strongly held opinion that most investors shouldn't be paying fees of 1% or 2% to a year to their local broker is intensified when it comes to those individual investors who have the majority of their money in fixed income investments. No one would argue with this premise in the summer of 2003 when even long-term bond rates have barely yielded 4%. But the reality is that this was just as true over the last decade when bonds and other fixed income investments produced yields that were in the mid single digit range. The math has just never made much sense. Additionally, fixed income investments such as long-term or mid-term bonds simply do not need that much active management. A 1% to 2% a year management fee is difficult to justify. Just as the majority of bond mutual funds charge less than their comparable stock mutual funds, the ethical thing for firms to do is to charge a much lower flat fee on a pure fixed income account.

With interest rates being what they have been the last few years, if an investor is paying 1% to 2% a year on even a conservative fixed income portfolio, after taxes and inflation there is a reasonable chance the investor will be left with a negative return. Likewise, keep in mind that if your client has a percentage of her portfolio in money market funds or similar investments, you'd better make sure that there is not a management fee on top of that money or that's a truly bad deal.

The Double Dip

Double dipping can be a good thing if you're talking about ice cream. But when it comes to paying commissions and fees, it is nothing but a drag on your client's investments. As a matter of fact, all commissions, fees, markups, markdowns and any other charges assessed against your client's portfolio are characterized as "capital impairment." In simple terms, what that means is that before an investor can make any money in the account, he has to overcome the costs to have the account managed and traded. This is the same concept used when performing a churning analysis – the cost equity ratio is what rate of return the investor would have to make just in order to break even with all of the costs in the account.

One of the single biggest problems with flat fee accounts is that the investor's portfolio might get double dipped. For years brokerage firms have been telling investors that even if the investor's money is put in mutual funds that they need to pay the stockbroker and the brokerage firm to monitor their mutual funds. Maybe the same individuals should be hired to watch the forest grow. We all know that the forest will grow just fine and we don't need individuals to stand around watching it grow. It's not a lot different for mutual funds. As I stated earlier, many of the best and most experienced money managers are managing the money of the top respected mutual funds. Why do you need some broker watching over their shoulders? 90% of the time, it was the broker who recommended that your client put his money in this mutual fund in the first place. So he must have confidence in the mutual fund manager. Most professionals will agree that managed money in mutual funds and similar products shouldn't be switched around very often in the first place. Yes, there are needs like evaluating portfolios and reallocating funds, but not on a short-term basis. You paid your brokerage firm commissions to buy these loaded funds in the first place; you should not have to pay them again every few years to give you a review.

In an October 1999 speech given by SEC Chairman Arthur Levitt, he stated "Over time, expenses and fees can really add up. On an investment held for 20 years,

a 1 percent annual fee will reduce the ending account balance by 18 percent."[1]

And to make matters worse, at many brokerage houses the firm has a real conflict of interest in this proposal because not only is the broker being paid to oversee the funds, but he has sold your client in-house funds. So your client is also paying the same firm to manage those funds. That's a triple dip, so to speak.

There are many brokerage firms that do not charge their flat fee on top of managed accounts like mutual funds and annuities. This is the way it should be. But as you'll see later in this article, they still rake in extra commissions on these products.

Margin Use in Flat Fee Accounts

Conflicts have a tendency to raise their ugly heads in the use of margin. Once a broker has talked your client into a fixed fee account, he can double his annual fees by convincing your client to margin up his account. You see, brokerage firms charge their flat fee based on the account value, not on the account equity. For example if your client had an account into which he deposited $100,000, and the brokerage firm charged him 1% a year, the annual fee would be $1,000. But if your broker convinces your client to use margin to buy more securities, your client's account value could swell to between $200,000 and $300,000. Your client would pay, and conversely your broker and firm would reap, an additional $1,000 to $2,000, double or triple what the broker and firm made without the use of margin. It might not seem like a lot on the surface, but for brokers and brokerage firms who have hundreds of millions of dollars in these flat fee accounts, the use of margin can increase the commissions and fees significantly.

Realize also that at some brokerage firms, such as Merrill Lynch, stockbrokers actually pocket a component of their client's margin interest, so there may exist additional incentives for brokers to recommend margin.

There is yet another big conflict of interest when it comes to using margin in general and specifically in flat fee accounts. The interest rate that the brokerage firm charges your client on his margin balance is much higher than what the brokerage firm is charged for lending your client the money. The margin interest that the brokerage industry takes in every year is a huge profit center. The irony and conflict is that while margin interest boosts the revenue of the brokerage industry, margin use invariably increases the risks to an account.

Commission Kicker – A New Jaguar

At far too many brokerage firms, there is a policy that allows the stockbroker to have an investor's account set up on a flat fee basis but when the broker has some need for extra commissions, he can just sell the investor a loaded product. Eventually the regulators will get around to addressing this incredible conflict of interest, but not yet.

You may be wondering, "How can they do that? Firms tell investors that flat fee accounts are in their best interest because they wipe out the conflicts by eliminating the commissions!" Au contraire! And what makes matters worse is that the products that the brokerage industry has singled out for your client to not get the benefit of a flat fee are the very investments that pay the highest commissions to the

[1] "Financial Self-Defense: Tips From an SEC Insider," Boston Globe's "Moneymatters" Personal Finance Conference, Boston, Mass., October 16, 1999; http://www.sec.gov/news/speech/speecharchive/1999/spch305.htm.

brokerage firm and the broker. This is obviously not a mistake.

So instead of lessening the conflicts of interest, as advertised, the brokerage industry has in fact increased the conflicts of interest. The firms and their brokers convince their clients to pay them a high annual fee. This way the brokerage firm and the broker are assured to get a steady flow of fees. But when the broker's commissions are down, or when he has his a payment due on a new Jaguar, or it is Christmas time, the brokerage firms allow the broker to pad both the broker's and the firm's pockets with high commission products such as loaded mutual funds and annuities.

Even at the brokerage firms that do not charge clients the 1% or 2% in addition to what the mutual fund or annuity charges each year to manage the funds, the situation still is ripe for when your broker is short on a house payment, to just sell your client a loaded product.

Why Would a Broker Actively Trade a Flat Fee Account?

The above sections have shed some light on what would motivate a broker to actively or excessively trade a flat fee account – markups, markdowns, spreads, and margin interest. There may also be soft dollar and order flow payments that also make it profitable for an account to actively trade. Finally, be aware that some flat fee agreements contain limitations on the number of trades that get the benefit of the flat fee, after which additional fees kick in.

The industry has just come off of three years of leaving investors holding the bag. In the late nineties, the balance sheets of brokerage firms swooned while compensation for executive officers, investment bankers and brokers was astronomical. Did the major brokerage firms analysts who were making millions of dollars a year ever consider who was inevitably paying their salaries? Did the brokerage firms really earn their commissions and fees - be they flat fees or regular per trade commissions for their advice? There are a variety of ways that your client's flat fee might morph into a fat fee and depending on the amount of these commission kickers and other incentives, your client may well have gotten a bum wrap! The sad reality is that flat fee or wrap accounts can be a hotbed of conflicts where you would least expect them. Now you know.

*Expert's Corner - How To Conduct A Complex Financial Arbitration Part 1: Matters To Consider Prior To The Hearing**

By Richard Chernick and Rufus V. Rhoades

Richard Chernick is an arbitrator and mediator and is Managing Director of the JAMS Arbitration Practice. He is a co-author of The Rutter Group's "California Practice Guide -- Alternative Dispute Resolution." Rufus V. Rhoades is the Senior Arbitrator for Financial Arbitration Services (www.info@finarb.com).

<u>Introduction</u>

In some parts of the United States, there are as many complex cases tried in arbitration as in court. The increasing acceptability of arbitration in complex cases results from court decisions making arbitration more reliable and accessible, provider organizations making their rules more appropriate for the determination of complex matters and the increasing availability of experienced and skilled arbitrators who are able to conduct such cases.

Arbitration and litigation bear many similarities; indeed, the recent trend is to make arbitration more like litigation, by permitting or encouraging such procedures as discovery, dispositive motions, provisional relief and reasoned awards. *See* Revised Uniform Arbitration Act, approved by National Conference of Commissioners of Uniform State Laws, July, 2000.[1] This is especially true for arbitrations involving financial, accounting or valuation issues. But there are crucial differences between arbitration and litigation, and the skilled advocate understands how to tailor traditional litigation tactics to become an effective arbitration advocate in such cases.

A. <u>The Arbitration Clause</u>.

Arbitration is a contractual process, so the arbitration clause is the foundation upon which the arbitration is built. Any analysis of the process begins with careful review of the arbitration clause. A typical arbitration clause will usually (and at a minimum should) address the following issues:

1. <u>Arbitrability</u>.

The arbitration clause defines the scope of the arbitration (what issues are subject to arbitration) and who the parties to the arbitration will be. There is extensive case law on the interpretation of this aspect of arbitration clauses and on the subject of who (court or arbitrator) determines arbitrability and is

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[1] See http:www.law.upenn.edu/bll/ulc/uarba.

itself a matter of contract between the parties.[2]

It is possible to require a party not mentioned in the clause to arbitrate (such as an affiliated corporate entity); such matters are determined by applicable contract law principles.

2. Administration of the Arbitration and Arbitral Rules. The arbitration clause usually contains a provision identifying the institution which will administer the arbitration. We discuss below how to deal with arbitral institutions and their rules.

3. The Arbitrator Selection Provision. The arbitration clause should also identify the mode of arbitration (sole arbitrator, tripartite panel) and describe how the arbitrators are to be selected. We discuss selection of the arbitrators below.

4. Venue. Finally, the clause may identify where the arbitration is to be held. The place of arbitration has rather significant effects on the process, from the choice of arbitrators to the choice of procedural law which will apply to the arbitration. If the clause is silent on the location of the arbitration, the institution will determine this issue in accordance with its internal administrative processes. If the arbitration is non-administered, the arbitral panel will determine the place of arbitration.

B. Preparing the Claim and Responses.

A Statement of Claim or Demand for Arbitration is a far different document than a Complaint in litigation. A claim is much more informal than a pleading and is usually much shorter. There are virtually no "rules of pleading" in arbitration, and motions to dismiss are almost always denied; technical pleading rules need not be followed.

State your claim in plain language; do not be legalistic because one or more of the panel members may not be a lawyer. Do not, however, assume that the "plain English" admonition is license to be careless or vague. Within that framework, a good Statement of Claim in a complex case should contain the following:

- The name, address and contact data of the Claimant and Claimant's counsel;
- Identification of the Respondent(s);
- Identification of the clause which forms the basis for the arbitration. Attaching a copy of the clause or agreement is good practice;
- A description of the dispute in sufficient detail to allow rudimentary appreciation by the administrator and the arbitrator of the general framework of the dispute and to permit a meaningful response (this description should conform to your understanding of the scope of arbitration as defined in the clause)
- Requested relief. That is, describe what remedy you wish the arbitrator or the panel to award the Claimant if the claim is established.

