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PIABA Bar Journal

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The Bar Journal of the Public Investors Arbitration Bar Association

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

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The deadline for receiving submissions for the Spring, 2004 issue of *PIABA Bar Journal* is March 30, 2004. All submissions should adhere to the following format:

Written materials should be submitted on a disk in word or word perfect format with a printed copy.

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3. Do not indent paragraphs.
4. Put the title of the article at the top followed by the author's name and a short author biography.
5. Do not use footers or headers except for footnotes.
6. Use footnotes rather than endnotes.
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President's Message

Charles W. Austin, Jr.

The arena in which we all operate is being undermined and distorted by the tactics and strategies utilized by members of the securities industry geared toward limiting their exposure for what everyone now knows to be the fraud and malfeasance of the last decade. Since my last message - and consistent with PIABA's mission - PIABA has undertaken some important initiatives aimed directly at stopping the industry's perversion and subversion of the arbitration process and investor rights before any more people get hurt.

Discovery Abuse

The most obvious example of the securities industry's attempts to skew arbitration in its favor is its systemic abuse of the discovery process. By asserting a host of frivolous and baseless objections and arrogantly refusing to respond to even the most rudimentary requests for information and documents, those who bear responsibility for one of the largest financial frauds in the history of Wall Street now strive to ensure that the defrauded parties are deprived of a meaningful opportunity to recover their losses. This must stop.

The NASD has taken a good first step by issuing Notice to Members 03-70, reminding member firms of their discovery obligations. In order to ensure that the brokerage industry gets the NASD's message and that the NASD does its job, PIABA has launched the Discovery Abuse Project. PIABA is currently collecting evidence of the firms' persistent and systemic abuse of the discovery process which it will present to the NASD with the expectation that the regulators will enforce their own rules and policies.

Hiding Behind Outside Investment Advisors

More and more investors have been moved into managed accounts over the last few years, and claims involving those types of accounts are hitting the arbitration stream. A recurring pattern has emerged of brokerage firms attempting to escape liability on these claims by hiding behind the "outside investment advisors." PIABA has been advised by various regulators that they are concerned about these defenses and will take appropriate action when presented with examples of such defenses. PIABA members are collecting examples of firms hiding behind outside investment advisors for presentation to the regulators.

Discovery Guide Revision

We've all lived with the NASD Discovery Guide long enough now to know that it needs to be revised. PIABA members on the National Arbitration and Mediation Committee (from which all NASD arbitration rules ultimately emanate) intend to push for changes to the guide and are soliciting member suggestions.

Details of all of these projects may be found in the archives of the "Members" section of the PIABA Website

Nietzsche said, "Many people wait all their lives for an opportunity to be good in their way." PIABA offers all of us the opportunity to "be good in our way." Our membership has grown to over 740 members representing all 50 states. We have the resources to change things. PIABA's value rests on the collective efforts of **all** of its members. Don't let this opportunity pass any of you by.

It's time to pitch in.

Charles W. Austin, Jr. is an attorney in Richmond, Virginia whose practice is devoted exclusively to the representation of investors in disputes with the securities industry.

Second Report Of The Shadow Task Force On Securities Arbitration Reform: The Shadow Returns

By Seth E. Lipner

This is the Second Report of the Shadow Task Force on Securities Arbitration Reform.[1] The First Report was written in 1997 and proposed a variety of changes to securities arbitration. While some of the suggestions were well-received in the securities arbitration community, virtually none were ever adopted.

The Task Force is nevertheless undeterred. Since its last Report, the Task Force (hereinafter referred to as "The Shadow") took over the body of investor attorney Seth E. Lipner [2], conducting arbitrations, participating on various SRO committees, and battling and schmoozing with counsel from both sides, all the while taking mental notes. The Shadow tried to take over the body of a defense lawyer, but found he could not fill Davidson's shoes (or trousers), could not mimic Rath's yankee speech, or wear any of Sneeringer's sport coats.

This Second Report is, in part, the product of the Shadow's experiences. The Task Force met (with itself) on April 7, 2003 ("a snowy day in April"). For the record, the Shadow has since vacated Lipner's body, and he has resumed his normal identity. Lipner knows nothing of these events, so please do not discuss them with him.

The Shadow's recommendations fall into 3 categories: Discovery; Pre-Hearing Practice; and Hearings. They are addressed here in that sequence. All the recommendations here are designed to help arbitration achieve its promise of efficiency and fairness.

> **Recommendation No. 1- Discovery**: Create a system that is (a) in line with business reality and (b) which encourages a more orderly and honest discovery process.

Discovery in arbitration is a thicket. While the rules require "cooperation", discovery in arbitration is anything but cooperative. While the NASD's Discovery Guide helped considerably on the substantive side, i.e. defining what documents are to be discoverable and thereby giving the arbitrators guidance, there remains a tremendous amount of disorderliness in the discovery process.

The disorderliness in the process stems from a combination of factors. The

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[1] The first Report was published in PLI's Securities Arbitration 1997, at p.333.

[2] Prof. of Law, Zicklin School of Business, Baruch College; Member, Deutsch & Lipner, Garden City, New York.

defense complains that assembling large volumes of documents often takes more than the currently-allowed 30 days. Claimants assert that some counsel seeks to obtain unfair advantage by withholding document production until the last minute.

In addition to timing, there is neither rule nor procedure in place which requires third-party discovery to be made in an orderly fashion. Documents are sometimes produced in a helter-skelter fashion, with neither bates stamps nor appropriate segregation. Finally, there is the debate over the propriety of attorney-issued discovery subpoenas - a debate which both sides ought to want to see be resolved.

The Shadow has three (3) recommendations to improve process of discovery in arbitration:

> **1. Extend from 30 to 60 days the time period under which documents are be due following the service of a document request.** [3] With a more realistic time period in place, the rule ought then to state that if documents are not served in that time period, the party that has not made production shall be automatically required to pay the cost of any discovery pre-hearing conference in the event that the opposing side seeks one.

This automatic arbitration-fee-shifting provision for conferences will put an end to the withholding of documents. The current system offers no meaningful penalty for lawyer or client who is recalcitrant regarding document production. Arbitrators seem loath to, at the time of the conference, exercise their discretion and make an immediate assessment of the costs of the conference. Since many cases settle, often there is no penalty for discovery gamesmanship. In cases that do not settle, the arbitrators tend not to make the assessment (do they remember the discovery games by that point?). Even if an assessment were made at the award stage, it would not work to deter the bad conduct. Put differently, the dog that pees on the rug must be smacked on the nose near the time of the offending incident in order for the smack to be effective. Furthermore, the message ("pay if you play") will be transmitted to the client, who is often the culprit when production is delayed.

An automatic fee-shifting provision is the key to this (and other recommended improvements) because it removes discretion from the equation. The message is sent not by the arbitrators but by the rule-makers, who are in a better position to observe and deal with systemic problems.

2. Require that documents be served in an orderly fashion. The rules should not allow production "in gross". Instead, participants in arbitration should be required to produce documents that are either bates-stamped and referenced or put in clearly-marked folders designating which documents are responsive to which requests. The recipients should be entitled to know that information, and should not have to sift through an entire box of documents randomly arranged.

Again, the sanction for non-compliance should be that any participant who does not make orderly production must automatically pay the cost of any discovery conference associated with that failure.

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[3] The NASD has indeed proposed such a change. But without the "teeth" described presently, an extension of 30 days to 60 days is not going to solve the problems.

3. Develop rules for third-party discovery. Neither the NYSE nor NASD rules contain any provisions for third-party discovery, but that fact is often overlooked or ignored. The rules speak only of one party serving a discovery request upon another party. The rules further mention that subpoena power shall be "as provided by law", but the Shadow is aware of no state whose law authorizes third-party discovery in arbitration absent and upon agreement or reference thereto in the Arbitration Rules. Nevertheless, participants in arbitration have (incorrectly) assumed that "subpoena power as provided by law" gives them the right to conduct third-party discovery by simply signing and sending out a paper titled "Subpoena".

As the note at the foot explains, anyone who believes that such subpoenas are "by law" is very sorely mistaken.[4] Most other states follow the Uniform Arbitration

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[4] For example, the New York Court Appeals has said:

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

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

The Court of Appeals has also held:

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

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

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

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

Matter of North American Foreign Trading Corp. [Rosen], 58 A.D.2d 527, 395 N.Y.S.2d 194 (1st Dept. 1977); see also Goldsborough v. New York State Dept. of Correctional Services, 217 A.D.2d 546, 628 N.Y.S.2d 813 (2d Dept. 1995).

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

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

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

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

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

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

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

The subpoena power conferred by CPLR 7505 is limited to the procuring of evidence for the hearing or trial of the dispute. Depositions and other forms of pretrial disclosure are ordinarily

Act, which by implication prohibits attorneys from issuing subpoenas ("The arbitrators may subpoena. . . ."). The FAA is similar. ("The arbitrators, or a majority of them may subpoena . . . .") See also National Broadcasting Co., Inc. v. Bear Stearns & Co., Inc., 165 F.3d 184, 187 (2d Cir. 2002).

Because of the issues in securities arbitration, it cannot be said that third-party discovery is always inappropriate, however. There is sometimes relevant evidence to be obtained from third-parties, but there is a tendency on lawyers to overreach.

The rules ought to thus provide for some third-party discovery, but, to keep it in line with the expedited nature of arbitration, only under the supervision of the arbitrators.[5] The rules ought to provide that a request for third-party discovery be made upon notice to ones. In the event that there is an objection to the third-party discovery, all third-party discovery shall await a ruling from the arbitrators on both its propriety and its scope.[6]

Institution of these procedures for third-party discovery will have the immediate effect of ending the arguments about the propriety of third-party discovery, as well as ending the

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not contemplaqted in arbitration proceedings.
V. Alexander, Practices Commentaries, CPLR 7505, McKinney's, at p.682.

None of this is meant to suggest or assert that attorneys lack the power to issue subpoenas to compel attendance "at a hearing before the arbitrators", (see, e.g. Henegan Const. Co. Inc. v. Bettinger & Leech, Inc., 196 A.D.2d 763, 764 (1st Dept. 1993), but no such subpoenas are before this Court. These attorney-issued discovery subpoenas are ultra vires, and they should be quashed by this Court. Any other ruling would have the effect of giving to Merrill Lynch the collateral advantage forbid them by De Sapio and Goldsborough, supra.

See also, The Use and Abuse of Subpoenas in Arbitration: A Primer on Third-Party Discovery, PLI's Securities Arbitration 2001, at p.833.

[5] The AAA Commercial Arbitration Rules, for example, so provide.

[6] The Shadow understands that the Public Investors Arbitration Bar Association has asked SICA to change NYSE Rule 619 to read as follows:

(F) Subpoenas The arbitrator(s) and any counsel of record to the proceeding shall have the power of the subpoena process as provided by law. All parties shall be given a copy of a subpoena upon its issuance. Parties shall produce witnesses and present proofs to the fullest extent possible without resort to the subpoena process.

(G) Discovery Subpoenas Addressed to Non-Parties

(1) No subpoenas shall be issued to or served upon non-parties to an arbitration as part of discovery unless, at least 10 days prior to the issuance or service of the subpoena, the party seeking to issue or serve the subpoena sends notice of intention to serve the subpoena, together with a copy of the subpoena, to all parties to the arbitration.

(2) In the event a party receiving such a notice objects to the scope or propriety of the subpoena, that party shall, within the 10 days prior to the issuance or service of the subpoena, file with the Director, with copies to all other parties, written objections. The party seeking to issue or serve the subpoena may respond thereto, but may not serve the subpoena until the arbitrator has ruled thereon. The arbitrator appointed pursuant to Rule 619(e) shall rule promptly on the issuance and scope of the subpoena.

(3) The arbitrator and a court of competent jurisdiction shall have the power to quash or limit the scope of any subpoena.

The Shadow takes some credit for the drafting; the NYSE gets no credit for failing to adopt to the proposal.

arguments about attorney-subpoena power in arbitration as a vehicle for conducting third-party discovery.

Recommendation No. 2: Pre-Hearing: Motions and the 20-day exchange - discourage most motions and eliminate surprise.

The Shadow task force makes two (2) recommendations regarding pre-hearing practice. The first concerns dispositive motions, and the second concerns the 20-day pre-hearing exchange.

1. **Motions**. Both the NASD and NYSE rules are currently silent on the propriety of pre-hearing dispositive motions in arbitration. Respondents read that silence as permissive, while claimants refer to the rule that seems to require that each case have a in-person hearing.

Respondents assert that there are certain clear-cut cases where a dispositive motion ought to be allowed. They argue as examples: res judicata; the expiration of the eligibility rule; and a prior arbitration. The SRO rules' silence, however, becomes a license for The Big Paper Boys [7] to more litigation-like motions, including those that are more akin to motions to dismiss for failure to state a claim, or last minute motions for dismissal and/or summary judgment.

Such motions are generally inappropriate for arbitration, and the rules should so state. Nevertheless, there may be some efficiency achieved in the very limited situations where an early dispositive motion could rid the docket entirely of a completely frivolous case. Motions for partial disposition rarely accomplish that result, making, for example, statute of limitations motions inappropriate. But in clear-cut situations that are likely to dispose of any entire case, dispositive motions have some utility. [8]

To discourage the making of motions which are not clear-cut, however, there must be a cost-incurring provision in the rules, so that if the motion is not successful the costs (perhaps here attorneys fees as well as arbitrator costs) are assessed against the losing side. Sanctions ought to be expressly permitted.