Remedies in complex financial disputes may vary

[2] *First Options of Chicago, Inc. v. Kaplan,* 514 U.S. 938 (1995)). *See* also JAMS Comprehensive Arbitration Rules & Procedures, Rule 11(c) (arbitrator determines his/her own jurisdiction); American Arbitration Association Commercial Arbitration Rules, Rule R-8(a) (same). *See* also *Howsam v. Dean Witter Reynolds, Inc.,* 537 U.S. 79 (2002) ("gateway issue" of applicability of six year ineligibility rule contained in NASD Code of Arbitration Procedure is a "procedural" question for the arbitrator, not an issue of "substantive arbitrability")*; see* also Revised Uniform Arbitration Act § 6(c), Comment 2.). Case law is developing as well to define the scope of arbitration broadly wherever the language permits. *See, e.g., ACE Capital Re Overseas Ltd. v. Central United Life Insurance Co.,* 307 F.3d 24 (2d Cir. 2002); *Simula, Inc. v. Autoliv, Inc.,* 175 F3d 716 (9th Cir. 1999); *Tate v. Saratoga Savings and Loan Ass'n.,* 216 Cal. App. 3d 843 (1989).

greatly and may involve equitable relief. Arbitrators have the power to grant relief consistent with the parties' agreement that a court could not grant.[3] Therefore, thought should be given to possible relief prior to commencing the arbitration and specified in the statement of Claim. The nature of the relief requested may affect the way the arbitration is structured (bifurcation and sequencing of issues for the hearing, etc.)

Here is a list of things to avoid in your Statement of Claim:

- Do not cite authority or make legal arguments. That comes later;
- Do not use legal phrases, especially Latin phrases;
- Avoid excessive detail in the recitation of facts;
- Avoid pejorative or argumentative words or phrases, such as "Claimant was clearly right . . ." or "Respondent's abusive behavior led Claimant to . . ."

C. <u>Dealing With Arbitral Institutions and Their Rules</u>.

1. <u>Selecting the Institution</u>.

Many arbitration clauses identify which institution is to administer the arbitration (sometimes referred to as a "self-executing" clause). Typical examples of such institutions are JAMS, American Arbitration Association ("AAA") or Financial Arbitration Services. Other clauses do not provide for administration (so called "ad hoc" or "non-administered" arbitration). Parties are free to agree to alter the institution identified in the clause after a dispute arises (just as they are free to agree to arbitrate a dispute arising out of an agreement that contains no dispute resolution clause at all).

Our preference in most complex cases is for administered arbitration. Although the cost will be somewhat higher, they are outweighed by the reliability and predictability of the process and likelihood of confirmation of the award.

If your clause calls for institutional administration, the Demand for Arbitration is filed with that entity (some rules require service of the Demand on the Respondents as well). Electronic and fax filing are permitted by most institutions.[4] The filing of a proper Demand for Arbitration commences the proceeding. The arbitral institution assumes responsibility for the process at that point and until the panel of arbitrators is in place. The case manager will assist you on the selection of the Rules, how to format and file your claim, and the payment of its fee.

The administrator will send the claim to all Respondents and notify them of the arbitration. Early administrative conferences with the case manager may address venue, arbitrator selection and qualification, division of fees, appointment and designation of party representatives (who need not be lawyers) and other threshold issues. The arbitral institution will also determine if the clause or agreement supports the right to proceed against designated Respondents.[5]

The institution will administer all aspects of the arbitration from initiation through issuance of the final award and will make important decisions prior to the

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[3] *See, e.g., Advanced Micro Devices, Inc. v. Intel Corp.,* 9 Cal. 4th 362 (1994).

[4] JAMS can be accessed at *www.jamsadr.com*; the AAA web address is *www.adr.org;* FSA web address is *finarb.com*

[5] For example, the administrator may not permit the inclusion in the arbitration of a Respondent who is not named in the arbitration agreement; that issue must be taken to court or deferred until the arbitrator is selected.

appointment of an arbitral panel. All informal contact by you and by the Respondents will be with the case manager, not the arbitrators. Your and the Respondents' contact with the arbitrators will be joint and as directed or arranged by the administrator, including preliminary hearings, motions, and other matters.

2. Non-administered Arbitrations. This form of arbitration is more challenging for the parties than an administered arbitration because the parties and the arbitrator must cooperate to address and resolve preliminary issues usually handled by the arbitral institution and do the administrative work (scheduling, notices, disclosures, sharing of expenses and the like). Disagreements may arise as to the proper venue for the arbitration and the selection of the arbitrator or the arbitration panel. These issues may be manipulated by the party resisting arbitration; even where the parties are cooperative, such procedural uncertainty can be a daunting obstacle to an efficient process.

Prompt resort to court each time there is a process impasse is sometimes the only way to move the process expeditiously. If the opponent understands that a failure of agreement will result in court intervention, and that there will be minimal delay, the tactic of non-cooperation may prove not to be effective and the reluctant opponent might realize the values of cooperation and self-determination.

3. Arbitration Rules. All arbitrations are conducted under some set of rules. Usually the selection of an institutional provider (JAMS, AAA) implies a choice of that institution's own rules.[6]

You may, however, find that you are either involved in an ad hoc arbitration or you have selected an administrator which does not have its own rules. In that event, the parties and the arbitral panel will agree on (or the panel will determine) applicable procedural rules. One popular choice is the UNCITRAL Rules, which are intended to be used in non-administered arbitrations. It is also possible to agree to use JAMS or AAA rules as a guideline to the parties in a non-administered setting.

As you address the rules which might be chosen, keep the complexity of your case well in mind. Some sets of rules may be more appropriate for complex financial matters than others.

D. Selecting the Arbitrator or the Arbitration Panel.

There is no more important decision that the selection of the arbitrator. The freedom to select the arbitrator(s) is the hallmark of the flexibility and party autonomy which distinguishes arbitration from litigation. Obviously, it should be done with great care and thought.

1. When the Arbitration is Administered. Procedures to be followed to select an arbitrator or a panel of arbitrators are controlled by the clause [7] or by the parties' chosen rules, if applicable. Absent a clear direction on these issues by the parties, the administrative practice of the arbitral institution will govern.

Clauses usually specify either a sole arbitrator or a panel of three arbitrators. The panel may consist of three neutral arbitrators or two party appointed arbitrators (usually expected to be non-neutral)

[6] Typical rules of arbitral institutions provide that the selection of the institution implies agreement to use its rules (and vice versa). *See* AAA Commercial Arbitration Rules, Rule R-1; JAMS Comprehensive Arbitration Rules and Procedures, Rule 2.

[7] *Brook v. Peak Int'l,* 294 F.3d 608 (5th Cir. 2002).

and a presiding (neutral) arbitrator. In international cases, all arbitrators, however appointed, are expected to be independent of the parties and neutral.

The parties are always free to agree on arbitrators; failing agreement, the typical administrative practice is for the arbitral institution to submit a strike list of candidates for the neutral arbitrator(s), and to allow the parties to strike a certain number and rank the others in order of preference. If you wish to influence the composition of the strike list, be sure to inform the case manager promptly of the unique aspects and complexity of the matter and the qualities and experience that arbitrator candidates should have. Remind the case manager of any provision in the clause that defines the qualifications of the arbitrator. The administrative conference is the best opportunity to provide this information to the case manager.

The case manager then determines the arbitrator with the highest acceptability by both sides. The selected neutral arbitrator(s) would then be asked to make disclosures of any circumstances which might suggest bias or non-neutrality, and the parties may object to the arbitrator on that basis. If the nominated arbitrator is not accepted, the selection process may be repeated or the case manager may make an administrative appointment (subject to the Same disclosure/ disqualification process). This is your best opportunity to shape the arbitral panel. Later efforts to disqualify arbitrators are less likely to be successful.

2. <u>When the Arbitration is Non-administered</u>. Selection of an arbitrator or, even worse, a panel, is much more difficult when the arbitration is ad hoc than when it is administered. The parties follow the process (if any) designated in the clause or their designated rules (if any); failing agreement application must be made to a court to have an arbitrator or panel appointed. (Some non-administered arbitration clauses designate an appointing authority which will act if the parties are unable to agree.)

3. <u>Arbitrator Qualifications</u>. The crucial question is which candidates are right for your arbitration. Intelligence, experience as an arbitrator (process expertise), subject matter expertise, financial experience, diligence, availability, neutrality and compensation requirements are most relevant. Examine the candidates' biographical information, ask your colleagues for recommendations and evaluations, go on-line. Try to obtain references from parties (preferably both sides) in recent similar cases. Do not look for colleagues or friends. If you happen to golf with or periodically eat lunch with one of the candidates, cross him or her off your list.

E. <u>The Preliminary Hearing</u>.

The preliminary hearing is a unique arbitration procedure; it is superficially similar to a court status or management conference but is much more important to the arbitration process than its counterpart because it is an opportunity to work cooperatively with the arbitrator to plan the entire arbitral process and to shape prehearing and hearing procedures to the unique aspects of the particular case. Preparation is therefore crucial.

1. <u>Preparation</u>. Think carefully what you wish to accomplish in the preliminary hearing and how that might be accomplished. Focus first on structural issues such as arbitrability of claims and counterclaims, the status of party-appointed arbitrators, the need for supplemental pleadings, the proper venue for the hearing, the existence of other, parallel or related proceedings, and the need for unique remedies that may require an unusual hearing process (such as the dissolution of a partnership that may require a liability phase and then a remedial phase).

Discovery and other information exchanges are

major topics in every preliminary hearing. You should have a good sense of what information you will need and how you might obtain it (from parties and third parties). The context in which these issues will be addressed is what does the clause say about discovery, what do the applicable Rules provide and what does the applicable procedural law say about the power of parties in an arbitration to obtain information from third parties?

You and your opposing counsel may well have different views about these issues; it is wise to have a pre-preliminary conference among counsel to assess what areas of agreement exist and what issues will need to be resolved by the arbitrator. If a stipulated protective order will be required, try to work out its terms prior to the preliminary conference so that differences can be raised with the arbitrator.

Bear in mind that, in most financial disputes, one side (generally, the Respondent) has far more data and documents than the other. In such cases, the Claimant will seek means to level the playing field by allowing significant discovery and information exchange.

Each side will likely rely on expert testimony on financial or accounting issues. Early disclosure of experts and appropriate information exchange will be addressed in the preliminary hearing. Anticipate your needs so that this process suits the needs of the particular case.

Assess whether dispositive motions might play an important role in the conduct of your case. The preliminary hearing is the time to address not only the nature of such motions and the timing of their filing and hearing, but also the interrelationship between discovery and other information exchange and the consideration of such motions.[8]

How long do you anticipate the hearing will take? This will influence when it can be scheduled. Be sure that all necessary witnesses are available at the time set and have reserved those dates on their calendars. Try to schedule a hearing that is continuous rather than spread over a longer period of time. A continuous hearing is more efficient for counsel and more conducive to a decision-making process that is based on actual recollection of testimony and argument.

Once the hearing date is set, discuss and schedule the exchange of witness and exhibit lists and prehearing briefs well in advance of that date so that counsel can properly prepare to conduct the hearing. Expert exchanges should be coordinated with the hearing date as well.

2. The Preliminary Hearing. Most preliminary hearings are conducted over the telephone, without the client being in attendance. Consider an in-person hearing where there are difficult or complex issues or where the number of parties in attendance may not be manageable on a telephone conference.

The sole arbitrator or chairman of the panel will conduct the preliminary hearing, usually with the aid of a checklist of issues prepared in advance. Counsel are free to submit pre-preliminary hearing statements to assist the arbitrators in being aware of any unique issues or concerns. Counsel should also suggest topics or issues during the course of the preliminary hearing as appropriate.

Cooperative, professional and prepared counsel are appreciated by arbitrators. Perceptions about cooperativeness and professionalism are formed at this first exposure of counsel to the arbitrators. Skilled counsel seek to establish a professional relationship with

[8] *Schlessinger v. Rosenfeld, Meyer & Susman,* 40 Cal. App. 4th 1096 (1995).

the arbitrators at all stages of the process.

3. The Scheduling Order. Shortly after the preliminary hearing is concluded, the chair will distribute to counsel a scheduling order reflecting the decisions made at the hearing. Be sure that all issues are addressed and that all agreements and orders are correctly reflected in the order. Place applicable dates in your calendar and plan well in advance so that all deadlines are met. Expect that subsequent events in the arbitration process will require further preliminary hearings and further scheduling orders. Skilled arbitrators manage a complex arbitration through a series of such hearings and orders.

4. The Voluminous Document Case. Many financial and accounting and valuation disputes are complex because there are thousands of pages of relevant documents and electronic records. How to efficiently handle those documents both in terms of exchange and at the hearing itself can pose tricky problems. Discovery or exchange of documents should be addressed by counsel prior to the preliminary hearing, and necessary orders should be sought through the preliminary hearing process. Counsel and experts should be prepared to identify and organize relevant documents early in the process. These documents will be relied on by witnesses in their hearing preparation and any expert analysis. They must be narrowed or summarized for effective presentation at the hearing. The key is to be able to present complex issues, supported by appropriate documentary evidence, in a manner that will be convincing to the arbitrators.

It may be necessary to create electronic files in order to analyze and present such evidence. Assistance may be required of technical experts; they should be identified and engaged early in the process.

Ultimately, the form of presentation of this evidence at the hearing must be agreed upon. The arbitrators may have a preference for hard copies or electronic records; whatever the form, they must be identifiable so that a proper hearing record is kept and preserved. These issues should first be raised at the preliminary hearing and in subsequent hearings as necessary. All arrangements should be documented in written orders.

Many experienced counsel (and most arbitrators) prefer to sort the documents into discrete exhibits, numbered consecutively, and place them into three-ring binders. Usually the arbitrators require the combination of both side's documents and the preparation of a joint exhibit list. Modern arbitration (and trial) practice makes use of PowerPoint and other electronic visualizations of exhibits. Advance planning is required to make this technique useful to the arbitrators.

Ensure that each member of the panel has a separate set of binders, as well as all counsel. Although the witnesses will not need a complete set of binders, you should have a set of those documents about which the witness will be asked to testify ready to hand to the witness.

Splintering Shareholder Groups and Mutual Funds

Who's Mutual Fund Is It Anyway?

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Introduction

There used to be just one type of mutual fund shareholder—long-term investor. Now there are short-term traders, market timers, sector speculators and all manner of arbitrager. Today's mutual funds serve different groups of investors buying and selling shares for different ends, using methods that adversely effect their fellow shareholders. The ultimate effect of the Spitzer fund probe will be to shine a light on these inequalities. In this article I explain how I have analyzed some of these issues and how you can improve your skills in mutual fund analysis.

Fund Sales and Redemptions Data—An Empirical Approach to Improper Fund Manipulations

Just like a bank, every month millions of people deposit (invest) money into mutual funds and every month millions of people withdraw (redeem) from their accounts. For the most part, the deposits equal the withdrawals, so that month to month, the banks and funds end up with the same amount of total deposits (investments).

Few funds maintain the same assets month to month. Most funds are slowly growing or slowly shrinking. But it must be kept in mind that there is always an amount of money that everyone expects to "net out" no matter how well or poorly the fund is doing. Just like a bank, some people invest because they have to put their inherited money somewhere and others withdraw because they have to pay tax bill.

Example Fund - Monthly Sales and Redemptions
Assets $500,000

		January	February	March	April	May
Sales	**$10,000**					
Sales	**$10,000**		**Job Bonus**			**Tax Refund**
Sales	**$10,000**	**Bonus**	**Inherit**	**Inherit**	**Gift**	**Bonus**
Sales	**$10,000**	**Inherit**	**Inherit**	**Other Fund**	**Bonus**	**Lotto Ticket**
Redemptions	**-$10,000**	**Tax Bill**	**Vacation**	**New Car**	**Tax Bill**	**Changed Fund**
Redemptions	**-$10,000**	**Family**	**Fix House**	**Tax Bill**	**Lost Lawsuit**	**Divorce**
Redemptions	**-$10,000**			**Tax Bill**	**Divorce**	
Redemptions	**-$10,000**					

In the above table most of the money moving back and forth (the accounts in light green) don't change the total amount of money in the fund. In February the fund took in an extra $10,000; in March and April it lost $20,000 and then in May took in another $10,000.

What we can say is that the fund averages $20,000 a month in both sales and redemptions. Twenty thousand left in January from a Tax Bill and Family Matter; $20,000 came in from a Bonus and Inheritance. For whatever reason, we can expect that in June, July, August will see $20,000 coming in and the same amount leaving (just like January, February, March, April and May). Twenty thousand works out to 4% of the funds half-a-million, which means we can expect that in 24 months (2 years) five hundred thousand will have cycled through the fund.

Danger signs appear when share-turnover exceeds 8% which puts the fund under the 1-year total-asset turnover mark. Only a market-timer would hold any equity fund for less then a year. In other words, <u>if more than 8% of a funds assets are being sold and redeemed on a consistent monthly basis without a corresponding change in the overall size of the fund then the fund is probably being churned</u>.

If a lot of money is entering or leaving the fund every month it better stay or leave. Keep in mind that these monthly numbers are averages of daily sales and redemptions. On a daily basis these movements can create havoc with the portfolio manager trying to maintain a balance between invested money and cash.

If you look at the Nations International Equity fund before Canary started working it you can see that it behaved as expected.

Nations International Equity ($ Thousands)

					Percent (%) of Assets	
Date	**Net Flows**	**New Sales**	**Redemptions**	**Assets**	**New Sales**	**Redemptions**
Apr-99	($40,747)	$74,883	($115,630)	$791,524	-14.61%	9.46%
May-99	($34,579)	$55,254	($89,833)	$791,524	-11.35%	6.98%
Jun-99	($18,140)	$15,548	($33,688)	$791,524	-4.26%	1.96%
Jul-99	($4,800)	$31,829	($36,629)	$791,524	-4.63%	4.02%
Aug-99	$19,352	$84,175	($64,823)	$791,524	-8.19%	10.63%
Sep-99	($24,527)	$34,680	($59,207)	$791,524	-7.48%	4.38%
	($17,240)	$49,395	($66,635)		-8.42%	6.24%

					Percent (%) of Assets	
Date	**Net Flows**	**New Sales**	**Redemptions**	**Assets**	**New Sales**	**Redemptions**
Apr-00	$58,658	$211,211	($152,553)	$955,920	-15.96%	22.10%
May-00	$34,917	$310,304	($275,387)	$955,920	-28.81%	32.46%
Jun-00	$196,432	$408,808	($212,376)	$955,920	-22.22%	42.77%
Jul-00	($40,730)	$256,547	($297,277)	$955,920	-31.10%	26.84%
Aug-00	$56,048	$287,549	($231,501)	$955,920	-24.22%	30.08%
Sep-00	($45,013)	$108,198	($153,211)	$955,920	-16.03%	11.32%
	$43,385	$263,770	($220,384)		-23.05%	27.59%

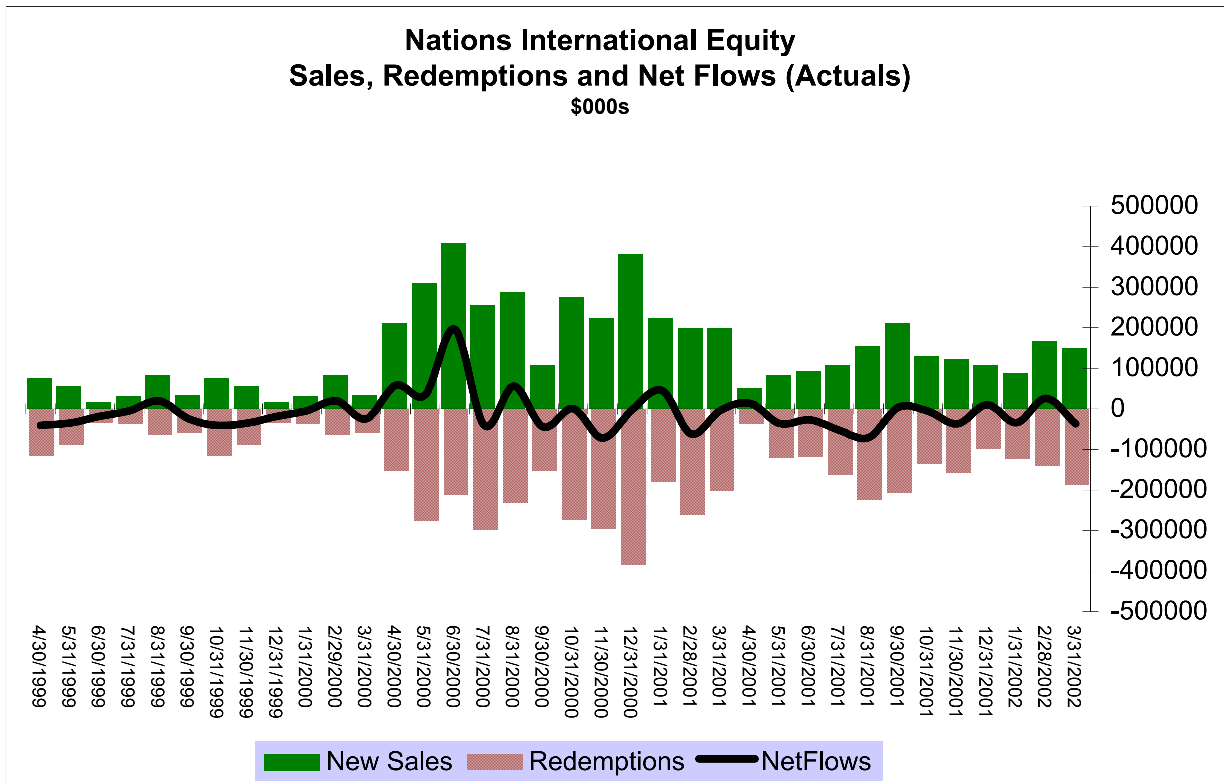
At eight percent this fund is running a high 1-year turnover, but many months it's running a standard 4% turnover.

Now let's look at the funds sales and redemption six months later when the New York Attorney General alleges that Canary was "late-trading" the fund.

As you can see, there is now an average of about $250 million of money moving back in forth in a $1 billion fund. Every four months the shares have been recycled. The Nations International Equity is showing an average net flow of $43 million a month even though four times that amount is being redeemed at the same time. At 25% per month, this fund is well above the 8% warning line which should be a clear warning sign to any conscientious trustee.