Furthermore, any motion rule should expressly state that no such motions can be brought within 45 days of the first-scheduled hearing date. The practice of serving last-minute motions will disappear. [9]

2. Pre-hearing Exchanges: Eliminate the rebuttal/ cross examination exception to the 20-day disclosure requirement. Securities arbitration appears to be the last holdout dispute resolution system which now uniformly discourages surprise at the hearing. All courts in which the Shadow has practiced require that all exhibits which either side intends to use at trial must be pre-marked, and exchanged with the other side. There is no exception for rebuttal or cross examination, as there is in securities arbitration; in these other forums, there is no opportunity for a calculated surprise.

In his surreptitious interviews with participants of both sides, the Shadow has learned

[7] And women.

[8] The same is true of motions for accelerated judgment in favor claimant, such as in the case of a default, or an unlicensed salesman or product which was not blue-skyed.

[9] The NASD is considering adopting just such a rule. The Shadow was there.

that both claimants and respondents are using the cross examination / rebuttal exception to withhold documents so that cross examination can begin with a big surprise.[10] Claimants call the broker or manager as their first witness, and pull out some document which was not exchanged and begin to cross examine. Respondents do the same thing on their case.

This practice of holding back documents always leads to an objection, an executive session of arbitrators, a need for a ruling (that puts the arbitrators in an uncomfortable situation because they want to let everything in but have a distaste for game-playing). The result is always that time was wasted, and interests of fairness have not been served.

Both sides ought to cut out the gamesmanship. Fairness is better served by a system which discourages surprise. On some occasions, in such situations, the surprised party is unable to undo an adverse inference gleaned from the surprise because of the short time period in which to make an effective rebuttal. It is not fair.

The SROs should thus adopt a "full disclosure" policy, instead of a policy which encourages sandbagging and surprise. All they need do is eliminate the "cross-examination/rebuttal" exception.

Recommendation No. 3: **Testimony of Experts.** The parties should be required to stipulate on arithmetic, and to submit all expert direct examination in writing.

Virtually every securities arbitration these days seems to involve the testimony of expert witnesses. Expert witnesses are expensive. Since arbitrators are sophisticated people, expert testimony is rarely worth the money paid for it. These recommendations are designed to at once cut down on the amount of time spent on expert testimony. Without compromising fairness, efficiency can be achieved.

1. Require the parties to stipulate to damage "arithmetic". Adverse parties will likely never agree to the appropriate "measure" for damages, but they ought to be able to stipulate to each other's "arithmetic." If Stipulations are required by the rules, the parties will not need to put on an expert simply to establish the quantum of damages they claim. The attorneys will make their legal arguments as to the measure of damages, but there will be no debate over the "pluses and minuses" of the profit and loss statements.[11]

This rule would not preclude either side from putting on a witness to give testimony on measure of damages (if they deem it appropriate), but it would obviate the need to do so where one (or both) parties wishes to present their damage calculations in writing. Since many attorneys and brokerage firms are capable of conducting the damage-calculating aspect of the case called in-house, this rule might lead to real cost-savings in arbitration.

Again, an automatic fee shifting provision will provide the necessary discipline.

[10] Not to be confused with "Shock and Awe".

[11] The first Report of the Shadow Task Force recommended that SROs encourage the creation of accounting protocols in an effort to avoid the duplication of efforts associated with each side producing its own profit and loss statement.

2. Require that expert direct examination be submitted in writing. An expert's direct examination is often a drawn-out process of establishing credentials and reciting facts and explanations which lead to concise expert conclusions and opinions. As result, most courts, in technical bench-trial cases (such as antitrust and bankruptcy) have dispensed with oral direct examination of experts; instead, these courts require that expert direct examination be in the form of an affidavit. These courts sometimes allow perhaps a brief oral summary of that affidavit on the witness stand, and that is all. Following the introduction of the affidavit or "summary direct", cross examination begins.

As is the case with the elimination of the cross examination / rebuttal exception discussed above, the advance-submission of the expert's direct testimony in the form of an affidavit will allow the attorney examining that expert to be better prepared to do so. Less time will be spent floundering around as thought processes develop. Cross-exam will be more organized and to the point. Fairness does not suffer, but efficiency is achieved.

CONCLUSION

The Shadow continues to see many benefits accruing to both claimants and respondents (investors and brokers dealers) in securities arbitration (as opposed to those cases which are resolved in court). Indeed, the Shadow continues to believe that life remains far too short to spend it in court. Most investors cannot afford all that must be done to get a case to a jury, and respondents gain efficiency from a stream-lined, user-friendly dispute resolution process.

Nevertheless, arbitration requires continuous improvement. Arbitration needs more changes than are listed here (first among them remains having arbitrators write reasons for their awards),[12] but these recommendations are a good start. See you in another 5 years.

[12] See Lipner, Ideas Whose Time Has Come: Single Arbitrator and Reasoned Awards, PLI's Securities Arbitration 2000, at p659.

Practitioner's Column - NASD's New Code of Arbitration Procedure for Customer Disputes "Plain English Codifications of Current Practices"

By David E. Robbins

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Mr. Robbins is on the Board of Editors of this Journal and is the proud recipient of the 2003 PIABA Golden Bow Tie Award, named in honor of past PIABA president Jim Beckley. He is the author of *Securities Arbitration Procedure Manual* (Matthew Bender 2003 www.lexis.com) and can be reached at 212-755-3100 or DRobbins@KFYGR.com

Introduction

Get ready for some changes in the way you practice securities arbitration. NASD Dispute Resolution, Inc. now administers 95% of all securities arbitrations. It is presently anticipated that in late 2004, its single Code of Arbitration Procedure will become three codes - a **Customer Code** (the Rule 12000 series), an **Industry Code** (the Rule 13000 series) and a **Mediation Code** (the Rule 14000 series), all of which: simplify language from the prior single Code; codify into rules what had previously been practices, recommendations and guides; and, implement substantive changes.

This article highlights the most significant changes you will see in the **Customer Code** and examines their practical application to our practice. This article is written before the SEC has sought public comment on the Customer Code and before the NASD submitted its proposed Industry Code and Mediation Code to the SEC (which it will do in early 2004). The Industry Code will track most of the new Customer Code and the Mediation Code will not contain any substantial changes from the current mediation rules.

While the NASD's initial impetus was to rewrite the Code of Arbitration Procedure in "plain English", its goals expanded and, in its rule filing with the SEC for the Customer Code, the NASD stated that the added purposes were:

- Reorganizing the Code in a more logical, user-friendly way, including creating separate Codes; and
- Implementing several substantive rule changes, including codifying several common practices, providing more guidance to parties and arbitrators, and streamlining the administration of arbitrations in the NASD forum.

The Code of Arbitration Procedure for Customer Disputes (the Customer Code) will now be divided into nine parts, which, said the NASD in its Rule 19b-4 filing with the SEC (File No. SR-NASD-2003-158), are intended to approximate the chronological order of a typical arbitration:

- **Part 1** – Rules 12100 – 12105: **Interpretative Material** - definitions and rules relating to the organization and authority of the NASD.
- **Part 2** – Rules 12200 – 12213: **General Arbitration Rules** - what claims are subject to NASD arbitration and what claims are not, sanctions, hearing locations and payment of arbitrators.

- **Part 3** – Rules 12300 – 12314: **Initiating and Responding to Claims**
- **Part 4** – Rules 12400 – 12414: **Arbitrators**
- **Part 5** – Rules 12500 – 12514: **Prehearing Procedures and Discovery**
- **Part 6** – Rules 12600 – 12609: **Hearings**
- **Part 7** – Rules 12700 – 12702: **Termination of an Arbitration Before Award**
- **Part 8** – Rules 12800 – 12801: **Simplified Arbitrations and Default Proceedings**
- **Part 9** – Rules 12900 – 12904: **Fees and Awards**

What's New Other Than the Order of Things, Shorter Words, Bullet Points and Active Verbs? Here are 17 subjects.

1. What to do About the Inactive Party When the Other Parties Agree to Modify the Rules for that Case - Rule 12105

Under the former rule, if all the active parties in a case agreed to go forward with less than three arbitrators; agreed to change the time to respond to pleadings; or, agreed to some other change in the rules, decisions of the panel or of the Director of Arbitration, an inactive, non-appearing party could gum up the works. That party's non-responsiveness would prevent unanimity, which was required to modify the rules for particular cases. The new rule permits the Director to determine that that party's non-responsiveness will not prevent the agreed-to modification or other change to go forward.

2. Denial of the Use of the NASD - Added Power to the Director - Rule 12203

Some heated arbitrations bring out the worst in people, creating a security risk to the forum or to the other parties. In the past, if the Director wanted to deny that party the use of the NASD's arbitration facilities because of "extraordinary circumstances," this rule did not provide for such authority. All the Director could do was deny the use of the forum if the dispute was "not a proper subject matter for arbitration." And in that instance, the Director had to secure the approval of the NASD's National Arbitration and Mediation Committee or its Executive Committee. Now the Director can take such action directly if he or she determines "the subject matter of the dispute is inappropriate" or "for other reasons if extraordinary circumstances exist."

3. Extensions of Deadlines – Rule 12207

Until this new rule, there was no guidance in the Code for the extension of deadlines other than the filing and serving of pleadings (which required the consent of the Director or the initial Claimant). Now parties can agree in writing to extend or modify any deadline for serving an Answer, returning arbitrator or chairperson lists, responding to motions or exchanging documents or witness lists. If there is such an agreement, the parties are required to notify the Director, in writing, of the new deadline. The rule further provides that the panel itself, without full party consent, can extend or modify any deadlines on its own initiative or upon the motion of a party. Lastly, the Director may also extend deadlines "for good cause" or the panel may do so "in extraordinary circumstances."

4. *Ex Parte* Communications Prohibited (Except) - Rule 12210

While this new rule prohibits parties or anyone acting on their behalf from communicating with any arbitrator outside of a scheduled hearing or conference – unless all parties or their representatives are present – and further prohibits directly sending an arbitrator anything in writing (e.g., motions, requests, submissions) – unless the arbitrators and the parties agree – the NASD also separately implemented a rule on the joint administration of cases, which bypasses the NASD under certain circumstances.

Entitled "Direct Communication Between Parties and Arbitrators", the rule provides that:

- All arbitrators and parties must agree to use direct communication during the Initial Prehearing Conference or a later conference or hearing.
- Parties may only send the arbitrators items listed in an Order of the arbitrators.
- Parties may send items various ways: by regular mail, overnight courier, facsimile or email. Faxes and emails may only be used if all the arbitrators and parties have such capability.
- Copies of all materials sent to the arbitrators must be sent at the same time and in the same manner to all parties and the Director of Arbitration (or the assigned Staff person). If the submission exceeds 15 pages, it must be sent to the Director by regular mail or overnight courier.
- The Director must receive copies of any Orders and decisions made as a result of direct communications among the parties and the arbitrators.
- Parties are prohibited from communicating orally with the arbitrators unless all the other parties are present (e.g., are also on the phone). As such, the prohibition on *ex parte* communications still applies.
- Any party or arbitrator may terminate this procedure at any time after giving written notice to the other parties and arbitrators.

5. Sanctions Against Parties <u>and</u> Their Representatives – Rule 12211

This rule codifies sanctions described in the NASD's Discovery Guide, goes beyond discovery abuses and even affects a party's representative (despite the fact that the representative is not a party to the arbitration agreement). If a party or the party's representative fails to comply with any provision of the Code or any Order of the arbitrators, sanctions may be imposed (as long as those sanctions are not "prohibited by applicable law"). Those sanctions can include but are not limited to:

- Monetary penalties payable to one or more parties
- Precluding a party from presenting evidence
- Making an adverse inference against that party
- Assessing postponement and/or forum fees
- Assessing attorney's fees, costs and expenses

In the past, Rule 10305 permitted the arbitrators to dismiss a claim, defense or proceeding with prejudice as a sanction for the willful and intentional material failure to comply with an order of the arbitrators if lesser sanctions proved ineffective.

6. Hearing Location – Rule 12212

While there had not been a specific rule on where hearings usually take place, experienced securities arbitration attorneys knew that it would usually be in the city closest to where the Claimant resided at the time of the dispute, as long as the NASD had a hearing location there. This new rule codifies this practice.

The NASD currently maintains 50 designated hearing locations. The new rule provides that the Director will decide which of those locations will be the hearing location for the arbitration. "Generally," states the rule, "the Director will select the hearing location closest to the customer's residence at the time of the events giving rise to the dispute." However, the rule also provides that the parties may agree in writing to a hearing location other than one selected by the Director if they agree before arbitrator lists are sent out under Rule 12403 (see below). Lastly, the rule allows the Director to change the hearing location upon a party's motion.

7. Time to Answer Counterclaims and Cross-Claims - Rules 12304 & 12305

This rule provides for uniformity for responsive pleadings. In the past, Claimants had only 10 days to file a Reply to a Respondent's Counterclaim. Now Claimants have 20 days to respond. Respondents had 45 days to answer a Cross-Claim from another Respondent. Now such Respondents also have 20 days to respond.

8. Curing Deficient Statements of Claim – Rule 12307

Before this rule's enactment, if the NASD determined that a Claimant had filed a deficient Statement of Claim, it would notify the Claimant and give him or her 30 days to correct the deficiency. If it wasn't corrected in time, the Statement of Claim would be dismissed without prejudice from filing it again. Until this rule, parties were not entirely sure as to what qualified as a deficient Claim. Now there are enumerated examples of such deficiencies:

- The Uniform Submission Agreement was not filed, was not properly signed and dated or does not name all parties who are named in the Statement of Claim.
- Claimant failed to file the correct number of Statements of Claim, exhibits thereto or Submission Agreements. Remember – the NASD gets the original, three copies for the arbitrators and additional copies for each named Respondent.
- Statement of Claim failed to specify the customer's home address at the time of the events in question or did not specify the Claimant's current address or that of the Claimant's representative.
- Claimant failed to pay all required filing fees and deposits, unless they were deferred by the Director.