In the Nations Capital Growth Fund, which wasn't named in the complaint, redemptions occurred at a rate of 3.97% and sales at 3.31%, what you'd expect.

Getting back to the Nations International Equity fund we can see the startling tale of the tape.



The chart shows that in April of 2000 the activity of this fund's shares became frenetic. Something happened. From April 2000 to April 2001 the fund experienced 25% monthly flows; that is, every month 25% of the shares were sold and 25% were bought. What was going on? If these shares were owned by typical investors we'd have to assume that ever four months ALL the fund's shareholder's cashed out and another set bought in—highly unlikely. Of course, it wasn't all the investors buying and selling their shares. It was the group of "short" term investors manipulating the fund at the expense of the "long" term investors.

One would expect an International fund to have rather dull flows. After all, one buys International funds because they believe foreign markets will do better sometime in the distant future. Or they buy these funds to diversify their portfolios. Foreign investments are, by nature, long term bets. Foreign securities exhibit erratic appreciation and one has to weather much bad weather in both currency exchange rates and politics.

For an arbitrager, however, International funds offer great opportunity. If you can stay up late and follow the prices of stocks half-way around the world, or you read their newspapers or have contacts overseas, then International funds can turn your knowledge into money. If you know that Stock X in Singapore is higher than the price it was valued at in the National International Equity fund then you can safely buy the mutual fund knowing that eventually, in a few days or sooner, the fund's value will be re-priced to reflect that underlying security's value.

Fund managers have recognized this problem for years and usually do what they can to weed out active traders. Allowing a trader to buy fund shares after closing, however, is flat-out illegal and benefits the trader at the expense of the shareholder.

An interesting case which the tale of the tape seems to support. Eliot Spitzer may not need to bring in hundreds of e-mails and witnesses. Some charts may be worth a thousands words.

Where The Bodies Are Buried

The mutual fund industry is a Byzantine network of distributors, advisors, sub-advisors, transfer agents, custodians, brokers, legal firms for the funds and separate legal representation for the boards. The problems in researching fund practices are exacerbated by the fact that EDGAR, the repository of S.E.C. filings, was not designed primarily for investment managers. In the early 1990s when the S.E.C. first started designing an electronic filing system (EDGAR) for public corporations like GM, IBM and Ford, mutual funds were minor issues. At the time there were about 3,000 mutual funds with $1 trillion in assets. Today there are over 8,000 funds with nearly $7 trillion. Today, those minor drawbacks in the way the S.E.C. registered funds in the early 1990s have become major headaches.

An article I wrote about the Merrill Lynch Focus 20 fund was mentioned in the September 11th edition of the Wall Street Journal and appears below. Many lawyers were interested in how I "found that stuff out" so I will try to explain the process here. Hopefully these tips will help you in your fund research endeavors.

In the case below, the fund was relatively easy to research. You can visit www.sec.gov, enter the EDGAR site, and type in "Merrill Lynch Focus" and view "Merrill Lynch Focus Twenty Fund Inc" (S.E.C. registrant 000109293). Clicking on the link you see a list like this:

Home | EDGAR Search Home | Latest Filings | Previous Page

U.S. Securities and Exchange Commission

MERRILL LYNCH FOCUS TWENTY FUND INC (0001097293)

State location: NJ | Fiscal Year End: 1231
formerly: MERRILL LYNCH CONCENTRATED GROWTH FUND INC (until 1999-10-27)

Business Address
C/O MERRILL LYNCH ASSET MANAGEMENT
P O BOX 9011
PRINCETON NJ 08543-9011

Mailing Address
C/O MERRILL LYNCH ASSET MANAGEMENT
P O BOX 9011
PRINCETON NJ 08543-9011

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Form Type
Prior to
Ownership? Include Exclude Only
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Items 1 - 40

Form	Formats	Description	Filing Date	File Number
N-CSR	[html][text] 115 KB	Certified Shareholder Report	2003-07-31	811-09651
NSAR-A	[html][text] 8 KB	Semi-annual report for management companies	2003-07-30	811-09651
497J	[html][text] 2 KB	Certification of no change in definitive materials	2003-04-01	333-89775
497	[html][text] 7 KB	Definitive materials	2003-03-27	333-89775
485BPOS	[html][text] 2 MB	Post-effective amendment [Rule 485(b)]	2003-03-27	333-89775
24F-2NT	[html][text] 5 KB	Rule 24F-2 notice	2003-02-27	333-89775
NSAR-B	[html][text] 45 KB	Annual report for management companies	2003-01-28	811-09651
N-30D	[html][text] 115 KB	Annual and semi-annual reports mailed to shareholders [Rule 30d-1]	2003-01-23	811-09651
NSAR-A	[html][text] 7 KB	Semi-annual report for management companies	2002-07-25	811-09651
N-30D	[html][text] 90 KB	Annual and semi-annual reports mailed to shareholders [Rule 30d-1]	2002-07-23	811-09651

There are many filing types, but I generally only look at three. The 485BPOS is the latest "final" prospectus. The 497 is a "Statement of Additional Information" which either reports a change in the fund, typically a new portfolio manager, fund name change, a fee rebate, etc. (However, sometimes the fund publishes the entire prospectus in the filing). The third filing type is the semi-annual/annual which used to be called the N-30D, but is now the N-CSR.

The semi-annual/annual reports are filed every 6 months. You would have hoped the S.E.C. had made a different filing name for each one, semi-annual or annual, but they didn't. For the most part I look at the annuals since the semi-annuals only have 6 months worth of data. But to find the annuals you need to know the fund's fiscal year-end date.

```
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ACCESSION NUMBER:               0000900092-03-000096
CONFORMED SUBMISSION TYPE:      N-CSR
PUBLIC DOCUMENT COUNT:          2
CONFORMED PERIOD OF REPORT:     20030531
FILED AS OF DATE:               20030731
EFFECTIVENESS DATE:             20030731

FILER:

        COMPANY DATA:
                COMPANY CONFORMED NAME:                 MERRILL LYNCH FOCUS TWENTY FUND INC
                CENTRAL INDEX KEY:                      0001097293
                IRS NUMBER:                             223711535
                FISCAL YEAR END:                        1231
```

If you open any filing you'll see the fiscal year end date in the filing header. The Focus Twenty shows a year-end of December, 31st. Most semi-annual reports are submitted 60-70 days after the fiscal semi-annual/annual date. So if you look for a filing near the end of February or beginning of March you'll probably find the N-CSR (or N-30D previously). But I did, and didn't. It turns out that the fiscal year end date reported in the header is incorrect. The fund's actual fiscal year-end date is November. I found the latest annual on January 28th, 2003. Fortunately, Sarbanes-Oxley is improving the funds filing habits and such slip-ups are rarer.

Another trick to finding the fiscal year-end date is the NSAR-B filings. These are the filings from which I populate our database at www.fundexpenses.com They are also filed semi-annually, but are computer questionnaires filled out and submitted to the S.E.C. in answer-key format. If you try to open one you'll see something not-very-helpful like this.

```
<TYPE>NSAR-B
<SEQUENCE>1
<FILENAME>answer.fil
<TEXT>
<PAGE>      PAGE  1
000 B000000 11/30/2002
000 C000000 1097293
000 D000000 N
000 E000000 NF
000 F000000 Y
000 G000000 N
000 H000000 N
000 I000000 6.1
000 J000000 A
001 A000000 MERRILL LYNCH FOCUS TWENTY FUND, INC.
001 B000000 811-9651
001 C000000 6092822800
002 A000000 P.O. BOX 9011
002 B000000 PRINCETON
002 C000000 NJ
002 D010000 08543
002 D020000 9011
003  000000 N
004  000000 N
005  000000 N
006  000000 N
007 A000000 N
007 B000000  0
```

You'll notice that question B000000 contains the fund's fiscal year-end date. In a single-fund trust, which we'll get to in a minute, you can find the annual N-CSR or N-30D by looking for the one closest by filing date to the NSAR-B. The NSAR-A matches the semi-annual filings.

Many years ago there were usually only one or two funds per trust. With the proliferation of new fund introductions in the 90s the trusts began to bloat. There are currently 2,935 distinct trusts of 10,409 fund portfolios. There are more than 18,000 fund share classes, but the S.E.C. doesn't make a distinction for share classes in its filings. Although individual share class information is given in the public reports, like Focus Twenty A, B , C and I shares, the funds only send portfolio level data to the S.E.C. through their NSAR reports.

The NSAR reports are generally filled out by a fund's treasurer through a special computer program. The software sends the answer key to the S.E.C. which uses the data to populate their internal database. The NSAR data is ultimately used by the S.E.C. to help them build a list of questions for their audits. (a note to the computer savvy: the NSARs

are not as easy to parse as they look).

Some trusts have more then 40 portfolios, which makes finding a specific fund in a trust filing no easy task. When you open the Fidelity Select trust (CIK: 320351), for example, you'll find each fund's report jammed into the document one fund after another. The annual report is a whopping 12 megabytes (it froze my computer for 2 minutes). Put another way, the "Fidelity Select Medical Equipment and Systems Portfolio" is not a fund you want to research from your beach-house dialup connection.

More thoughtful trusts put each fund in their own document. For example, you'll see a list like this for the 15 portfolio Goldman Sachs Trust (CIK: 822977)

You just have to open each document one at a time until you find the "Goldman Sachs Intermediate Bond Fund", if that's what you're looking for. It looks like the N-CSRS forms are now marked annual or semi-annual (N-CSR and N-CSRS) which will be a great help. Earlier filings in N-30D format will still need to be figured out.

Each semi- and annual-report contains a "Statement of Operations" for each fund. These statements provide the expense breakdowns for the funds. By compiling this data, year for year, I was able to see expense items that rose or fell unexpectedly for

the Focus Twenty fund. Although I seldom look at the holdings data it's available in these forms. Such data is used by some arbitrators looking to show that two funds of different expense ratios invest in the same securities, a serious breakdown in the broker's fiduciary duty.

Business Address
4900 SEARS TWR
C/O GOLDMAN SACHS & CO
CHICAGO IL 60606
3126554400

Mailing Address
85 BROAD ST
85 BROARD STREET
NEW YORK NY 10004

Form Type
Prior to
Ownership? Include Exclude Only
Retrieve Filings

Items 1 - 80

Form	Formats	Description	Filing Date	File Numbe
N-CSRS	[html][text] 2 MB	Certified Shareholder Report, Semi-Annual	2003-09-08	811-0534
N-CSRS	[html][text] 1 MB	Certified Shareholder Report, Semi-Annual	2003-09-08	811-0534
N-CSRS	[html][text] 3 MB	Certified Shareholder Report, Semi-Annual	2003-09-08	811-0534
N-CSRS	[html][text] 3 MB	Certified Shareholder Report, Semi-Annual	2003-09-05	811-0534
N-CSRS	[html][text] 3 MB	Certified Shareholder Report, Semi-Annual	2003-09-05	811-0534
N-CSRS	[html][text] 2 MB	Certified Shareholder Report, Semi-Annual	2003-09-03	811-0534
497	[html][text] 6 MB	Definitive materials	2003-09-02	033-1761
N-CSRS	[html][text] 144 KB	Certified Shareholder Report, Semi-Annual	2003-09-02	811-0534
NSAR-A	[html][text] 134 KB	Semi-annual report for management companies	2003-08-27	811-0534
485APOS	[html][text] 2 MB	Post-effective amendment [Rule 485(a)]	2003-08-20	033-1761
N-CSR	[html][text] 3 MB	Certified Shareholder Report	2003-07-03	811-0534
N-CSR	[html][text] 8 MB	Certified Shareholder Report	2003-07-03	811-0534
N-CSR	[html][text] 6 MB	Certified Shareholder Report	2003-07-03	811-0534
NSAR-A	[html][text] 91 KB	Semi-annual report for management companies	2003-06-27	811-0534
485APOS	[html][text] 1 MB	Post-effective amendment [Rule 485(a)]	2003-06-13	033-1761
N-CSR	[html][text] 4 MB	Certified Shareholder Report	2003-05-09	811-0534
N-CSR	[html][text] 5 MB	Certified Shareholder Report	2003-05-08	811-0534
N-CSR	[html][text] 2 MB	Certified Shareholder Report	2003-05-08	811-0534
N-CSR	[html][text] 5 MB	Certified Shareholder Report	2003-05-08	811-0534

Quick Tips

- Each trust has a unique S.E.C. registrant number called CIK (Central Index Key) and the trust may have multiple funds. If you follow specific funds keep those CIK numbers handy.
- Read Prospectuses (485BPOS) filings for fund's sales, advisory and service-provider information.
- Read 497s to track changes to fund over time.
- Read N-CSR (formerly N-30Ds) for financial statements.
- Open NSAR-B to quickly get fiscal year-end date for fund
- Keep in mind that a semi-annual report shows 6-months worth of data and the annual shows 12 months so that you can't quickly compare the numbers of a semi-annual to annual (at least not without subtracting the semi-annual numbers from the annual numbers).

Merrill Lynch Focus 20 Fund

What will Eliot Spitzer's soldiers conclude after their war with Merrill Lynch's analysts?

> "…home to old lies and new infamy;
> usury age-old and age-thick
> and liars in public places." – Ezra Pound (*E.P. Ode Pour L'election De Son Sepulchre*)

Chances are Merrill Lynch's problems are not over. Companies are often sued because management knew something detrimental to the company that they didn't report to their shareholders in a timely matter. Are funds any different? I believe this will eventually come up in court.

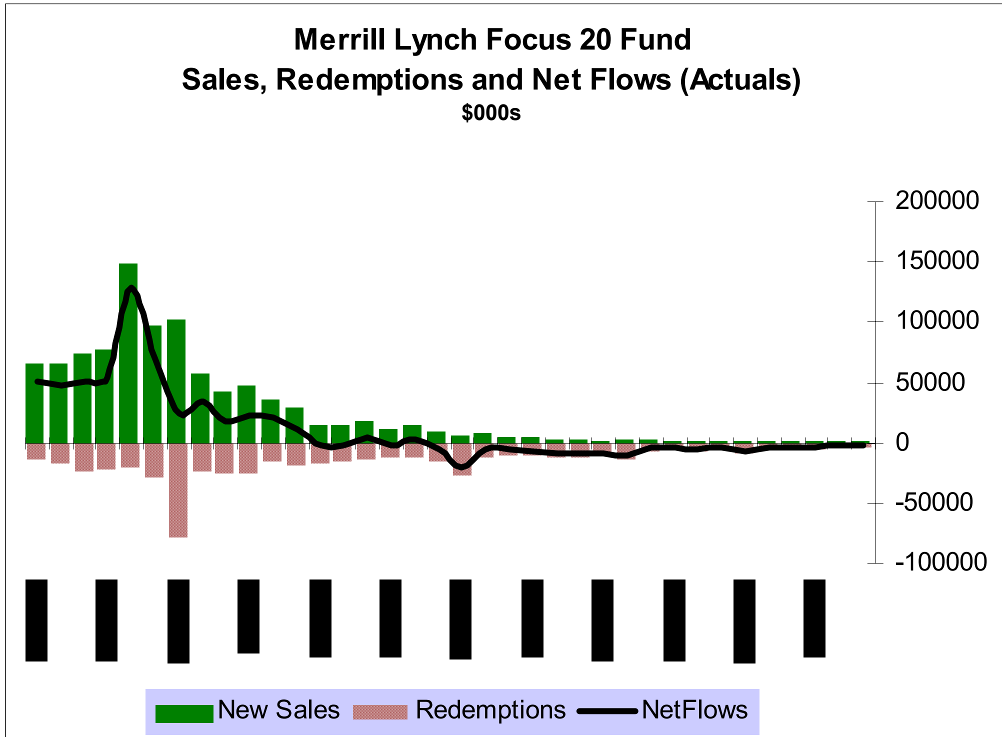
As late as the November, 2002 annual report, Terry K. Glenn
President and Director/Trustee of the Merrill Lynch Focus 20 Fund wrote:

> *We appreciate your continued support in this exceedingly difficult environment for aggressive growth equity investing. While the environment continues to be challenging, we remain confident that*
> *our process will prove itself over the long term, and we look*
> *forward to sharing our outlook and strategy in our next report to shareholders.*

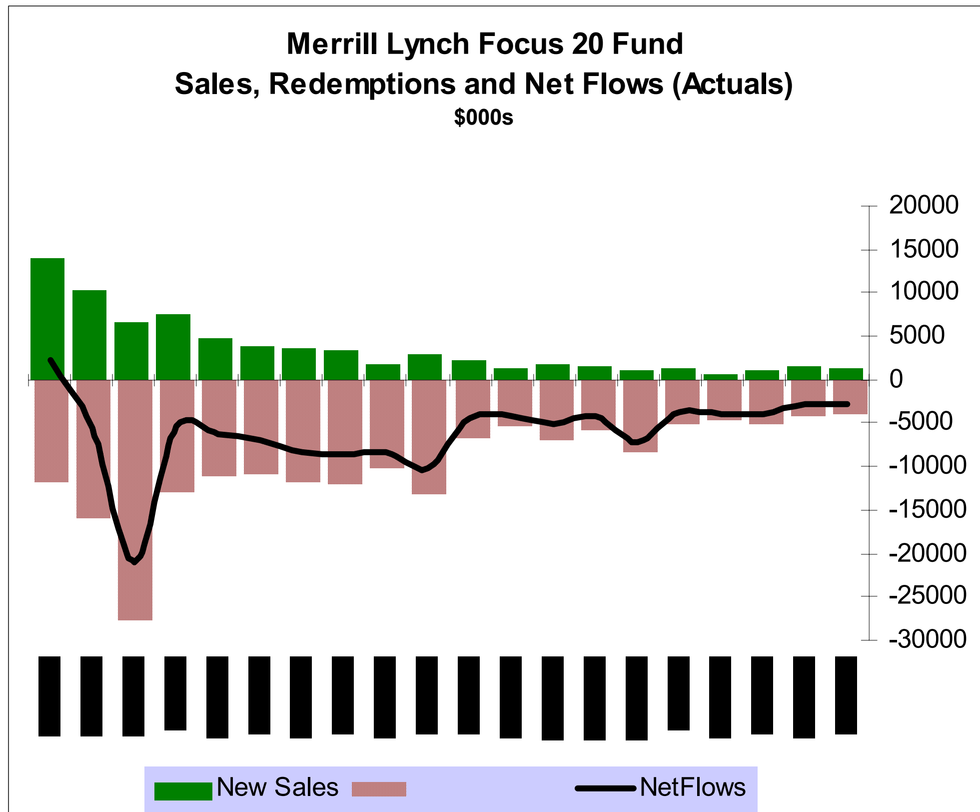
Long term? This fund is on its way to running out of assets by the first half of 2006, less then three years away. The fund has been losing an average of $6 million a month since October, 2001. The fund currently has a paltry $170 million in assets. Does Mr. Glenn really believe there is any hope for this fund?

To give you an idea of how horrendous this fund has performed consider this. If you put $10,000 in the Focus 20 fund on June, 2000 and the same amount in the S&P 500 you would end up with $1,624 in June of 2003 for the former and $7,003 for the latter. You can be sure there are already some very bitter Focus Twenty current and former shareholders.

On the following page is a chart showing the rise and fall of the Focus 20's, its sales, redemptions and net flows (black line).



Now for a close-up on the fund's recent misery.



How can any honest executive (and Trustee no less) look at those charts and say they believe this fund will do well "long term"? What good is a long-term plan if in a year or so the shareholder gets a letter saying the fund had to be closed or folded into a fund with a short-term plan?

The funds expenses over its short life show some interesting fee bulges. Shareholders may contest these charges.

In the first year the fund records $3.4 million in "other" fees? Then in 2001 its administrative fees bulk up another $1.5 million before shedding one million the following year. In 2002 shareholder servicing puts on another $700,000. Legal fees go up to $233,000, no doubt to deal with those lawsuits about insider-dealing. Should the shareholder pay?

The annual report says this fund will be around long term. The numbers paint another story. In 2002 the front load fees collected were $73,000, down from $4,687,000 the year before. Clearly, even Merrill's brokers are staying away from this fund like the plague. Will management collect its 2%+ in fees to the bitter end?

Merrill Lynch Focus 20	**2000**	**2001**	**2002**
Monthly average assets	1,361,486	745,098	287,282
Total Front Loads Collected	6,652	4,687	73
Deferred Sales Charges Collected	1,475	1,416	938
12b 1 Paid	9,057	6,349	2,302
Gross advisory fees	8,656	4,618	1,719
Gross administrator fees	368	1,828	882
Shareholder servicing agent fees	1,378	1,661	2
Custodian fees	107	47	59
Printing expenses	19	106	106
Directors fees	56	38	39
Registration fees	793	64	145
Auditing fees	0	40	58
Legal Fees	6	28	2
Marketing distribution including 12b 1	9,057	6,349	2,302
Amortization of organization expenses	160	238	10
Other expenses	3	41	39
Total expenses	24,023	15,058	7,907
Expense reimbursements	0	0	0
Total number of shareholder accounts	125,605	124,656	90,950

Expert's Corner - Detecting Personal Trading Abuses

By Craig J. McCann, PhD, CFA

© 2003 Securities Litigation and Consulting Group, Inc., 3998 Fair Ridge Drive, Suite 250, Fairfax, VA 22030. www.slcg.com. *Dr. McCann can be reached at 703-246-9381.* *This paper resulted from work I did at the SEC in 1995 and first widely distributed in 1999. The current version of the paper differs from the version available at http://www.sec.gov/rules/other/f4-433/mccann1.htm only with my changed contact information and the correction of a couple of typographical errors.*

Preface

The mutual fund industry has been rocked recently by disclosures of alleged personal trading abuses. The market timing alleged by portfolio managers in their personal trading accounts is just the tip of the scandalous personal trading abuses, some of which will be uncovered in the months and years to come.

While working at the Securities and Exchange Commission in 1994 and 1995, I studied alleged personal trading abuses by mutual fund portfolio managers. At this time, the Division of Investment Management conducted a "study" of the industry, asking large mutual fund companies to voluntarily report the results of self-audits. These funds reported that their portfolio managers did not front-run fund trades and the Division therefore concluded that personal trading abuses were not widespread. It was my view at the time that front running was the least profitable and easiest to detect form of personal trading abuse and therefore that the Division's factual observations were pre-ordained and told us nothing about widespread personal trading abuses.