What happens if all the deficiencies are not corrected within 30 days from the time Claimant receives notice from the Director? The case will be closed and there will be no refund of any filing fees or deposits made by the Claimant.

The new rule also applies to Counterclaims, Cross-Claims and Third Party Claims that are similarly deficient, except for those pleadings the Director will not be making the determination – the arbitrators will. If the panel determines them to be deficient and the deficiencies are not corrected within 30 days of notification, "the panel will proceed with the arbitration as though the deficient" pleading had not been made in the first place.

9. Amending Pleadings to Add Parties - Rule 12309(c)

Under the old rule, if a party amended a pleading to add a new party to the case between the time the Director consolidated the arbitrator lists and the time the panel was appointed, the newly-named party was not able to take part in the arbitrator selection process. Nor could that new party object to being added to the arbitration. Now, no party may amend a pleading to add a party during the period of time between the date the ranked arbitrator lists are due to the Director and the panel is appointed.

Once the panel is appointed, a pleading may not be amended – for any reason – without the panel's approval. In addition, the party added after the panel has been appointed must be given an opportunity to be heard before the panel may grant the motion to amend (to add the party).

10. Time Extended to Answer an Amended Pleading - Rule 12310

Under former Rule 10328, parties had 10 business days to answer an amended pleading. Now they have 20 calendar days, making it consistent with the time to respond to Counterclaims and Cross-Claims.

11. Arbitrators – The Rules Have Changed With Respect to Their Number, Selection and Appointment - Rules 12400 – 12407

Rule 12400 – Neutral List Selection

- Arbitrator names will now

be selected by the Neutral List Selection System (NLSS) on a *random* rather than a *rotational* basis, primarily, says the NASD, because of computer programming requirements.

- Parties may no longer unilaterally request arbitrators with particular expertise.
- There are now three rosters of arbitrators:
    - Non-public arbitrators
    - Public arbitrators
    - Chairpersons – public arbitrators who have either completed chairperson training provided by the NASD (or have substantially equivalent training or experience) and either: (1) have a law degree and are a member of a bar of at least one jurisdiction and have served as an arbitrator through the issuance of an Award on at least two SRO arbitrations, or (2) have served as an arbitrator through Award on at least three SRO arbitrations.

Rules 12401 and 12402 – Number of Arbitrators and Panel Composition

- *Claims of up to $25,000, exclusive of interest and expenses* – one public arbitrator hears the case under the simplified arbitration procedures of Rule 12800. That single public arbitrator must be selected from the chairperson roster, unless the parties agree in writing otherwise.
- *Claims of more than $25,000 up to $50,000, exclusive of interest and expenses* – one public arbitrator (from the chairperson roster) unless any party requests a panel of three arbitrators (then, two from the public and one from the industry; the one from the public must be from the chairperson roster, unless the parties agree in writing otherwise). The former rule also allowed the single arbitrator to request a panel of three.
- *Claims of more than $50,000 or where unspecified or non-monetary Claims are made* - the panel consists of three arbitrators, unless the parties agree in writing to one arbitrator.

Rules 12403 and 12404 – Reducing the Chance of a Strike Out

The NASD's Neutral List Selection System is based, in part, on the arbitrator selection process of the American Arbitration Association. At the AAA, however, there are limits to the number of "strikes" a party may exercise, reducing the chance that the opposing parties will strike everyone from the list. Until this rule was amended, that is what often happened since there were no limits to the strikes.

These rules now provide:

- If a panel consists of only one arbitrator, NLSS will generate a list of 7 public arbitrators from the chairperson roster.
- If a panel consists of three arbitrators, NLSS will generate three separate lists of 7 arbitrators each – of non-public arbitrators, public arbitrators and chairpersons.
- Within approximately 30 calendar days after the last Answer is due, the Director will send the lists generated by NLSS to all the parties at the same time (along with 10 years of employment history and other background information about each arbitrator).
- If a party requests "additional information about an arbitrator", the Director will ask the arbitrator to supply that additional information and will then forward it to all the parties at the same time. At the Director's discretion, this request for additional information can toll the time for parties to return the ranked lists.
- Each separately represented party may strike up to 5 of the arbitrators from each list for any reason.
- Each separately represented party must rank the remaining arbitrators on the lists in order of preference and must return the lists no

more than 20 calendar days after the Director sent out the lists to the parties. If the Director does not receive the lists in time, he or she will proceed as if that party had no objection to any of the arbitrators on the list, nor any preference to their ranking on the lists.

12. Mandatory Initial Prehearing Conferences - Rule 12500

In the past, Rule 10321(d) provided for prehearing conferences upon the written request of a party, an arbitrator or at the discretion of the Director to consider discovery-related issues "and any other matters which will expedite the arbitration proceedings." In practice, however, these "discretionary" prehearing conferences became the norm and now this rule codifies that practice.

After the panel is appointed, the Director will schedule an Initial Prehearing Conference (IPC), which shall generally be held by telephone. Notice will be at least 20 calendar days before it takes place.

At the IPC, the panel will:

- Set discovery, briefing and motion deadlines
- Schedule subsequent hearing sessions
- Address other preliminary matters

This rule provides for eliminating an IPC if the parties submit specific information, in writing, to the Director before the IPC has been scheduled concerning: their acceptance of the panel's composition; a minimum of four mutually agreeable hearing dates; a discovery schedule; a list of anticipated motions, with filing and response due dates; and, a determination of whether briefs will be submitted and, if so, the due date for the briefs and the reply briefs.

13. Procedural and Dispositive Motions - Rules 12503 and 12504

Since the NASD's Code did not provide for motion practice, arbitrators lacked guidelines, resulting in inconsistent outcomes. Rule 12503 establishes procedures and deadlines for making, responding to and deciding procedural motions and Rule 12504 provides a framework for dispositive motions.

Rule 12503 – Procedural Motions

- They can be made in writing or orally during any hearing session. They can be in any form but if they are written, such motions must be served directly on each other party at the same time and in the same manner, with a copy sent to the Director and (usually through the NASD) to each arbitrator.
- However, before making a motion, "a party must make an effort to resolve the matter that is the subject of the motion with the other parties." Therefore, every motion must include a description of the efforts made to resolve the matter.
- Procedural motions must be served at least 20 calendar days before a scheduled hearing, unless the parties decide otherwise.
- Parties then have 10 calendar days to respond to the motion, unless the moving party agrees to an extension of time or the Director or the panel decide otherwise. As with motions, responses have to be served on all the parties, the Director and the arbitrators.
- The rule specifically provides who decides certain procedural motions:
  - Use of the forum – the Director.
  - Combining or separating Claims or arbitrations or changing the hearing location – the Director, until a panel is appointed, and then by the panel.
  - Discovery-related motions – generally the chairperson of the panel.
  - Arbitrator recusal – the arbitrator who is the subject of the request (see Rule 12409).
  - Eligibility and dispositive motions – the full panel.

Rule 12504 – Dispositive Motions Before a Hearing on the Merits

This is probably the most controversial new rule. Many customer attorneys contend that the institutionalization of dispositive motion practice will turn this *forum of equity* into a *forum of law*; will be made as a knee jerk reaction to each and every Statement of Claim; and, will force all panels to be proficient in various legal principles and statutes. On the other hand, many defense attorneys see dispositive motion practice as necessary to meet the goal of arbitration as an expeditious alternative to litigation by eliminating absolutely groundless claims that have no basis in the law.

Believing that it must recognize the reality of current arbitration practice, the NASD seeks, by this rule, to draw a fine balance between the competing interests and arguments of the customer and defense bar. It starts by stating in the rule that "motions to decide a claim before a hearing are discouraged, and may only be granted in extraordinary circumstances." Examples of such circumstances are not listed.

Dispositive motions must be in writing and must usually be served at least 60 days before a scheduled hearing. Parties have 45 days to respond to the motion. These particular motions will be decided by the full panel and cannot be granted unless a prehearing conference on the motion is held (provided the parties do not waive such a conference and permit the arbitrators to decide the motion on the written submissions).

To discourage the unbridled use of such motions, the final provision of the rule provides that the arbitrators may issue sanctions if they determine that a party filed the motion in bad faith. Examples of such bad faith are not listed.

In its rule filing with the SEC on the new Customer Code, the NASD said that it "believes that parties have the right to a hearing in arbitration. However, NASD also acknowledges that in certain extraordinary circumstances, it would be unfair to require a party to proceed to a hearing."

14. The Discovery Guide Becomes a Rule - Rules 12505 - 12511

In 1999, the NASD dealt squarely with the most troubling and vexatious aspect of securities arbitration – discovery abuses. It issued NASD Notice to Members 99-90 "The Discovery Guide" and while that guide has largely been followed by parties and arbitrators, it remained just that: a guide. The new discovery rules codify the discovery procedures outlined in the Guide; extend deadlines for compliance with and objections to discovery requests; and, provide for motions to compel discovery, depositions under certain circumstances and heightened sanctions for non-compliance.

Rule 12505 – Reiterates what had been in Rule 10321(a). Namely, that the parties must cooperate to the *fullest extent practicable* in the voluntary exchange of documents and information to expedite the arbitration.

Rule 12506 – This rule is divided into two parts:

- The first part states that Document Production Lists 1 and 2 of the Discovery Guide describe the documents that are presumed to be discoverable in all customer arbitrations and that other Document Production Lists in the Guide may also apply, depending on the specific causes of action alleged.
- The second states that unless the parties agree otherwise, they must either: (1) produce to all parties all documents in their possession or control from Lists 1 and 2 and any other Document List that is applicable based on the causes of action alleged; (2) identify and explain the reason that specific documents in those lists cannot be produced within the required time and state when the documents will be produced; or (3) object as provided in Rule 12508 (see below).

- Production, explanation or objection must be made within 60 calendar days of the date that the Answer to the Statement of Claim is due.

Rule 12507 – Provides for the procedure to follow when a party seeks additional documents or information not in The Discovery Guide. Such requests may be on the Claimant or on any Respondent named in the initial Statement of Claim 45 calendar days or more after the Director serves the Statement of Claim on the Respondent(s). At the same time, the requesting party must serve a copy of the request on all the other parties. The requests must be "specific and relate to the matter in controversy."

Rule 12508 – This new rule sets forth the manner in which a party may object to document or information production requirements.

- The party must identify which document or requested information it is objecting to and why.
- Objections must be in writing and must be served on all other parties at the same time and in the same manner.
- Objections should not be filed with the Director and parties must produce all applicable listed documents and other requested documents or information that has not been specified in the Rule 12508 objection.
- As a result, any objection not made within the 60 day required time period is waived, unless the panel determines that the party had substantial justification for failing to make the objection within the required time.

Rule 12509 – Motions to request the panel chairperson to compel the opposing party to produce documents or information may be made when that party has failed to comply with Rule 12506 [Document Production Lists] or Rule 12507 [Other Discovery Requests] or has objected to the production of documents or information in accordance with Rule 12508. Motions to compel discovery must include the disputed document request or list, a copy of any objection thereto, and a description of the efforts of the moving party to resolve the issue before making the motion.

Rule 12510 – This rule codifies the practice of depositions in securities arbitration. The rule categorically states that they are strongly discouraged but, upon motion of a party, may be permitted by the panel "only under very limited circumstances." Those circumstances include:

- Preserving the testimony of ill or dying witnesses;
- Accommodating essential witnesses unable or unwilling to travel long distances for a hearing;
- Expediting large or complex cases; or,
- "If the panel determines that extraordinary circumstances exist." Examples of such circumstances are not set forth.

Rule 12511 - The arbitrators may issue sanctions against any party for failing to comply with the discovery provisions of the Code (unless the panel determines that there is substantial justification for the failure to comply) or for frivolously objecting to the production of requested documents or information.

> Under Rule 10305(b) of the former Code, arbitrators were empowered to dismiss a claim, defense or proceeding with prejudice as a sanction for the willful or intentional material failure to comply with their Order "if lesser sanctions have proven ineffective." The new rule goes a step further. Such dismissal with prejudice can now take place for the "intentional and material failure to comply with a discovery order of the panel if prior warnings or sanctions have proven ineffective."

15. The 20 Day Rule Becomes More Inclusive – Rule 12514

The 20 day prehearing exchange rule [Rule 10321(c)] used to require all parties: (1) to serve on each

other copies of documents in their possession they intended to present on their direct case (only) at the hearing and (2) to identify witnesses they intended to present on their direct case. The arbitrators were given the authority to exclude from the arbitration hearing any documents nor so exchanged or witnesses so identified. That rule has been expanded and modified.

Now, at least 20 calendar days before the first scheduled hearing date, all parties must provide all other parties (not the Director or the arbitrators) with copies of all the documents and other materials in their possession or control that they intend *to use* at the hearing that have not already been produced. That is, there is no longer an exclusion for documents a party intends to introduce on the *cross-examination* of an adversary's witness. The names and affiliations of all witnesses the parties intend to present at the hearing must also be disclosed and the parties must file their witness lists with the Director, with enough copies for each arbitrator.

What happens if the new 20 day exchange rule is not complied with? Parties may not present any document or other materials not produced and or any witnesses not identified, unless the panel determines that good cause exists for the failure to produce the document or to identify the witness. What is good cause? The rule states that it includes "the need to use documents or call witnesses for rebuttal or impeachment purposes based on developments during the hearing." While this "good cause" exception to the new rule may appear to be similar to the earlier rule's exclusion of cross-examination and rebuttal documents from the 20 day production requirement, one runs the risk that "developments during the hearing" may not take place, preventing a party from introducing those documents or witnesses at the hearing.

16. Postponements Get Even Tougher, But … - Rule 12601

No arbitration forum is fond of adjournment requests. It is very difficult scheduling hearings and a number of people (particularly the arbitrators) set valuable time aside. Rule 10319 used to provide that arbitrators had the discretion to adjourn hearings on their own initiative or at the request of a party and, if granted, the requesting party had to pay a fee equal to the initial deposit of hearing session fees for the first adjournment and twice the initial deposit of hearing session fees, not to exceed $1,500, for a second or subsequent adjournment request by that party. Upon receiving a third adjournment request consented to by all the parties, the arbitrators had the authority to dismiss the arbitration without prejudice to the Claimant filing a new arbitration. The rule has gotten harsher. Now:

- A hearing may only be postponed if:
  - All the parties agree (intended to make the adjournment rule more user-friendly)
  - The Director postpones it "in extraordinary circumstances" (such as a national or regional emergency);
  - The panel chooses to exercise its discretion; or
  - The panel grants a motion to postpone that is made 10 or more calendar days before the hearing is scheduled to begin, *unless* the panel determines that good cause exists.
- While a postponement fee will now be charged for each postponement agreed to by the parties or granted by the panel upon the request of one or more parties, the arbitrators may assess part or all of any such fee against a party that did not request the postponement if the panel determines that the non-requesting party caused or contributed to the need for the postponement (e.g., failed to comply with document requests or arbitrator Orders). The fee schedule is now less confusing.
- To encourage mediation, no postponement fee will

be charged if a hearing is postponed because the parties agree to submit the matter to mediation at the NASD.

17. Fees – Still High But Less Confusing - Rules 12900 – 12903

Before the fee rules were revised, Claimants had to pay a non-refundable filing fee and an initial hearing session deposit that could be refundable under certain circumstances. Parties also had to pay hearing session fees for each hearing session. Although the filing fee and initial hearing session deposit were both due on filing of the Statement of Claim, they were presented in the Code as separate fees, causing confusion. The fee schedules have been revised in two ways:

1. **One Fee** - There is now one single fee that is paid when a Claim is filed and, in most instances, the total amount paid is the same as they had been. An amount equal to the hearing session deposit would be refundable if the case is settled at least 10 calendar days prior to the hearing on the merits. Under the former rule, the initial hearing session deposit was refundable if the case settled 8 days before the hearing on the merits.
2. **Brackets** - Several sets of brackets in the filing fee schedule have been condensed, without any appreciable difference in the total amount of fees that had been required.

Conclusion

The NASD is to be complimented on continuing to adapt its rules to the increased demands put on its arbitration system. It is obvious that a great deal of thought went into the changes. While the discovery rules have gotten tougher; while the formalization of dispositive motions may create a procedural quagmire; and, while the sanction authority of arbitrators over attorneys may be problematic, the primary goals of the new Code have a good chance of being achieved – to provide more guidance to parties and arbitrators and to streamline the administration of cases.

NASD's Proposed Customer Code of Arbitration

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On October 15, 2003, NASD filed with the SEC a completely revised arbitration code for customer-broker disputes[1] that the SEC is expected to publish for public comment in early 2004. The SEC's "plain English" initiative was the impetus for NASD's project to rewrite the arbitration rules to make them more "user-friendly." The project evolved from this modest goal to include a complete reorganization of the arbitration code. In addition, NASD proposes to codify some current arbitration practices and to effect a few significant substantive changes: a "chair-qualified" public arbitrator category; a motion practice rule; a rule authorizing dispositive motions; a rule authorizing sanctions against a party's attorney.

The proposed customer code is the first of three proposed rule changes, to be followed by a revised code for industry disputes and a code of mediation procedure. Each code will contain all pertinent definitions and provisions and will be independent of the others.[2]

The Customer Code is divided into nine parts that, after definitions and general matters, track the customer arbitration in chronological order, from pleadings through awards. A comparison chart of the current and proposed NASD arbitration rules and an old-to-new conversion chart are helpful exhibits to the SEC filing. In this article I follow the proposed code's organization and discuss the major changes in each part, as well as some unaddressed issues. I also briefly mention minor changes.

Part I – Interpretive Material; Definitions, Organization, and Authority

Definitions.[3] The proposed code sets forth in one rule definitions used throughout the customer code. Most of the definitions are straight forward and not likely to generate much comment.

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[1] File No. SR-NASD-2003-158 – Reorganization and Revision of NASD Rules Relating to Customer Disputes, *available at* www.nasdadr.com/rule_filings_index03.asp#03-158. Page numbers in subsequent notes refer to this document.

[2] The proposed Customer Code will use the Rule 12000 series of the current NASD rule numbering system. The Industry Code will use the Rule 13000 series, and the Mediation Code will use the Rule 14000 series.

[3] Proposed Rule 12100.

The definitions of "non-public"[4] and "public"[5] arbitrator are those proposed by NASD on June 12, 2003.[6] The definition of non-public arbitrator is broadened by increasing from three to five the number of years before former associated persons or members of broker/dealers, commodities or futures associations could be classified as public arbitrators. The definition of non-public arbitrator also includes anyone who spent "a substantial part" of his career engaged in the securities, commodities or futures business. Added to the definition of public arbitrators are individuals who were not engaged in the securities, commodities or futures business for a total of at least 20 years, are not investment advisers, and are not attorneys, accountants or other professionals whose firm derived at least 10 per cent of its annual revenues in the past two years from persons or entities in the securities, commodities or futures business. In addition, a parent, stepparent, child or stepchild of any person engaged in the securities, commodities or futures business is not considered a public arbitrator, whether or not the child is claimed as a dependent or is a member of the household.

The proposed code, like the current code, does not define an important term -- "customer." Courts have looked for guidance in determining who is a "customer" in cases where firms have challenged the arbitrability of certain claims.[7] There are two definitions of "customer" in other NASD rules. The broadest definition defines a customer as not including a broker or dealer.[8] NASD should consider incorporating this definition into the customer code.

Agreement of the Parties. Code provisions that allow parties to modify the rules have created problems in instances where there are inactive parties. The proposed code allows active parties to dispense with approval from inactive parties if NASD or the panel approves.[9]

Part II – General Arbitration Rules

Arbitration under an Arbitration Agreement or the Rules of NASD. The proposed rule [10] contains no substantive change from the current rule that requires arbitration of disputes between customers and associated persons or firms whenever there is an agreement or the customer requests it. Firms occasionally seek to avoid arbitration by asserting that the claimant is not a customer of the firm and did not transact business with it. While a majority of courts correctly interpret the NASD rule as mandating arbitration when a customer of the associated person brings an arbitration against the firm because of a dispute arising

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[4] Proposed Rule 12100(n).

[5] Proposed Rule 12100(r).

[6] File No. SR-NASD-2003-95, *available at* www.nasdadr.com/rule_filings_index03.asp#03-95.

[7] *See, e.g.,* Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc. (8th Cir. 2001) (company cannot arbitrate a dispute involving advice provided by the firm about a merger).

[8] NASD, General Provisions, Rule 0120(g), *Definitions.* A narrower definition is found at Conduct Rule 2270(b) ("any person who, in the regular course of such member's business, has cash or securities in the possession of such member.")

[9] Proposed Rule 12105.

[10] Proposed Rule 12200.

from business between the customer and the associated person,[11] a minority of courts requires a relationship between the customer and the firm. [12] In light of this, NASD should consider revising the language to make it clearer.

Time Limits (Eligibility Rule). The proposed code adopts the version of the eligibility rule that NASD proposed for comment on June 19, 2003.[13] The proposed rule [14] provides that the panel will decide all eligibility rule issues. If arbitrators dismiss any claims because of the eligibility rule, a party may pursue the claim in court; by filing the motion to dismiss on eligibility rule grounds, the moving party agrees that if the claim is dismissed, the non-moving party may withdraw any remaining claims without prejudice and may purse all of them in court.

Sanctions. Under the proposed code, the arbitration panel has broad authority to sanction any party *and his representative* for failing to comply with any code provision, any order of the panel, or any order of a single arbitrator authorized to act on behalf of the entire panel. It does not limit sanctions "unless prohibited by applicable law." [15] Examples include: imposing monetary penalties, precluding a party from presenting evidence, making an adverse inference against a party, assessing postponement and other forum fees, and assessing attorneys' fees, costs and expenses.

NASD's commentary to the proposed rule indicates that sanctions on a party's representative should be limited to "egregious situations," although this limitation is not set forth in the proposed rule itself. [16] At least one state court has, in the context of consumer arbitration, disapproved of arbitral power to impose penalties on the consumer's attorney expressing concern about the deterrent effect this could have on the arbitration of consumer complaints, given the limited judicial authority to review arbitration awards. [17]

The proposed code, [18] consistent with the current code, gives the panel the authority to dismiss a claim, defense or arbitration with prejudice as a sanction for "material and intentional" failure to comply with the panel's order if prior warnings or sanctions were ineffective.[19]

Use of the Forum. The current code requires the Director of Dispute Resolution to obtain NAMC approval if he

[11] *See, e.g.,* WMA Sec., Inc. v. Wynn, 32 Fed. Appx. 726 (6th Cir. 2002); Vestax Sec. Corp. v. McWood, 280 F.3d 1078 (6th Cir. 2002); John Hancock Life Ins. Co. v. Wilson, 254 F.3d 48 (2d Cir. 2001).

[12] *See, e.g.,* Mony Sec. Corp. v. Vasquez, 238 F. Supp.2d 1304 (M.D. Fla. 2002).

[13] File No. SR-NASD-2003-101, *available at* www.nasdadr.com/rule_filings_index03.asp#03-101.

[14] Proposed Rule 12206.

[15] Proposed Rule 12211(a).

[16] P. 11.

[17] MCR of Am., Inc. v. Greene, 811 A.2d 331 (Md. Ct. App. 2002).

[18] Rule 10305(b).

[19] Proposed Rule 12211(c).

decides to decline the use of the forum because the claim is not a "proper subject matter for arbitration."[20] Under the proposed code, the Director alone can refuse the use of the forum if the subject matter of the dispute is inappropriate or "for other reasons if extraordinary circumstances exist."[21] The expansion of authority is intended to deal with emergency situations where the Director believes that a party presents a security risk to the forum or other parties.[22]

Shareholder Derivative Actions. The current code does not address shareholder derivative actions, although NASD's longstanding position is that they are not eligible for arbitration since they involve corporate governance claims.[23] The proposed code codifies this position.[24]

Extension of Deadlines. The current code provides limited guidance on extending deadlines.[25] The proposed code clarifies that parties may agree to modify deadlines for serving answers, returning arbitrator selection lists, responding to motions, and exchanging documents or witness lists. In addition, the panel may modify any deadlines on its own initiative or upon a party's motion, and the Director may modify any deadline set by the code for good cause or any deadline set by the panel in extraordinary circumstances.[26]

Legal Proceedings. The current code prohibits a party from litigating any claim against another party that is the subject of an ongoing arbitration.[27] Unfortunately, firms frequently ignore this provision and bring litigation to enjoin or interfere with ongoing customer arbitrations, and courts have on occasion permitted this.[28] The proposed rule contains the same prohibition "except as otherwise provided by the Code *or by applicable law.*"[29] Firms may assert that the prior judicial decisions allowing judicial intervention are "applicable law" that legitimate this practice.

Ex Parte Communications. Current practice bars ex parte communications, although the code is silent on this. The proposed code adds an express prohibition against ex parte communications.[30] The proposed rule does not set forth the duration of the ban; presumably it should run from the appointment of an arbitrator until the release of the award.

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[20] Rule 10301(b).

[21] Proposed Rule 12203(a).

[22] P. 8.

[23] P. 9.

[24] Proposed Rule 12205.

[25] *See* Rule 10314(b)(5) (extensions for pleadings).

[26] Proposed Rule 12207.

[27] Rule 10106.

[28] *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Green, 936 F. Supp. 942 (S.D. Fla. 1996) (also finding that customer waived his right to arbitrate).

[29] Proposed Rule 12209.

[30] Proposed Rule 12210.

Hearing Location. The proposed code codifies current NASD practice of selecting the hearing location that is closest to the customer's residence at the time the dispute arose.[31] The parties may agree to a different location before the arbitrator selection lists are sent to them, and the Director may change the hearing location upon the motion of a party.

Part III – Initiating and Responding to Claims

Adding Parties. The current code permits parties to amend a pleading before the appointment of the arbitration panel and requires the panel's approval after its appointment.[32] The proposed code continues this distinction, but with one exception: it does not allow amendments to add parties in the period between the due date of the arbitrator selection lists and the appointment of the panel.[33] This is to permit added parties either to participate in the selection of arbitrators or to have an opportunity to object to their addition.

Deficient Claims. Under current NASD practice, NASD notifies a claimant if it finds his claim deficient. The claimant has thirty days to correct the deficiency; then NASD dismisses the claim without prejudice.[34] The proposed code codifies this practice and enumerates the most common types of deficiencies.[35]

Time to Answer Counterclaims and Cross Claims. Under the current code, the deadline for responding to a counterclaim is ten days,[36] while the deadline for responding to a cross claim is forty-five days.[37] Under the proposed rule, twenty calendar days is the deadline for responding both to counterclaims and cross claims.[38]

Part IV – Appointment, Disqualification and Authority of Arbitrators

Changes in Arbitrator Selection Process. The proposed code makes several significant changes in the arbitrator selection process. Under current practice, parties in three-arbitrator cases receive two lists of proposed arbitrators, public and non-public. After NASD appoints two public arbitrators and one non-public arbitrator from the parties' selections, the parties may select one of them as the chair. If the parties do not agree on a chair, as is the case in most instances,[39] NASD appoints

[31] Proposed Rule 12212.