The paper, which follows, was written to explain a simple, cost effective method for ferreting account personal trading abuses. The paper was updated slightly and included in published comments at the SEC's Roundtable on Investment Adviser Regulatory Issues (*see* http://www.sec.gov/rules/other/f4-433.shtml). If my proposal had been adopted abuses like the abuses which have recently come to light would have been avoided. CJM 11/19/03.

1 Introduction

On August 20, 1999, the Securities and Exchange Commission adopted amendments to its Rule 17j-1 regarding personal trading by mutual fund company and investment adviser personnel.[1] Effective this spring and summer, these amendments place additional duties on fund companies' boards of directors to monitor personal investment activities of their employees and to detect and deter personal trading abuses.

The amendments require that all persons with regular access to information concerning funds' trading file initial and annual reports detailing their security holdings and quarterly reports detailing their security transactions. The amendments also require that fund's boards of directors approve codes of ethics

[1] *See* U.S. Securities and Exchange Commission (1999).

governing personal trading and review annual reports describing any personal trading abuses uncovered during the previous year. Critically, the amendments require that funds' management or compliance personnel review the reports to detect violations of the funds' code of ethics. Unfortunately, current discussions of personal trading abuses provide little useful guidance for boards of directors seeking to comply with the amended Rule 17j-1.

The purpose of this paper is to describe an effective method for determining when employees of mutual funds and investment advisers might be engaging in abusive personal trading without placing undue burden on fund companies and investment advisers. I argue that effective detection of personal trading abuses can only be accomplished by monitoring trading profits not trades. The proposed technique will be u seful for securities regulators faced with the daunting task of overseeing the ever-growing mutual fund industry while operating on restrictive budgets. It raises a red flag when suspect trading needs to be investigated more thoroughly. Finally, it suggests a simple yet effective disclosure that investment companies could make that would inform investors about personal trading activities.

2 Background

In 1963 the Securities and Exchange Commission reported to Congress on the results of its comprehensive study of securities markets. [2] Three years later, the SEC returned to Congress with recommendations to deal with problems in the mutual fund industry including several potential conflicts of interest arising from personal trading by portfolio managers. [3] First, managers might use information about pending client trades to inform their personal trading. Second, and closely related, personal trades in advance of fund trades might adversely affect the prices at which the funds traded. Finally, portfolio managers might use their portfolios' holdings to prop up the value of securities managers hold in their personal trading accounts.

More than thirty years later, questions persist about personal trading in an industry which has grown from $21 billion in 1962 to over $6.8 trillion in 1999. Fund companies and investment advisers increasingly have a clear business incentive to maintain public confidence in the industry and assure investors that excessive personal trading does not distract portfolio managers.[4] Revelations about the size and rumored profitability of Jeff Vinik's personal trading during a time when the funds he managed floundered created a heightened public awareness of potential conflicts of interest in the mutual fund industry.

The Securities and Exchange Commission has stepped up its efforts to scrutinize personal trading abuses and initiated a number of high profile enforcement actions against investment advisors. [5] In 1994, the SEC alleged that Invesco Funds Group portfolio manager John Kaweske diverted fund resources to his son by investing in startup companies who agreed to pay secret commissions and failed to disclose many fund-matching personal trades.

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[2] *See* U.S. Securities and Exchange Commission (1963).

[3] *See* U.S. Securities and Exchange Commission (1966).

[4] *See Lowenstein (1996) and SEC v. Capital Gains Bureau, Inc.* 375 U. S. 180 (1963).

[5] The SEC reallocated resources from inspecting holdings of money market mutual funds to increased inspections of other types of mutual funds in 1994. *See* Sturc and Tycko (1996).

Chairman Arthur Levitt has forcefully made the case for strict adherence to the highest standards of ethical conduct, going so far as to say "If I were a director, I would have reservations about portfolio managers trading for their own account."[6] Mutual fund companies have taken steps to reduce personal trading abuses.[7] Yet there remains a vast gulf between the opportunities for abuse and the ability of fund companies and the SEC to detect such abuse.

Proposals for regulating personal investing activities of portfolio managers continue to focus on the conduct identified in the 1966 SEC Report. However, these practices are less likely to be profitable and are more easily detected than subtle forms of trading abuses available to investment advisors. In an effort to curb personal trading abuses by investment managers, current regulatory, compliance and enforcement activities should be revised to address the greater scope for abusive trading in the investment management industry.

3 Traditional Regulation

3.1 Front-running and Scalping

Rule 17(j)-1 has been interpreted to make it illegal for portfolio managers to *front-run* their clients. Front-running occurs when portfolio managers buy securities in their personal accounts prior to buying the same securities for their clients, or when the managers sell securities out of their personal accounts prior to selling the same securities for their clients. The rule has also been interpreted to prohibit managers from scalping stocks. Scalping occurs when managers purchase securities for their clients for the sole purpose of increasing the value of the same securities held in the managers' personal accounts.[8]

A manager might buy shares for his personal account that he intends to subsequently buy for one of his clients if he believes that the client's purchases will cause the securities' prices to rise. Likewise if a manager plans to sell a security out of the fund's portfolio he might first sell any of the same security he holds in his personal account if he believes that the fund's sales will reduce the securities' prices. Front-running harms a portfolio manager's clients if the trades affect the prices at which the clients subsequently trade. This will occur when a manager's personal trades are large or if the trades convey information of impending large or informed client trades. Even where the manager's personal trades are relatively small, if front-running is detected and that trading pattern is emulated by other market participants before the client's trades are effected, the combined effects will cause the prices paid (received) by the client to increase (decrease).

Portfolio managers might use fund assets to buy securities that the manager already owns in his personal account if he believes that the funds' purchase will prop up the securities' prices. If a manager identifies an opportunity in a stock with only $100 million in capitalization, a $3 million purchase would constitute a 3% holding. Stakes of this size are likely to have significant price effects. More subtly, the manager might fail to sell securities from the funds' portfolio securities that he owns in his personal account if he believes such trades would depress prices.

Scalping harms portfolio managers' clients in two ways. The price support that

[6] *See* Levitt (1996).

[7] *See* "Fidelity Curbs Employee Stock Trades," *The Reuter Business Report,* June 21, 1996.

[8] *See* Frankhauser and Frye (1988).

funds' assets provide is directly related to the size of price impacts of the trades. That is, portfolio managers benefit from scalping only to the extent that the trades adversely affect prices at which clients buy and sell. Furthermore, scalping is more likely to occur in securities that have fallen in price or that portfolio managers believe are going to underperform the market. Scalping thus results in a perverse selection of securities for funds to purchase or sell.

3.2 Front-running and scalping generate thin profit margins

Conventional front-running is an extremely unlikely form of investment management personal trading abuse. When fund trades are large and uninformed, managers must make opposing trades in the same securities within a day or less *after* funds trade and even then can capture only a fraction of a transitory blip in prices induced by liquidity constraints. If the trades are small there isn't even this transitory blip to chase. When trades are informed, managers must front-run clients' trades but such fund-matching trades are easy to detect and therefore effectively deterred.

If trades don't convey private information, their price effects are likely to be temporary. Mutual funds' trading is uninformed on average and therefore any price effects caused by fund trading are likely to be short-lived.[9] When a manager enters a trade for his client he knows whether the trade was informed or not; the market has only an expectation that will be right on average but wrong on every individual trade. The manager therefore knows better than the market whether the price will return to its pre-fund-trade level.

To profit from prior knowledge of uninformed trades managers must *back-run* their funds; front-running is only incidental and often unnecessary. Managers can profit by following uninformed fund sales with personal purchases and following uninformed fund purchases with personal sales. That is, to profit from clients' sales, managers must buy immediately after the fund sells before the price returns to its full information level. To profit from funds' buying, managers must sell immediately afterwards. Of course, absent short selling, in order to sell the manager must already own the securities or front-run the fund's purchases. The returns to be earned from such abusive trading are limited to the amount of the short-term liquidity-induced price change that the manager can capture. This amount is likely so small that the manager would have to establish a regular pattern of close back-running his clients that would be easily detected.

If a manager has determined that a security is over- or under-priced, the manager will profit by preceding informed fund sales with personal sales and informed fund purchases with personal purchases. Knowing that the fund is going to trade based on this information allows the manager to profitably front-run since the initial price reaction to the fund's trade will be in the same direction as the ultimate price reaction. Current monitoring efforts which focus on personal trades in securities traded in clients' portfolios easily detects such trading abuses.

4 Personal Trading Abuses

[9] Actively managed mutual funds earn risk adjusted returns which equal those earned by passively managed benchmarks. In this sense mutual fund trading is "uninformed on average." In addition, to a first approximation for every transaction where an investment adviser is selling a security because it is over-priced there is an investment adviser buying the same security because it is under-priced.

Transfer Clients' Wealth

Potential trading abuses are more varied than front-running and scalping. Trading abuses may be as blatant as profitable allocations of hot initial public offerings or other "sure bets." Trading abuses may be as subtle as trading stocks across the bid-ask sp read or refraining from making the indicated trades for clients after using valuable research insights developed at clients' expense to inform personal trades. [10]

4.1 Favored allocation of trading opportunities

Portfolio managers may receive advantageous trading opportunities in exchange for trading with certain brokers. They might induce brokers to preference them when favorable trading opportunities are being rationed in exchange for heavy trading and a light monitoring of execution quality. Such preferencing occurs when brokers allocate underpriced initial public offerings ("IPOs") to managers in exchange for heavy fund trading actively. Of course, not all trading in IPOs is suspect and many managers may earn only normal risk-adjusted profits on their IPO trading.

The allocation of underpriced IPOs to active traders is not of concern when the IPOs are placed in the fund portfolio that generated the commissions used to fund the underpricing. But when hot IPOs are placed in the manager's personal account they represent a clear misappropriation of client wealth and breach of fiduciary duty. Recent amendments to Rule 17j-1 require that portfolio managers get prior approval before participating in an IPO or private placement.

4.2 Mispricing Thinly Traded Securities

Small capitalization stocks and almost all bonds are thinly traded; these securities are perfect conduits for personal trading abuses. If a portfolio manager does a significant amount of trading at high commission rates, brokers may be willing to sell him thinly traded securities for much less than their market value—or to buy them from him for much more than their value. Since the vast majority of bond trading, even in exchange-listed bonds, lacks quote and trade reporting, brokers can safely sell a bond to portfolio managers at 98 and have the manager turn around and sell *the same bond the same day* in a prearranged trade for 102. Both brokers can claim that their prices were at the market and the portfolio manager can claim to have identified and arbitraged an arbitrage opportunity. Yet it is likely that either the selling broker or the buying broker was paying the portfolio manager for his patronage and the portfolio manager was taking advantage of his control over his clients' portfolios to benefit himself surreptitiously.