[32] Rule 10328.

[33] Proposed Rule 12309(c).

[34] P. 12.

[35] Proposed Rule 12307.

[36] Rule 10314.

[37] Rule 10314.

[38] Proposed Rules 12304 and 12305.

[39] NASD estimates that parties agree in only 20% of the cases. N. 2, p. 15.

the highest-ranked public arbitrator as the chair.

As proposed, NASD will create and maintain a third roster of public arbitrators who are qualified to serve as chairpersons. Public arbitrators are eligible for the chairperson roster if they have completed NASD chairperson training, or have substantially equivalent training or experience, and either:

- have a law degree, are a member of a bar, and have served as an arbitrator through award in at least two SRO arbitration hearings; or
- have served as an arbitrator through award in at least three SRO arbitration hearings.[40]

NASD believes that these criteria balance appropriately the goals of assuring the chairs have the necessary experience and training and allowing arbitrators of all professional backgrounds to qualify.[41] Careful consideration should be given to whether NASD has struck the right balance. First, NASD does not explain what would constitute "substantially equivalent training and experience" in lieu of NASD chairperson training. If it plans to grandfather arbitrators who have regularly served as chair, it should so state. Second, the only difference between the lawyer and non-lawyer categories is that the non-lawyer must have served on one more arbitration. If NASD believes that legal training is a valuable attribute for a chair, service on one additional arbitration does not seem an adequate substitute.

Public arbitrators who meet these criteria will be placed on the chairperson roster only if they agree to serve as chairpersons. To avoid duplication, arbitrators who are on the chairperson roster will not be included in the general public arbitrator roster. A public arbitrator who is qualified to serve as a chair, therefore, must always serve as a chair; this may lead to a chair-qualified arbitrator turning down an appointment if his current commitments do not permit him to serve as chair, although he would have been willing to serve on the panel as a member.

In three-arbitrator cases the parties will receive three lists -- public, non-public, and chairperson.[42] In single arbitrator cases, the parties will make their selections from a chairperson list, unless they agree otherwise.[43]

The proposed code also contemplates other changes to the arbitrator selection process. Arbitrator names would be generated on a random, rather than the current rotational, basis,[44] primarily because of computer programming requirements.[45] Parties would no longer be able to request unilaterally arbitrators with particular expertise, as this practice has been controversial and presents administrative burdens.[46] Finally, the proposed code would increase the number of names on each list to seven, but would limit the number

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[40] Proposed Rule 12400.

[41] P. 17.

[42] Proposed Rule 12403(a)(2).

[43] Proposed Rule 12403(a)(1).

[44] Proposed Rule 12400(a).

[45] P. 17.

[46] P. 17.

that each party could strike from each list to five.[47] Currently, there is no limit on the number of names each party can strike, which frequently leads to NASD's appointment of arbitrators who were not on the selection lists. The proposed code does not provide for a second round of the arbitrator selection process, an idea that NASD advanced and then withdrew a few years ago.

Arbitrator Recusal. The current code does not provide for arbitrator recusal. The proposed code would codify current practice: a party may request at any time an arbitrator to recuse himself for good cause, and the arbitrator himself will decide whether to do so.[48] According to NASD, caselaw prohibits full panels from deciding recusal motions.[49]

Number of Arbitrators. Under the current code, if the amount of the claim is $25,000 or less, the arbitration panel consists of one public arbitrator, unless that arbitrator requests two additional arbitrators.[50] If the claim is between $25,000 and $50,000, the panel consists of one public arbitrator, unless that arbitrator or any party requests a three-arbitrator panel. The proposed code eliminates the ability of a single arbitrator to request a three-arbitrator panel for any claim of $50,000 or less.[51] This should help to keep down the costs of arbitrating small claims.

Part V – Prehearing Procedures and Discovery

Motions. In what will surely be one of the most debated proposals, NASD for the first time provides for a motion practice rule that establishes procedures and deadlines for making, responding to and deciding motions.[52] Most commentators on the arbitration process decry the increased use of motions in arbitration. NASD recognizes the concern that a rule may encourage more motions, but opts to accept the reality of motion practice as a part of arbitration process.[53] Under this view, participants would benefit from a rule that provides guidance on the procedures. The proposed rule requires that a party making a motion first make an effort to resolve the matter informally,[54] a weak attempt at limiting the proliferation of motions.

Dispositive Motions. An equally controversial proposal is NASD's authorization of dispositive motions before a hearing on the merits.[55] The

[47] Proposed Rule 12403.

[48] Proposed Rule 12409.

[49] P. 19.

[50] Rule 10308(b).

[51] Proposed Rule 12401.

[52] Proposed Rule 12503.

[53] P. 20-21.

[54] Proposed Rule 12503.

[55] Proposed Rule 12504.

full panel must hold a prehearing conference before granting a motion to dismiss. NASD states that it believes that "generally" parties have a right to a hearing, but "in certain extraordinary circumstances" it would be unfair to require a party to proceed to a hearing.[56] The proposed rule states that motions that would resolve a claim before a hearing on the merits (*except for* motions to decide eligibility rule questions) are discouraged and may only be granted in extraordinary circumstances. The panel is authorized to issue sanctions against a party that makes a dispositive motion in bad faith.

Discovery. NASD recently issued a notice to members expressing its concern about widespread noncompliance by brokerage firms of discovery orders.[57] It also acknowledges, in the comments to the rule change, complaints that the NASD Discovery Guide guidelines are frequently ignored.[58] In an effort to improve compliance, NASD proposes to incorporate the NASD's Discovery Guide procedures[59] and to establish that the discovery procedures are mandatory. Within sixty calendar days (currently thirty) after the answer is due, parties must

- produce all documents that are responsive to the Discovery Guide's applicable document production lists,
- identify and explain why specific documents cannot be produced within the required time and state when the documents will be produced, or
- object to their production.[60]

As in current practice, parties may also request additional documents.[61] The proposed code provides that the panel may impose sanctions for noncompliance[62] (including dismissal of a claim, defense or proceeding with prejudice for intentional and material failure to comply with the panel's discovery order if prior warnings or sanctions were ineffective.)[63] As a practical matter, compliance will improve only if panels impose meaningful sanctions for noncompliance and send a consistent message that they will not condone noncompliance.

Requests from brokerage firms to keep documents (particularly compliance manuals) confidential have generated controversy. The proposed code, however, ducks the issue and is silent on the issues of confidentiality and privilege. The discussion in the Discovery Guide, asserting that arbitration panels have the power to issue confidentiality orders, remains unchanged.

The proposed code retains

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[56] P. 21.

[57] NASD Notice to Members 03-70: NASD Reminds Members of Their Duty to Cooperate in Arbitration Discovery Process (November 2003), *available at* www.nasdr.com/2610_2003.asp#03-70.

[58] P. 22.

[59] Proposed Rules 12505-12511.

[60] Proposed Rule 12506.

[61] Proposed Rule 12507.

[62] Proposed Rule 12511(a).

[63] Proposed Rule 12511(b).

the provision about requests for information.[64] The proposed code, however, does not include the Discovery Guide's discussion about the limited purpose of information requests and the admonition that they are not to be used as interrogatories; in fact, this language is proposed to be deleted from the Discovery Guide. This limitation on the use of information requests should be included in the code, to discourage the use of overly broad information requests that are the equivalent of interrogatories.

Initial Prehearing Conferences. The proposed code codifies NASD current practice on initial prehearing conferences found in the NASD Discovery Guide. The proposed rule provides that an initial prehearing conference will be held in every case unless the parties agree on certain scheduling and other issues in advance.[65]

Recording Prehearing Conferences. Under the proposed code, prehearing conferences are not generally tape-recorded, with the exception of prehearing conferences to decide dispositive motions. The panel may decide to tape-record the prehearing conference either on its own or upon a party's request.[66]

Subpoenas. The proposed rule on subpoenas is substantially the same as the current rule,[67] except that it adds that the issuing party must send copies to all other parties at the same time and the same manner as the party issued the subpoena.[68]

Exchange of Documents and Witness Lists. The current code provides that parties must exchange, at least twenty days before the hearing, copies of all documents that they intend to present at the hearing and must identify all witnesses they intend to call at the hearing.[69] Under the proposed rule, parties do not have to exchange documents that were previously exchanged.[70] The proposed rule also creates a presumption that parties cannot use any documents at the hearing or call any witnesses that were not timely exchanged or identified, unless the panel determines that good cause exists. "Good cause" is specifically identified as the need to use documents or call witnesses for rebuttal or impeachment purposes.

Part VI – Hearings; Evidence; Closing the Record

Postponements. The proposed code limits the power of arbitrators to grant requests to postpone a hearing that are made within ten days of a scheduled hearing session; the panel must determine that good cause exists.[71] This is intended to reduce the

[64] Proposed Rule 12507(a).

[65] Proposed Rule 12500.

[66] Proposed Rule 12502.

[67] Rule 10322.

[68] Proposed Rule 10322.

[69] Rule 10321(d).

[70] Proposed Rule 12514.

[71] Proposed Rule 12601.

number of last minute requests for postponements.[72] The panel has the authority to allocate the postponement fee among non-requesting parties, if it finds that they contributed to the need for a postponement. The postponement fee would no longer increase for a second request by the same party.

Part VII – Termination of an Arbitration Before Award

Withdrawing Claims. The current code does not address withdrawing claims. Under the proposed code, after a respondent has answered the claim, the claimant may withdraw it against that party only with prejudice, unless the claimant and respondent, or the panel, decide otherwise.[73]

Part VIII – Simplified Arbitration and Default Proceedings

Simplified Arbitration. Both the current and proposed codes permit customers with small claims the choice of a hearing or a decision on the papers by a single arbitrator. The latter is a quick, inexpensive option particularly useful for *pro se* claimants. Under the current code, however, its utility is diminished because the arbitrator can call for a hearing even though the claimant does not want it.[74] The proposed rule restores the small claimants' choice; the arbitrator no longer can require a hearing when the customer has elected to have the dispute decided on the papers.[75]

Unfortunately, the proposed code would have a detrimental impact on simplified arbitration, by extending the deadlines for responding to conform to the standard deadlines. NASD explains the change as a desire for uniformity, but this change would diminish the benefits of the simplified arbitration procedure for small investors. A broker should be able to respond more quickly to a small uncomplicated claim; Current NASD practice permits the claimant to file a reply to the respondent's answer. However, the proposed code does not explicitly authorize this practice. Since many claimants filing simplified arbitration claims are *pro se,* it is particularly important that the code spell out its procedures clearly and completely.

Part IX – Fees and Awards

Fees. Claimants have complained that they have difficulty calculating the amount that is due upon filing of a claim. To correct this, the proposed code combines what are currently two fees -- the filing fee and the initial hearing session deposit -- into one single fee payable upon filing.[76] NASD would refund an amount equal to the current hearing session deposit if the case is settled at least ten calendar days before the hearing on the merits.[77]

Several sets of brackets in the filing fee schedule are consolidated. Unfortunately, as a result of this consolidation, fees on the smallest of claims – those up to $1000 -- would increase by $25, a hardship on very small claimants. On the other hand, fees on claims in the

[72] P. 24.

[73] Proposed Rule 12702.

[74] Rule 10302(f).

[75] Proposed Rule 12800.

[76] Proposed Rules 12900-12903.

[77] Proposed Rule 12900(c).

$30,000-$50,000 range would decrease by $50, a welcome change for these relatively small claims.

Conclusion

NASD expects that participants in the dispute resolution process will find the new customer code easier to use and more informative and that arbitration of customer disputes should become more standardized as a result. The proposed code contains more than just housekeeping changes. Some of the proposals are laudable efforts to improve the quality of arbitration, like the creation of a chair-qualified arbitrator roster and the incorporation of the discovery procedures. Other proposals, however, if adopted, will recognize some of the undesirable developments in arbitration practice, like the adoption of a motion practice rule and, in particular, a rule authorizing dispositive motions. There should be vigorous debate about the policy implications of authorizing sanctions against a party's representative. Finally, it is regrettable that NASD is maintaining the status quo on the eligibility rule. PIABA members should review this proposed code carefully and make their views known to the SEC.

Understanding Options for Lawyers: Puts and Calls

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The basic tools of Options are the Call and Put.[1] Once a person understands these simple concepts, everything is merely a combination of these two basic concepts.

Calls and Puts are each a type of contract. A **Call Option** is the right to buy an underlying (stock, commodity, bond, etc) at a set price and within a set time frame, in the future. As an analogy, think of a lease contract with option to buy a house. The lessee has a Call option (is Long) on the purchase of the house. If the price increases while he is renting, he exercises the right to purchase at a set purchase price (Strike Price) and within a set time frame (Expiration) in the future. If the property values have fallen, our renter allows the purchase option to expire worthless.

Similarly, the owner of the house who agrees to the lease-purchase contract on the house has done the same as sold (Wrote or is Short) a Call option. If the value of the house climbs dramatically, the owner must be ready to sell the house at the set price (Strike Price) if the renter exercises the purchase (Call) option within the set time frame (Expiration) of the contract. The homeowner receives a premium, a higher rent, in return for the lease-purchase option, which he keeps if no purchase transpires.

A **Put Option** is the right to sell an underlying (stock, commodity, bond, etc) at a set price (Strike Price) and within a set time frame (Expiration) in the future. To continue our analogy, let's use homeowner's insurance as an example of a Put option. The homeowner has the right but no obligation to sell his home to the insurance company if it greatly decreases in value by flood, fire, vandalism etc. The insurance company, by selling or writing the policy (Writing or being Short) must always be ready to buy the house or pay the cash difference for any loss to the house.

Thus, think of the owner of a Call option as a leassor with the right to purchase (the Call option seller is the property owner) and the owner of a Put option as someone who bought an insurance policy (the Put option seller agrees to be the insurance company).

Thus Long Calls are profitable if the underlying goes up, and Long Puts are profitable if the underlying goes down, and

[1] In this article I will keep terminology to a minimum. The reason is that these terms interfere with the rapid assimilation of the concepts, which are simple when the terminology and all the caveats are discarded. These terms and caveats are widely available in the literature or in glossaries available on line.

vice versa. The appendix has charts describing the characteristics of a Call and Put options. You must know these two tools well, both as a seller (writer or Short) and a buyer (Long), to understand options. *Go no further until you have accomplished this task. Once these characteristics are MASTERED, Options are easy.*

SYNTHETIC POSITIONS

This is the heart to understanding a portfolio with options and it is also simple to understand. Few brokers understand synthetic positions. Thus on cross-examination you can show that the broker did not understand how the option positions she/he purchased functioned together in the portfolio.

First understand that any financial position that exists in a portfolio can be recreated with Options (and or Futures and/or Convertible Bonds and/or Stocks and Bonds).[2] For example, if someone owns a Call option, the characteristics of that option can be created using other options or stocks and cash. This is
known as creating a synthetic position.

If you buy (are Long) a Call and sell (are Short) a Put option (same Expiration and Strike Price) the combination of these two options will be the same as the underlying (stock, commodity, bond etc). For example, assume we are Long (bought) the Call and are Short (wrote or sold) the Put for the S&P 500 index, trading under the ticker symbol SPX, with a strike price of 1,000 and expiration of March 2004. On the third week in March 2004 if the index is below 1,000 we will be forced to purchase the SPX Index at 1,000 since we sold the Put (The Put option is in-the-money). By the same token, on March 2004 if the SPX Index is above 1,000 we will want to buy the index as it is trading at a higher price than our Call option (the call option is in-the-money).

Thus we have the right to purchase the underlying at $1,000 a share and can consummate the trade anytime up to March 2004. *Make sure you understand the concept of the synthetic long underlying before reading further.*

Thus the synthetic underlying will trade at the same price with the same characteristics as the underlying (stock, commodity, bond, etc), otherwise there would be a risk free way to make money by selling one and buying the other (arbitrage). The markets are amazingly efficient. There is no free lunch.

What follows are a list of common synthetic positions.[3] When looking at a portfolio of options look to pair different positions and see if they add up to a synthetic position (assumes same expiration and strike prices).

Long Call (C) + Short Put (-P) = Synthetic Long Underlying (C-P)

Short Call (-C) + Long Put (P) = Synthetic Short Underlying -(C-P)

Synthetic Long Call (C) = Long underlying (C-P) + Long Put (P)

Synthetic Short Call (-C) = Short underlying -(C-P) + Short Put (-P)

Synthetic Long Put (P) = Short underlying -(C-P) + Long Call (C)

Synthetic Short Put (-P) = Long Underlying (C-P) + Short Call (-C)

[2] Rubinstein and Leland, *Replicating Options with Positions in the Stock Market***,** Financial Analysts Journal 63 July-August (1981). The costs of borrowing (small) at current interest rates makes up the differences between a synthetic position.

[3] Costs of borrowing (small) makes up the differences between a synthetic position. There are other synthetic positions that combine Futures and other financial instruments but we will not address them here, though these trades are well summarized in most texts. Eg. Sheldon Natenberg, *Option Volatility & Pricing: Advanced Trading Strategies and Techniques* (1994).

As an example of the usefulness of this tool, imagine cross-examining a broker who does not understand synthetic positions.

Q: You would agree with me that it would have been highly speculative or risky to sell (or write) a naked (not hedged) Put option at the top of the Bull market, agreed?
A: Yes.
Q: You would never recommend such a risky trade?
A: Correct.
Q: Writing a Covered Call (owning the stock and selling Call options for income) is regarded as a conservative investment strategy in the industry? [4]
A: Indeed.
Q: You made what you believed to be a conservative recommendation of Writing a Covered Call to my client?
A: Yes.
Q: Other brokers in your firm were recommending this same conservative trade during the Bull market?
A: Yes.
Q: You told my client that this was a safe recommendation since, if the stock rose in value, the position was covered (hedged or safe) since the investor owned the stock?
A: Yes.
Q: BUT, Writing a Covered Call is THE SAME THING AS SELLING A NAKED SYNTHETIC PUT!
A: (Impossible to say anything helpful to the defense)
Q: When the stock goes up, the trade makes only the premium as a profit?
A: Yes.
Q: But when the stock falls in price, the trade loses money at the same rate as a Short or Naked PUT?
A: (Impossible to say anything helpful to the defense)
Q: So it is **fair** to say that you were making investment recommendations using Options when you did not understand the most basic characteristics of them?

There are a large number of combinations of options with well known names and characteristics which you can look up in a book. [5] Even if a combination of options does not fit neatly into one of these synthetic positions, sometimes you will find that you have a synthetic position but the Strike price or the date of Expiration vary, grouping them into known synthetic positions gives you a good guide to the characteristics of the portfolio.

For example, let's assume that a portfolio has a Long SPX 1000 Jan 04 Call (bought-the S&P 500 tracking stock-Strike price 1000-Expiration January 2004) and Short SPX 1000 APR 04 Put (sold-the S&P 500 tracking stock-Strike price 1000-Expiration April 2004). In a sense, we can look at this as a Synthetic Underlying until January 2004 and then a naked (not hedged) Short Put from January to April 2004. Thus the position is the same as buying the stock AND being Short (selling/writing) a Put from January to April 2004. (This is an extremely aggressive position). No amount of broker spin, attempting to explain that a bunch of other factors make this a reasonable recommendation, can contradict the clear import of the portfolio.

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[4] Jeff D. Opdyke, *Some Call on Options to Put a Profitable Hedge In Portfolios That May Carry Volatile Potential, Wall Street Journal.* (February 22, 2000) (The article describes "(a)mong conservative strategies is selling covered calls" and how a retired Oregon couple who was selling covered calls on JDSU, a stock that subsequently fell over 95% in share price). *Id* This cross-examination suggested by Dr. William Welch, Chairman Dept. of Finance, Florida International University.

[5] Both Sheldon Natenberg, *Option Volatility & Pricing: Advanced Trading Strategies and Techniques* (1994) and The Option Institute, Chicago Board of Exchange, *Options: Essential Concepts and Trading Strategies* (1999) describe these trades well.

HEDGING WITH INDEX OPTIONS

Hedging is the practice of reducing risk, usually as a result of using options. Sometimes a stock will not have corresponding options or it will be impractical to buy options on all the stocks in the portfolio. This is not a problem for the person who desires to manage the risk in the portfolio. In almost every occasion, an option on an index will perform in a similar manner for the portions in the portfolio that need to be hedged.

For example, the holder of a arge amount of technology stocks at the top of the NASDAQ in March 2000 could have purchased Put options on the NASDAQ-100 index, trading under the symbol QQQ. When QQQ was trading for 100 a share in July 2000 each Put Contract on QQQ would have hedged $10,000 worth of technology stocks (remember 100 shares per contract multiplied by $100 per share).[6] Even if the technology stock in the portfolio is twice as volatile as the QQQ index tracking stock, this position could have been hedged by the purchase of twice as many dollars worth of QQQ Puts for every dollar of stock sought to be hedged.

Similarly, a well diversified portfolio could be hedged by buying Put options on SPX (the tracking stock for the S&P 500). All of the indexes and many of the Industries and Sectors within industries have tracking stocks. For example, the SOX is the tracking stock for the Semiconductor/Chips sector of the technology industry. Thus a large position in Intel could have been hedged by buying a Put option on the SOX.[7]

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[6] Option contracts trade in bundles of 100 shares of the underlying. In other words, 1 option contract represents 100 shares of the underlying.

[7] This is a list of popular Options on Indexes. Note that European Style means that the option can only be exercised at its expiration. American exercise options, which applies to individual stocks traded on domestic exchanges, are American Style and can be exercised at any time prior to expiration.

Index Name	**Symbol**	**Exercise Style**	**Exchange**
Dow Jones Transports	DTX	European	CBOE
Dow Jones Utilities	DUX	European	CBOE
Automotive	AUX	European	CBOE
S&P Banks	BIX	European	CBOE
Biotechnology	BTK	European	AMEX
S&P Chemical	CEX	European	CBOE
Morgan Stanley Consumer	CMR	European	AMEX
Morgan Stanley Cyclical	CYC	European	AMEX
Pharmaceutical	DRG	European	AMEX
CBOE Gaming	GAX	European	CBOE
Goldman Sachs Multimedia	GIP	European	CBOE
Super Cap	HIX	European	PHLX
Hong Kong	HKO	European	AMEX
S&P Insurance	IUX	European	CBOE
Japan	JPN	European	AMEX

Common Investing Strategies using Options

Using Put Options to Buy Stock instead of buying the stock. This provides a discount (premium received for the option) on the purchase price. The risk of puts expiring worthless is an opportunity risk, if the stock price rises and investor never got the opportunity to buy the stock.

Using Call Options to Sell Stock because sometimes investors are waiting for a rally in order to sell. When a stock holder is willing to sell stock when the price rises to a set price, selling a call option at that price effectuates this strategy.[8] Selling a Call in effect sells the stock for the investor when the desired price is reached.

A Covered Call is where an investor buys shares of a stock, and at the same time writes call options on this same stock. Most brokerage firms accept "buy-write" orders, in which stock is purchased and calls are sold at an established set price or not at all.

The **Costless Collar** involves the simultaneous purchase of options that set a lower and upper limit on a stock price. They use a combination of a **Long Put and Short Call** to produce a collar or fence around the stock or portfolio. First the investor buys an out-of-the-money protective put and sells a similarly priced call. "The call premium received would offset most or all of the put's cost, enabling the strategy to be effected with little up-front cost." The Option Institute, Chicago Board of Exchange, *Options: Essential Concepts and Trading Strategies* 321 (1999). The graph below "shows the payoff diagram for a collar strategy using XYZ stock from the previous example. It is assumed that XYZ stock is bought at $70,

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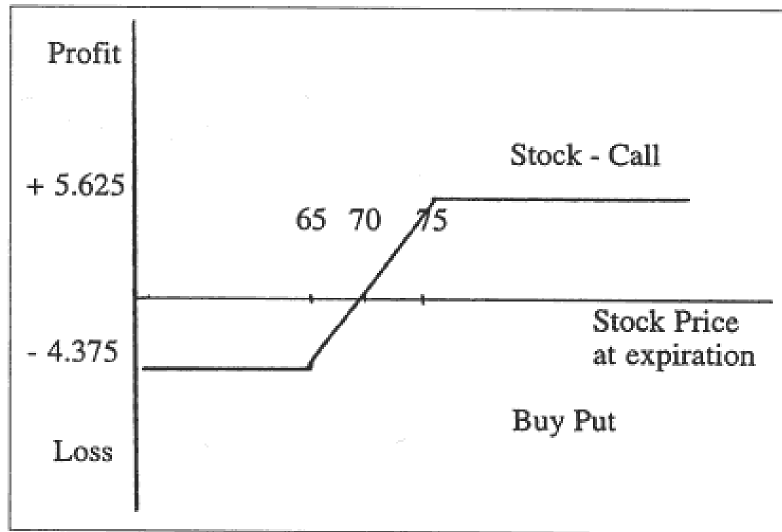
Morgan Stanley High Technology	MSH	European	AMEX
Networking	NWX	European	AMEX
Phone Sector	PNX	European	PHLX
PSE Technology	PSE	European	PSE
Semiconductor	SOX	American	PHLX
Semiconductor	SXE	European	PHLX
S&P Transportation	TRX	European	CBOE
CBOE Technology	TXX	European	CBOE
Utility	UTY	European	PHLX
Gold/Silver	XAU	American	PHLX
Computer Technology	XCI	American	AMEX
Natural Gas	XNG	European	AMEX
CBOE Oil	OIX	European	CBOE
AMEX Oil	XOI	American	AMEX

James B Bittman, *Trading Index Options* 49 (1998).

[8] The Option Institute, Chicago Board of Exchange, *Options: Essential Concepts and Trading Strategies* 95 (1999).

the 75 call is sold for $3.25 and the 65 put is bought for $2.625." *Id.*



Fence or Collar Strategy Sell the 75 Call and Buy the 65 Put, with the Same Expiration and Hold Long XY Z Stock " *Id.*

Brokers could have used this strategy to protect their clients' portfolios, with little cost to the investor. Options extend outwards in time for years. Options extending more than a year forward in time are known as LEAP Options.

A **Long Straddle** consists of a **Long Call and a Long Put** with the same strike price and expiration date. This is profitable if the underlying goes up or down substantially. It is best suited for a market in which the investor feels a large move is possible, but is unsure as to its direction. Should the underlying not move, the premiums are lost.

Description:	Buy call with strike price I; buy put with strike price I.
Opinion:	Uncertain–underlying security will move substantially in either direction, but you're unsure which way.
Selection:	Buy call and put with same strike price I when price of underlying security is near I.
Profit:	Increases as underlying security moves in either direction.
Loss:	Limited to sum of premiums paid for call and put.
Breakeven:	On upside = Strike price I + Total premiums paid. On downside = Strike price I − Total premiums paid.
Time:	Very negative–position has two long options with accelerating decay as expiration nears.
Comments:	Rarely held to expiration due to time effect. Used in anticipation of news that might greatly effect underlying security in either direction.
Equivalencies:	Long 100 shares of underlying, long two puts with strike price I. Short 100 shares of underlying, long two calls with strike price I.