4.3 Trading at Negative Commissions

Managers may be allowed to trade in their personal accounts at favorable terms. These favorable terms could be in the form of reduced commissions or trading at prices within - even across - the bid-ask spread. At the extreme, managers might be allowed to trade at *negative* commissions in their personal account, buying at the bid prices and selling at the offer prices. This strategy is guaranteed to generate significant abnormal returns in an active personal trading account as the broker transfers its customary revenues to the portfolio manager without transferring any of its customary costs. Reducing commissions

[10] I would add market timing of international funds to this list today. The main point though is that it is impossible to enumerate and detect specific practices given the ingenuity of traders. The only sure way to detect and deter personal trading abuses is to monitor the profitability of personal accounts. CJM 11/19/03.

and/or giving preferential price improvements to managers for their personal trading will increase the net returns earned by managers in their personal account and, even in their most extreme forms, are highly unlikely to be detected by inspection.

4.4 Valuable Research Insights

Portfolio managers can effectively front-run clients without any risk of detection by conventional methods. Where fund trades are informed, it is knowledge of the research insights informing the trade, not knowledge that the fund is trading *per se* (or even that the trading is informed), that is valuable to the manager. Managers can fully exploit the valuable information exactly as if they were front-running without trading any of the same securities as their clients by trading in their personal accounts based on the research insights developed and then not trading for the client.

4.5 Soft Dollars

Favorable personal trading terms can be created through the use of soft-dollars. Brokers regularly advertise their ability to convert commissions to pay research expenses and services incidental to brokerage. These soft dollars may be rebated directly to mutual fund companies or pension funds sponsors or as payments to third party suppliers to pension fund and mutual fund investment advisors. The difficulty of tracking soft dollar purchased benefits makes soft dollars a ready conduit for personal trading abuse. Managers can simply trade clients' portfolios at soft dollar commissions and use the rebates and services to support their personal trading activities.

4.6 Cross Front-running

If a portfolio manager can purchase securities whose returns are related to the returns on securities he plans to purchase for his clients he may be able to front-run his clients' trades without appearing to do so. If a portfolio manager can drive up the price of a small capitalization firm 10%, he will likely increase the price of firms in the same industry as well. For portfolio managers at the largest funds it may be quite possible to drive up the price of Ford or Motorola by buying General Motors or Intel. Not only is this type of abuse not going to be detected, it is likely to be praised! A portfolio manager can claim to believe in a sector so much that he puts his own money into that sector's poorer firms before buying the sector's best firms for his clients. The use of derivatives makes subtle forms of trading abuses like cross front-running more profitable. By purchasing options on Ford (or index futures) before buying General Motors, portfolio managers may be able to significantly increase their personal trading profits.

5 Trading Abuses Could Be Effectively Detected At Low Cost

The current approach to detecting personal trading abuses is to check for fund-matching trades and suspicious IPO trades. This approach will detect unsophisticated front-running and some scalping and fraudulent trade allocations. I have suggested a number of ways that portfolio managers can abuse their clients through personal trading activities that can not be detected by the current approach. These undetected personal trading practices have the same deleterious effects on investors as front-running and scalping.

Fortunately, the trading abuses I have identified, and the myriad others I haven't identified, can be detected with the data funds already gathered. Unscrupulous portfolio managers engage in personal trading abuses because it allows them to transfer wealth from their clients to themselves. It is precisely this wealth transfer that provides fund companies and regulators with an effective method for rooting out abuses.

5.1 Serious Trading Abuses Result in

Statistically Significant Abnormal Profits.

A portfolio manager who is front-running, scalping, being allocated hot IPOs, trading across the bid-ask spread, exploiting soft dollars or appropriating investment opportunities will receive abnormally high risk-adjusted returns in his personal trading account. So long as the portfolio manager is reporting all his trades the risk adjusted returns observed provide clear indications of which managers are most likely to be engaging in personal trading abuses.

5.2 Monitor *Trading Profits* Not *Trades*

Absent a complete prohibition on personal trading, the only way to detect personal trading abuses reliably is through statistical analysis of trading profits earned in personal accounts. Standard statistical tests of the returns to his personal trading can provide confirmatory evidence if there is reason to believe that a portfolio manager has engaged in personal trading abuses. Personal trading returns of more than two standard deviations beyond the average returns earned in similar portfolios is evidence that the suspect manager has engaged in personal trading abuses.[11] If the manager is trading the same type of securities in his personal account as he trades for his clients, a comparison of the returns earned in his personal trading with those earned for his clients will adjust for risk.

Extensive information on mutual funds' returns provides us with additional benchmarks for evaluating portfolio managers' personal trading profits.

Statistical analysis of all access persons' personal portfolio returns would highlight potential problems and allow fund companies and regulators to focus their limited resources. Fund companies being examined could report to the Securities and Exchange Commission the historic returns earned by all access persons in their personal accounts by fund. This information would give the SEC a clear indicator of which funds and which individuals should be investigated further.

The technique I have proposed for detecting personal trading abuses imposes no additional costs on fund companies or regulators; funds are already required to gather all the necessary information and the calculations are simple. In fact, detecting personal trading abuses by analyzing returns would not only be more effective than traditional methods it would be much less costly than searching trading records for fund-matching trades or suspect allocations.

5.3 Disclose Aggregate Personal Trading Profits

The SEC and the industry are searching for simple informative prospectus disclosure. My analysis suggests such a disclosure. Funds could disclose the historic returns earned by all access persons in their personal accounts in a footnote to the returns earned by the fund. The funds could also disclose aggregate returns to classes of funds and to the personal trading of all access persons of those classes. If a fund company's access persons as a group have earned significantly more than the fund has, there should be strong suspicion that the funds code of ethics, and perhaps federal securities laws, have been violated.

6 Conclusions

I have presented an analysis of personal trading by investment company

[11] *See* Meier, Sacks and Zabell (1994) at p. 10.

personnel that suggests much of the current focus on front-running is misplaced and cataloged numerous ways in which managers can abuse their positions with virtual personal trading returns. Finally, our analysis suggests a simple prospectus disclosure that would effectively inform investors about potential personal trading abuses.

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U. S. Securities and Exchange Commission,

impunity under current surveillance. Fortunately, these abuses can be detected through simple, low

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Business Report, June 21, 1996.

Recent Arbitration Awards

By Ryan Bakhtiari

Mr. Bakhtiari is an attorney with the law firm of Aidikoff & Uhl in Beverly Hills, CA. His email address is RBAKHTIARI@ aol.com and he can be reached at 310.274.0666.

Bryant Bumanlag v. Morgan Stanley DW, Inc. and Ephraim Tucker,
NASD Case No. 01-04641

Claimant asserted the following causes of action: violation of 10b-5, violation of California securities laws, breach of fiduciary duty, fraud, breach of contract and negligence involving the exercise of a Cisco employee's stock options and holding the stock on margin. Claimant requested compensatory damages, interest, punitive damages, and costs.

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

The arbitration panel made the following findings and award:

1. The panel found Respondents jointly and severally liable to Claimant for $10,000 in compensatory damages and Morgan Stanley solely liable for $395,750.66 in compensatory damages and $600 for Claimant's filing fee.

This award is significant because the panel found culpable Morgan Stanley for failing to supervise and adequately advise Claimant regarding the exercise of Cisco options and holding the stock. Claimant presented evidence that Morgan Stanley's analyst recommended the purchase and/or holding of Cisco stock during the relevant time period in which Claimant held his shares. Respondents argued that the firm had recommended that Claimant diversify but that he refused to follow the firm's advice. This defense was rejected by the panel in finding in Claimant's favor.

Claimant's Counsel –
Vincent DiCarlo, Esq.
Respondents' Counsel -
Walter F. Brown, Esq. of Gray Cary Ware & Freidenrich LLP
Claimant's Expert –
Marvin Breen (suitability) and Elizabeth Falk (account analysis)
Respondents' Expert - None
Hearing Situs –
San Francisco, California
Arbitrators -
Jonathan Krotinger, Public/Chairman
Maurice R. Egan, Ph.D, Public
Michael Carcia, Industry

Cynthia O'Donnell v. HealthComp Evaluation Services, Corp., et al.,
AAA Case No. 32-1810055302

Claimant asserted the following causes of action: common law fraud and F.S. 517.301 (statutory fraud) under Florida law. This claim was based on O'Donnell's allegation that she was not provided all material information in connection with the sale of her company Health Services of Florida,

Inc. to Respondents, Health Comp Evaluation Services Corp. O'Donnell also entered into an employment and non compete agreement as part of the sale of her company. O'Donnell alleged that the true value of the shares that she would receive in HealthComp Evaluation was omitted and concealed from her.

Respondent denied the allegations of wrongdoing set forth in the claim.

The arbitration panel made the following findings and award:

1. The panel found Respondents liable to Claimant for $182,000 in compensatory damages.

The panel held that the negotiation of the sale agreement occurred "in connection with the offer, sale or purchase of ... [a] security" and was the stock in HealthComp Evaluation Services Corp. was the primary consideration for selling O'Donnell's company. The award is significant because the panel awarded a portion of income taxes previously paid by O'Donnell as capital gains. The Respondents also presented the argument that Florida's 517.301 cause of action did not apply because O'Donnell was not in privity with some Respondents who were not "sellers" of the securities. This argument was rejected by the panel.

Claimant's Counsel –
Nicholas J. Taldone, Esq.
Respondents' Counsel –
Alan Oravec, Esq.
Claimant's Expert –
William Price
Respondents' Expert - None
Hearing Situs –
Sarasota, Florida
Arbitrator -
Burton L. Raim

David Nelson, et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al.,
NASD Case No. 02-03553

Claimants asserted the following causes of action: breach of fiduciary duty, negligent supervision and violations of the Colorado securities Act relating to the investment of Claimants' account in the Internet Capital Group, Inc. ("ICGE"). Claimants alleged that the purchase of ICGE was unsuitable and that Respondents engaged in wrongful conduct by trying to protect their investment banking business with ICGE rather than alerting investors of the true risks of investing in the company. Claimants requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, attorneys fees and costs.

Prior to the hearing, Respondent Merrill Lynch moved to strike the affidavit of Eric Dinallo which was attached to Claimants' Statement of Claim. This motion was denied. Thereafter Merrill Lynch renewed this motion at the arbitration hearing which was again denied by the arbitrators.

The arbitration panel made the following findings and award:

1. The panel found Respondents liable to Claimants for $600,000 in compensatory damages and interest at the rate of 8 percent pursuant to Colorado Revised statutes (CRS) 11-51-501 *et seq*. and 11-51-604(4) *et seq.*

2. The panel found Respondents liable to Claimants for $159,744.01 for "rescissionary damages" pursuant to Colorado Revised statutes (CRS) 11-51-501 *et seq*. and 11-51-604(4) *et seq.*

This claim was based on Merrill Lynch's recommendation of ICGE which was a stock that was touted by its Internet analyst, Henry Blodget. The case is significant because the panel rescinded the ICGE trade and awarded $159,744.01 which represent the Claimants' loss of capital on the ICGE purchase.

Claimants' Counsel -
Alan C. Friedberg, Esq. of
Pendleton, Friedberg
Wilson & Hennessey
Respondents' Counsel –

Robert A. Buhlman, Esq. of Bingham McCutchen
Claimants' Expert –
Claimants' current broker
Respondents' Expert - None
Hearing Situs –
Denver, Colorado
Arbitrators -
Peter G. Bowen, Public/Chairman
Avery B. Goodman, Public
Devra Perch, Industry

Davina Zucherman, et al v. First Union Securities, Inc. and Wedbush Morgan Securities, Inc.,
NASD Case No. 01-05628

Claimants asserted the following causes of action: breach of fiduciary duty, fraud and failure to supervise, violation of federal and state securities laws, elder abuse and unfair or deceptive practices against senior citizens involving the management of Claimants' retirement portfolios. Claimants requested compensatory damages, interest, punitive damages, and costs.