Long Straddle [9]

The **Long Strangle** is very similar to the long straddle. Like the straddle, it is a strategy that appropriate when a large move in the underlying, in an unknown direction, is predicted. The difference between a strangle and a straddle is that the strike prices of the

[9] The Option Institute, Chicago Board of Exchange, *Options: Essential Concepts and Trading Strategies* 116 (1999).

call and put differ with the strangle and not the straddle.

PRICING OF OPTIONS

Jim Bittman of the CBOE has a creative analogy to insurance for the pricing of Options. What follows is a summarizing table from the analogy, which is quoted in the footnote. [10]

Insurance companies consider five factors when calculating premiums. [11]

Table 3-1 Components of Insurance Premiums and Options

Insurance Policy	**Option**
Asset value	Stock or Index level
Deductible	Strike price
Time to expiration	Time to expiration
Interest rates	Interest rates and dividends
Risk	Volatility
= Premium	= Premium

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[10] "*The Insurance Analogy*
An option is simply an insurance policy that pays its owner if certain conditions are met on or before the expiration date. If the conditions are not met, the policy expires worthless.

The analogy between put options and insurance policies is, perhaps, easiest to understand. As with an insurance policy paying a claim on an insured asset that is damaged, a put goes up in value if the underlying instrument declines in value. If the underlying does not decline below the strike price before expiration, the put option expires worthless.

Why calls are like insurance policies may be less obvious. Calls are insurance policies that insure participation in a price rise. Calls contain a right to buy, as opposed to a right to sell. Whereas puts insure against the risk of being in the market—the risk of suffering from a price decline—calls insure against the risk of being out of the market—the risk of missing a rally. Although one loss is a "real loss" and the other an "opportunity loss," the put and call options that protect against these events both act as insurance policies in every respect.
Components of Insurance Premiums

Insurance companies consider five factors when calculating premiums. For example, consider automobile insurance. The first consideration is the value of the car. If other factors are equal, the more valuable the car, the more expensive the insurance. Second, the amount of the deductible affects the insurance premium. The higher the deductible, the lower the premium. The policy's term, or time to expiration, is the third factor. The longer the term, the higher the insurance premium. Fourth is interest rates. Insurance companies invest the premiums they receive until claims are paid. Consequently, the level of interest rates influences what premiums are charged. Fifth, and final, is risk. For automobile insurance, the age and driving record of the driver, where the car is parked, and how many miles per year it is driven are some of the risk factors considered. If other factors are equal, the higher the risk, the higher the insurance premium.

Insurance actuaries take these five components and apply a mathematical formula to arrive at the premium they charge for a particular policy. James B Bittman, *Trading Index Options*, 47-49 (1998).

[11] James B Bittman, *Trading Index Options*, 49 (1998).

Note that volatility translates to risk in Options. The Great insight that led to the creation of an Options market and the Nobel Prize for the professor who developed the Black-Scholes Option Pricing Model is that the price of an option depends on the future volatility of the stock or underlying. It does not depend on the expected future price of the underlying. Thus the more volatile the stock as measured by the implied or historical volatility, the riskier it is to sell options on that stock

Implied volatility is the level of future volatility that justifies the current price of the option. **Historical volatility** is the standard deviation of the PAST price movement of the underlying.

When the implied volatility causes the price of an option to exceed the theoretical price of an option based upon historical volatility, the option is said to be overpriced, and vice versa. Note that when the implied volatility causes the price of an option to exceed the theoretical price of an option based upon historical volatility, this means the market is pricing **INCREASED RISK** into the cost of the option. This may be a useful area for cross-examination of a broker who was reckless in his purchases. Several websites, including some brokerage firms, display the implied volatility of an option at no charge. These websites usually give both a theoretical value and current value for the implied volatility of the option.

Advanced Concepts 'THE GREEKS': Delta the change in Option Price for a one dollar change in Stock Price [12]

Sometimes a portfolio contains so many positions in options and stocks that it is impossible to group the options into synthetic positions. In this case calculating the deltas of the options in the portfolio will advise you whether the portfolio is bullish or bearish. This is a tool used by option traders who hold large positions in many different options. The Delta is defined as:

Change in option price / Change in stock price = Delta

As an example, assume that the underlying stock rises $1 and the option price rises $0.25. In this case, the delta of the option is .25; the option moved 25 percent of the stock price movement. The delta is important because it gives a current estimate of the expected value of an option price change for every $1 movement in the stock price. "Current" is the operative word. Option traders often think only of what will happen on the date of expiration forgetting about the potential volatility of the options prior to expiration.

Delta is also the probability that a stock will be in-the-money when the option expires. [13]

Delta, however, is not static. The delta of an option changes as the option goes from being an out-of-the-money option to an in-the-money option. The price of an out-of-the-money option changes by a small percentage of the stock price change. The price of an at-the-money option changes by approximately 50 percent of the stock price change. As an option becomes more and more in-the-money, its delta rises and gradually approaches 1.00 or trades with the same profit and loss as the stock itself (reflecting 100 percent change of the option as with the stock). This means that the price of a

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[12] Brokerage firms often provide The Greeks to customers on line. It is also available for free at websites like *available at* <www.pcquote.com> *(last visited December 22, 2003).*

[13] It is also the first derivative of the stochastic calculus equation in the Black-Scholes Option Pricing Model.

deep-in-the-money option moves dollar for dollar with the stock price movement. A Put option has a negative delta while a Call option has a positive delta. Shorting or selling these options reverses the sign, translating to a negative delta for a Short Call option and a positive delta for a short Put option.

Professional Option traders try to maintain Delta Neutral portfolios (where the negative and positive deltas cancel each other out), which are thus hedged and should not suffer much loss regardless of whether the market moves up or down. Calculating the delta of a portfolio or the position in a portfolio will provide a measure of how bullish or bearish is the portfolio. Thus if a broker claims a position was well hedged with options, calculating the deltas in the portfolio can impeach or verify this assertion.

TOOLS FOR THE SKILLED and "FINANCIAL WEAPONS OF MASS DESTRUCTION"[14] FOR THE UNSKILLED

There are differing view points as to whether Options represent tools to manage risk or are leveraged disasters waiting to happen. Famed investor Warren Buffett referred to options, in his annual letter to Berkshire shareholders, as "financial weapons of mass destruction, carrying out dangers that while now latent are potentially lethal." Berkshire Hathaway Annual Report 2002 13-15 *available at* <http://berkshirehathaway.com/2002ar/2002ar.pdf> *(last visited December 22, 2003)*. One of Buffett's recently acquired companies is closing its positions in these contracts. "We're now in the process of getting out - but it's a little like hell," Buffett said. *Id.* "It's easy to get into but very hard to get out of." *Id.* Referring to the bankrupt Enron Buffet noted that the "range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen)." *Id.*

On the other hand, Federal Reserve chairman Alan Greenspan believes that but for the use of derivatives such as options, the economy would be a mess perhaps akin to the Great Depression. Greenspan noted that "the performance of the economy and the financial system in recent years suggests that those benefits have materially exceeded the costs." Remarks by Chairman Alan Greenspan May 8, 2003 Corporate Governance *available at* http://www.federalreserve.gov/boarddocs/speeches/2003/20030508/default.htm> *(last visited December 22, 2003)*. He continued by noting that "(t)he use of a growing array of derivatives and the related application of more-sophisticated methods for measuring and managing risk are key factors underpinning the enhanced resilience of our largest financial intermediaries. Derivatives have permitted financial risks to be unbundled in ways that have facilitated both their measurement and their management." *Id.*

The reality is that brokerage firms trading their own portfolios and larger institutional investors benefited from the use of options to protect their portfolios and mange their risk. Few brokers understand options and how to use them to manage risk. Instead they used options to increase purchasing leverage and thus risk.

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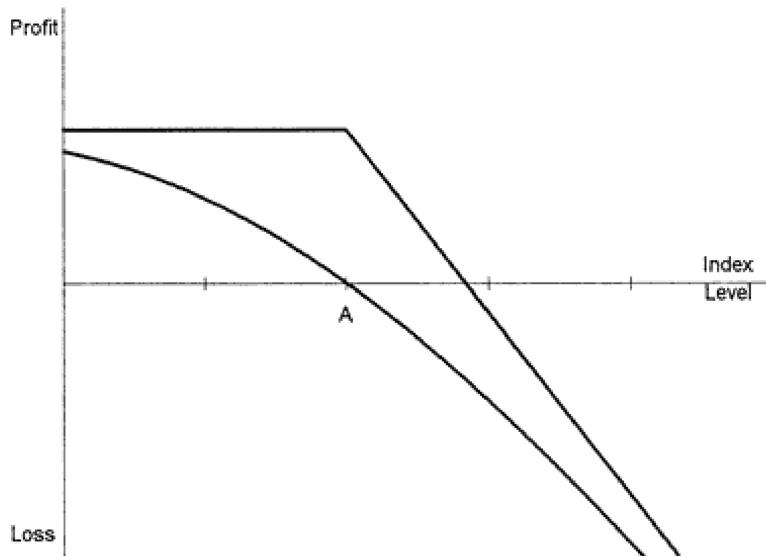
[14] Berkshire Hathaway Annual Report 2002 13-15 *available at* <http://berkshirehathaway.com/2002ar/2002ar.pdf> *(last visited December 22, 2003).*

Appendix [15]

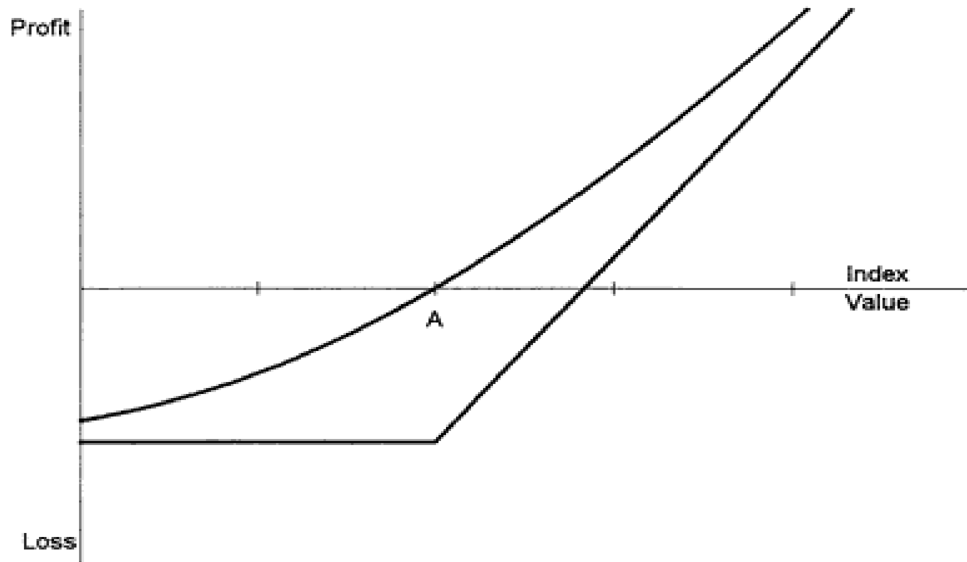
[15] James B Bittman, *Trading Index Options*, 24-26 (1998).

Long Call the straight line is a diagram of a strategy's profit and loss at expiration, and the curved line is an estimate of profit and loss at some time prior to expiration.

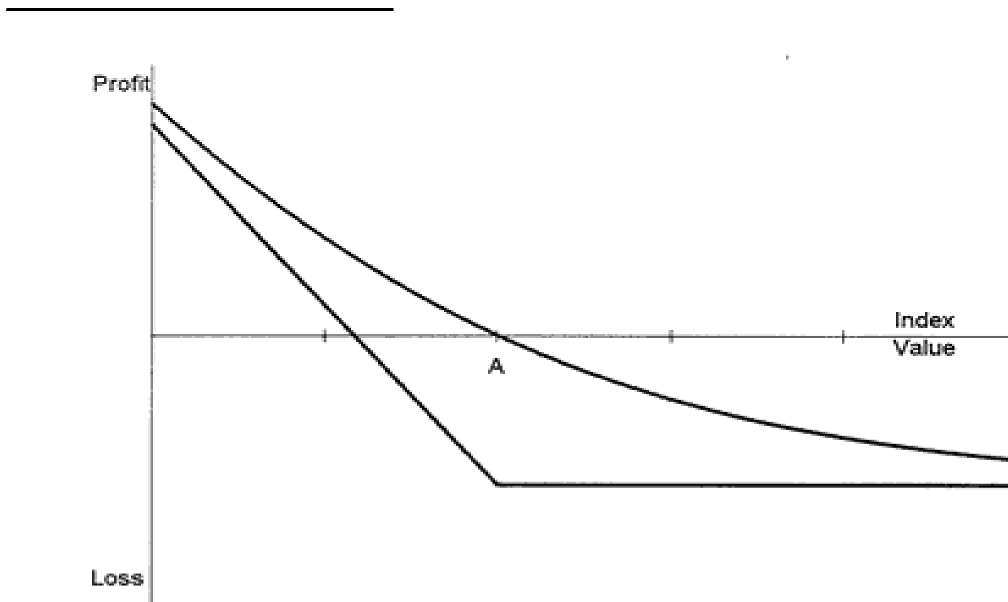


Example:	Sell 1 Call, Strike A
Maximum profit potential:	Limited to premium received
Maximum risk potential:	Unlimited
Break-even point at expiration:	Strike A plus premium received
Desired movement:	Neutral or moderately bearish
Effect of passage of time:	Positive. Options decrease in value with the passage of time if other factors remain constant.
Effect of increase in volatility:	Negative. Options increase in value with an increase in volatility if other factors remain constant.
Comment:	Suited only for experienced index option traders who qualify for the highest level of risk, this strategy is appropriate when a short-term market forecast is neutral or moderately bearish and when volatility is expected to remain constant or decrease. Successful application depends on making a three-part forecast: underlying price movement, time, and volatility. Selling calls is discussed in Chapter 9, "Selling Options."