Respondent First Union Securities, Inc. denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims.

Respondent Wedbush Morgan Securities, Inc. denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims. Respondent Wedbush Morgan Securities, Inc. also filed a counter claim against Davina Zucherman and The Davina Zucherman Living Trust for the failure to pay a debit balance.

The arbitration panel made the following findings and award:

1. Respondent First Union Securities, Inc. is liable to and shall pay Claimant the Sally Cassell Survivors Trust the sum of $32,000 in compensatory damages.

2. Respondent First Union Securities, Inc. is liable to and shall pay Claimants/ Counter- Respondents Davina Zucherman and the Davina Zucherman Living Trust the sum of $60,000 in compensatory damages.

3. Respondent/Counter-Claimant Wedbush Morgan Securities, Inc. is liable to and shall pay Claimant the Sally Cassell Survivors Trust the sum of $91,000 in compensatory damages.

4. Respondent/Counter-Claimant Wedbush Morgan Securities, Inc. is liable to and shall pay Claimants/ Counter-Respondents Davina Zucherman and the Davina Zucherman Living Trust the sum of $82,000 in compensatory damages.

5. Claimants/Counter-Respondents Davina Zucherman and the Davina Zucherman Living Trust are jointly and severally liable to and shall pay Respondent/Counter-Claimant Wedbush Morgan Securities, Inc. the sum of $47,000 in compensatory damages.

This award is significant because First Union Securities and Wedbush Morgan did not retain an expert witness emphasizing the fact that Davina Zucherman was an accountant who managed client's money. First Union Securities and Wedbush Morgan stressed that Davina Zucherman was the trustee of the Sally Cassell Survivors Trust and was the conservator of Sally Cassell (her mother) and therefore she should be responsible for the trading that occurred in that account. This award demonstrates that an accountant, who manages money and has a history of trading in options is protected by the law and the rules of the securities industry.

Claimants' Counsel –
David Harrison, Esq. of Spivak & Harrison, LLP
Respondents' Counsel –
Gary D. Nelson, Esq. of Rothgerber Johnson & Lyons, LLP on behalf of First Union Securities, Inc. and Gary Holmes, Esq. of Wedbush Morgan Securities, Inc.
Claimants' Expert –
Charles Pease
Respondents' Expert - None
Hearing Situs –
Los Angeles, California
Arbitrators -
Mandel E. Himelstein, Esq., Public/Chairman

A. Joel Klein, JD, Public
Luther Delano Prater, Industry

Dennis Quinn, et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. and Matthew Wilson,
NYSE Docket No. 2002-009954

Claimants asserted the following causes of action: violation of 10b-5, violations of California securities law, breach of fiduciary duty, fraud, breach of contract and negligence involving Merrill Lynch's advice to exercise Cisco employee stock options and to hold the Cisco position on margin. Claimants requested compensatory damages, interest, punitive damages and costs.

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

The arbitration panel made the following findings and award:

1. The panel found Respondent Merrill Lynch liable to Claimant for $142,815 plus interest at the rate of 2.5 percent from August 8, 2001 until the date of payment of the award in full.

This award is significant because it demonstrates the arbitrator's imposition of liability for Merrill Lynch's failure to suitably invest Claimants' portfolio by following Merrill Lynch's Financial Foundation Report which is a financial model based on a customer's needs and station in life. The panel also imposed liability based on the introduction of email correspondence sent and received by Henry Blodget who was Merrill Lynch's Internet analyst.

Claimants' Counsel –
Stuart Meissner, Esq.
Respondents' Counsel –
David Campbell, Esq.
Claimants' Expert –
Robert Lowry
Respondents' Expert - None
Hearing Situs –
Baltimore, Maryland
Arbitrators -
Nell King
G. Rick O'Shea
Janet Stern Solomon

Iral G. Hodge, et al. v. Prudential Securities, Rick Labare and Donald Arington, Pacific Stock Exchange Case No. 02-S033

Claimants asserted the following causes of action: fraud, misrepresentation, breach of fiduciary duty, breach of contract, suitability, elder abuse, violation of California Corporations Code §25401 and §25501 relating to the exchange of a Seligmann High Yield fund for a Seligmann Communications fund. Claimant requested rescission, compensatory damages, punitive damages, costs, expert costs and attorneys fees.

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

The arbitration panel made the following findings and award:

1. The panel found that Claimants were sold an unsuitable fund based on their Prudential Securities' account profile.

2. The fund was too volatile given Claimants' age and the amount invested which represented a significant portion of his assets.

3. Claimants did not receive a prospectus.

4. Respondent Prudential at the time of these transactions had inadequate internal procedures for review of purchases and exchanges of these types of investments which would require management's review.

5. Prudential provided no evidence of any special consideration regarding the handling of an elderly deaf client in his 90's.

6. Prudential and Rick Labare were found liable and ordered to pay Claimants $160,000.

This award is significant based on the findings of fact

made by the panel. Specifically that Prudential lacked the internal procedures to monitor and supervise the exchange and/or sale of mutual funds.

Claimants' Counsel –
Robert Gonser, Esq. and Brian Zagon, Esq. of Resolution Law Group, PC
Respondents' Counsel –
Charles La Chaussee, Esq. of Prudential Securities, Inc.
Claimants' Expert –
Marvin Breen
Respondents' Expert - None
Hearing Situs –
San Francisco, California
Arbitrators -
Peter Kassell, Public/Chairman
Michelle Brant, Public
Deborah Bernot, Industry

Lillian Frances Watts Knight, et al. v. Johnston Lemon & Co. and Anne L. Sexton, NASD Case No. 02-02521

Claimants asserted the following causes of action: breach of contract, negligence, failure to supervise, breach of fiduciary duty, omission of facts, fraud, misrepresentation and suitability relating to the order execution of Winn Dixie stock. Claimants requested compensatory damages, interest, punitive damages, costs and attorneys fees.

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

The arbitration panel made the following findings and award:

1. The panel found Respondents jointly and severally liable to Claimants for $200,000 in compensatory damages.

This claim was based on Respondents failure to take action to diversify Claimants' concentrated Winn Dixie position worth approximately $1.2 million when the account was opened in February 2001. Despite the fact that Claimants had no prior investment experience and Respondents admission that the concentrated position needed to be diversified, Respondents did not take action to diversify the Winn Dixie stock. In September 2001, Winn Dixie stock plummeted in price causing Claimant to lose approximately one-half the value of the portfolio. It is signficant to note during the period from February 2001 to September 2001 no trades were made in the Claimants' account and no commissions generated by Respondents. Respondents took the position that they owed "no duty" to Claimants and relied on the *DeKwiatkowski v. Bear Stearns & Co.* decision. The arbitrators rejected this rationale and awarded damages based on Claimants' citation to the *Merrill Lynch v. Millar* decision.

Claimants' Counsel –
Daniel A. Ball, Esq. of Goldberg Ball, PC
Respondents' Counsel –
Douglas K. Spaulding, Esq. and David Ober, Esq. of Reed Smith
Claimants' Expert –
Sidney D. Krasner
Respondents' Expert –
Kenneth Wagner, Esq.
Hearing Situs –
Washington, D.C.
Arbitrators -
Maureen Power Wilerson, Esq., Public/Chairman
Richard E. Lauziere, CPA, Public
Wayne J. Thaemen, Industry

Robert Perry, et al. v. Morgan Stanley Dean Witter & Co., NASD Case No. 02-00301

Claimants asserted the following causes of action: breach of fiduciary duty, fraud, failure to supervise and violation of federal and state securities laws relating to the unsuitable recommendations of money managers made by Respondent Morgan Stanley. Claimant requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, attorneys fees and costs.

The arbitration panel made the following findings and award:

1. The panel found Respondent liable to Claimants for $207,000 in compensatory damages plus interest at 10 percent from January 1, 2002 until April 1, 2003.

Morgan Stanley made the unsuitable recommendations to Claimants to investment their retirement money in the growth portfolio managed on a discretionary basis by Roger Engemann. Morgan Stanley's expert witness Alan Rockler, testified that Morgan Stanley did not owe a duty to the Claimants because Morgan Stanley did not recommend the actual securities purchased by the portfolio manager. The panel rejected this argument and awarded Claimants their entire out of pocket loss.

Claimants' Counsel –
Ryan K. Bakhtiari, Esq. and Keith D. Fraser of Aidikoff & Uhl
Respondent's Counsel –
Kevin Fitzgerald, Esq. and Jennifer Morris, Attorney at Law of Jones, Bell, Abbott, Fleming & Fitzgerald LLP
Claimants' Expert - None
Respondent's Expert –
Alan Rockler
Hearing Situs –
Los Angeles, California
Arbitrators -
Carlton Robinson, Sr., Esq., Public/Chairman
Martin Perlberger, Public
Larry Haugaard, Industry

William J. Torrence, et al. v. Edward D. Jones & Co. and Gregory Westray, NASD Case No. 02-00061

Claimants asserted the following causes of action: violation of 10b-5, violation of the Illinois Securities Act of 1953, violation of the Illinois Consumer Fraud and Deceptive Trade Practices Act, fraud, breach of fiduciary duty, negligence, control person liability involving the purchase and sale of common stock. Claimants requested compensatory damages, interest, punitive damages, costs and attorneys fees.

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

The arbitration panel made the following findings and award:

1. The panel found Respondents jointly and severally liable to Claimants for $2,687,558.69 in compensatory damages plus interest at 3 percent from December 31, 2001 until the award is paid in full.
This award is significant for its size. The arbitrators awarded approximately 90 percent of Claimants' out-of-pocket losses in connection with the aggressive trading on margin of an account heavily concentrated in technology.

Claimants' Counsel –
James J. Eccleston, Esq. and Steven S. Berkeley, Esq. of Shaheen, Novoselsky, Staat, Filipowski & Eccleston, PC
Respondents' Counsel –
Lisa A. Nielson, Esq. and Bradford B. Lear, Esq. of Greensfelder, Hemker & Gale, PC
Claimants' Expert –
Joyce Wagner
Respondents' Expert - None
Hearing Situs –
Chicago, Illinois
Arbitrators -
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Franklin P. Auwater, Esq., Public
Derek McSherry, CFP, ChCF, Industry

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Upcoming Events:

PIABA Board of Directors Meeting, March 13-14, 2004. Hyatt Regency Tamaya Resort & Spa.

California Mid-Year Meeting, February 21, 2004. Crowne Plaza, Los Angeles Airport, California.

PIABA Board of Directors Meeting, July 17-18, 2004, San Francisco, California.

PIABA 13th Annual Meeting and *6th Annual Securities Law Update*, October 20 - 24, 2004. Hyatt @ Coconut Pointe. Bonita Springs, Florida.

Annual Business Meeting, October 21, 2004. Hyatt @ Coconut Pointe. Bonita Springs, Florida.

PIABA Board of Directors Meeting, October 24, 2004. Hyatt @ Coconut Pointe. Bonita Springs, Florida.

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

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

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