Short Call the straight line is a diagram of a strategy's profit and loss at expiration, and the curved line is an estimate of profit and loss at some time prior to expiration.

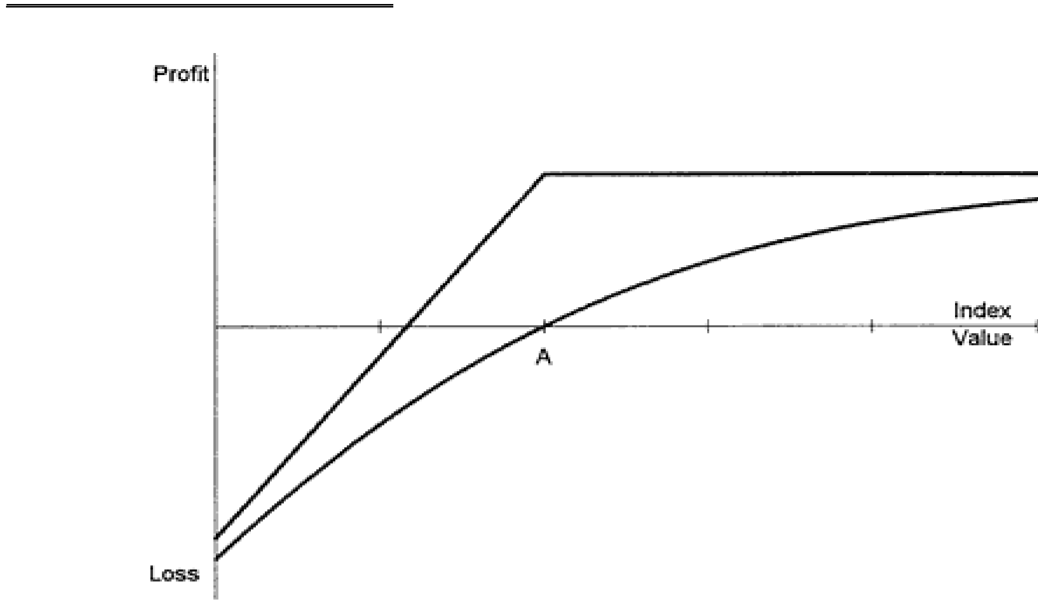


Example:	Buy 1 Call, Strike A
Maximum profit potential:	Unlimited
Maximum risk potential:	Limited to premium paid for the call
Break-even point at expiration:	Strike A plus premium paid
Desired movement:	Bullish
Effect of passage of time:	Negative. Options decrease in value with the passage of time if other factors remain constant.
Effect of increase in volatility:	Positive. Options increase in value with an increase in volatility if other factors remain constant.
Comment:	This basic strategy can be an excellent choice for a short-term bullish forecast when volatility is low and expected to remain constant or increase. Successful application depends on making a three-part forecast: underlying price movement, time, and volatility. Buying calls is discussed in depth in Chapter 8, "Buying Options."



Example:	Buy 1 Put, Strike A
Maximum profit potential:	Substantial. The profit potential is limited to the index falling to zero less the premium paid.
Maximum risk potential:	Limited to premium paid for the put
Break-even point at expiration:	Strike A minus premium paid
Desired movement:	Bearish
Effect of passage of time:	Negative. Options decrease in value with the passage of time if other factors remain constant.
Effect of increase in volatility:	Positive. Options increase in value with an increase in volatility if other factors remain constant.
Comment:	This basic strategy can be an excellent choice for a short-term bearish forecast when volatility is expected to remain constant or increase. Successful application depends on making a three-part forecast: underlying price movement, time, and volatility. Buying puts is discussed in Chapter 8, "Buying Options."

Long Put the straight line is a diagram of a strategy's profit and loss at expiration, and the curved line is an estimate of profit and loss at some time prior to expiration.



Example:	Sell 1 Put, Strike A
Maximum profit potential:	Limited to the premium received
Maximum risk potential:	Substantial. The potential risk is limited to the index falling to zero less the premium received.
Break-even point at expiration:	Strike A minus the premium received
Desired movement:	Neutral to moderately bullish
Effect of passage of time:	Positive. Options decrease in value with the passage of time if other factors remain constant.
Effect of increase in volatility:	Negative. Options increase in value with an increase in volatility if other factors remain constant.
Comment:	Suited only for experienced index option traders who qualify for the highest level of risk, this strategy is appropriate when a short-term market forecast is neutral or moderately bullish and when volatility is expected to remain constant or decrease. Successful application depends on making a three-part forecast: underlying price movement, time, and volatility. Selling puts is discussed in Chapter 9, "Selling Options."

Short Put the straight line is a diagram of a strategy's profit and loss at expiration, and the curved line is an estimate of profit and loss at some time prior to expiration.

Equity Unit Investment Trusts: Great to Sell/Expensive to Buy

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During the late nineties, there was a dramatic increase in the number of Equity Unit Investment Trusts (UITs) sold by brokers and brokerage firms to investors.[1] While the number of sales has declined in recent years, UITs are still actively marketed to investors. A review of the sales material used by broker-dealers provides that owning UITs is advantageous because they have low expenses, favorable tax treatment, diversification and professional portfolio selection.[2] An explanation of UIT features and a comparison to alterative products is warranted to evaluate the accuracy of these claims.

Background:

Historically, the majority of UITs were invested in fixed-income investments; in the late nineties, however, there was a significant increase in the creation of new equity UITs. According to the Investment Company Institute (ICI) of Washington D.C., in 1996, Equity UITs represented about 34 % of the total UIT market. This number rose to 49 % in 1997, 60 percent in 1998, and over 68 percent in 1999.[3]

Deposits into UITs also rose during that time. About $40 billion was deposited into Unit Investment Trusts in 1997, according to the ICI. That number climbed to about $60 billion in 1998, and grew to $75.32 billion in 1999.[4] In recent years deposits into UITs have declined, in part due to the increased popularity of Exchange Traded Funds and some companies, such as Merrill Lynch, are no longer offering them.

It is difficult to find historical or comparative data on UITs. Neither Morningstar nor Lipper offers information on them and you can't find daily prices on UITs in the paper.[5]

Some broker-dealers sponsor their own trusts, or they sell trusts sponsored by nationally recognized independent sponsors. The two prime independent sponsors of UITs are First Trust Portfolios (previously known as Nike Securities) and Van Kampen, a company owned by Morgan

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[1] Unit Investment Trusts are also known as Defined Portfolios and Defined-Asset Trusts.

[2] First Trust Portfolios, L.P, "Advantages of the Defined Portfolio" at http://www.ftportfolios.com.

[3] Investment Company Institute, "What is a Unit Investment Trust?" at http://www.ici.org.

[4] Id.

[5] Dagen McDowell, "UITs Are Hot, but Hard to Compare," March 11, 1999 at http://thestreet.com.

Stanley.[6]

Sponsors offer a variety of types of UITs; among them are Sector Portfolios, which are composed of companies involved in a specific industry such as technology, financial services, etc; Theme Portfolios, which invest in companies across a variety of sectors that share a common theme; and Target Strategy Portfolios, which are structured to mirror the performance of a particular index. [7]

Description

A UIT is a registered investment company that buys and holds a generally fixed portfolio of stocks, bonds, or other securities.[8] "Units" in the trust are sold to investors (unitholders) who receive a share of principal and dividends (or interest). A UIT has a stated date for termination that varies according to the investments held in its portfolio.[9] When these trusts are dissolved, proceeds from the securities are either paid to unitholders or reinvested in another trust.[10] There is no secondary market for the trusts unless the broker-dealer maintains one. However, the trusts are required by law to redeem outstanding units at their net asset value, which is based upon the current market value of the underlying securities.

Costs and Expenses

While annual expenses for UITs are usually lower than those of actively managed funds, an accurate portrayal of annual expenses should be adjusted to reflect all costs associated with the investment, including sales charges. The typical sales charge for a UIT is anywhere from 3.5% to as high as 4.95%, depending on the term of the trust. Sector-specific UITs issued in the late nineties were typically eighteen months to two years in duration. A review of the current sector-specific UIT offerings from First Trust Portfolios shows an average sales charge of 4.95% for an average term of five years. Van Kampen's average sales charge is 4.95% for an average term of two years.

The sales charges are staggered so that a 1% sales charge will be paid immediately, followed by monthly deferred sales charges thereafter. Investors are also charged annual expense fees that are between .400% to over .550%. These costs include a trustee's fee, administrative fees, creation and development fees, and an ambiguous category of "miscellaneous expenses".

For example, the breakdown of expenses for Morgan Stanley's Technology Index Portfolio Series 30 is as follows [11]:

Initial sales charge	1.00%
Deferred sales charge in first year	1.350%
Creation and development fee	0.600%
Maximum first year sales charge	**2.950%**
Deferred sales charge in second year	1.550%
Total sales charge	**4.500%**

[6] Morgan Stanley purchased Van Kampen in 1996.

[7] First Trust Portfolios, "Types of Defined Portfolios" at http://www.ftportfolios.com.

[8] Equity UITs typically hold between 25-35 stocks.

[8] Equity UITs terms are typically between 13 months to 5 years.

[10] Investment Company Institute, "What is a Unit Investment Trust?" at http://www.ici.org.

[11] Morgan Stanley Technology Index Portfolio, Series 30 at http://www.vankampen.com/products/uit/MSHT/MSHTovr.asp.

In addition to these sales charges there are –

Estimated Organization Costs	0.404%
Estimated Annual Expenses	
Trustee's fee and operating expenses	0.159%
Supervisory, bookkeeping and administrative fees	0.041%
Total Expenses	0.200%

These charges are not disclosed on the confirmation and, unless the broker informs the investor of these costs prior to the sale, the only other source for the information is the prospectus, which is typically mailed with the confirmation.[12]

While the following may not be considered an "apples to apples" comparison, it illustrates the costs and expenses of owning UITs relative to those of a mutual fund over ten years.[13] For comparison purposes, I will use the Morgan Stanley Nasdaq – 100 Index Fund and the Van Kampen Morgan Stanley Technology Index Portfolio Series 30. These products have similar objectives and holdings.

Morgan Stanley Nasdaq – 100 Index Fund:[14]

The maximum sales charge for A shares in this fund is 5.25%. The example provided assumes an investment of $10,000 for the time periods indicated, with redemption of all shares at the end of those periods. The example also assumes a 5% annual return, and that the fund's operating expenses remain the same each year.

Morgan Stanley Nasdaq 100 Index Fund:

1 Year	3 Years
$606	$779

5 Years	10 Years
$966	$1,508

Van Kampen Morgan Stanley Technology Index Portfolio Series 30:[15]

This trust has a term of two years (September 24, 2003 through September 20, 2005) with a Special Redemption Date of December 20, 2004.[16] The first year sales charge is 2.95% and the second year charge is 1.55% for a total sales charge of 4.5%. Assuming a $10,000 investment, a 5% annual return with redemption at the end of each period the expenses would be -

Morgan Stanley Technology Index Portfolio

1 Year	3 Years
$360	$810

5 Years	10 Year
$1,280	$2,520

The example assumes that the investment is rolled over into a new series of the Portfolio every two years.

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[12] Investors receive a prospectus with their confirmation of the sale, regardless of whether they buy units in the initial offering or in the secondary market.
Investment Company Institute – A guide to Unit Investment Trusts.

[13] Comparisons with actively traded funds render similar results.

[14] Morgan Stanley Nasdaq-100 Index Fund Prospectus at http://morganstanleyindiviudal.com.

[15] Morgan Stanley Technology Index Portfolio, Series 30

[16] Special Redemption is described as follows: The Trustee will redeem Units designated with a Classic CUSIP number or a FeeDom CUSIP number of the Special Redemption Date set forth in the "Summary of Essential Financial Information". If a substantial amount of Units are held by these accounts, this process could significantly reduce the size of your Portfolio and cause expenses to increase or cause the Portfolio to terminate before its Mandatory Termination Date.

If we were to compare the costs with a low cost, no load mutual fund such as Vanguard, the difference in costs would be even greater.

Vanguard Growth Index Fund [17]

1 Year	**3 Years**
$24	$74

5 Years	**10 Years**
$130	$293

Clearly the costs and expenses for UITs are high. The example above only extends for ten years. A twenty-year calculation would result in even greater cost disparities. In addition to high expenses, UITs carry a high tax burden. With limited exceptions,
investors who have gains on their UITs when the trust terminates must pay capital gains. Given that the average term of these trusts is two years, these expenses and tax costs will significantly erode potential earnings for an investor with a long-term time horizon.

Tax Treatment

The industry claims that UITs offer favorable tax treatment, because they are not actively traded and do not have any embedded capital gains at purchase and, because UITs have stated maturities longer than 12 months, investors receive the more favorable long-term capital gains tax rate at maturity. [18] However, with the limited exceptions discussed below, any gain or loss received upon termination of a trust is recognized immediately.[19] Given that the average term of an Equity UIT is two years, and assuming an investor has a minimum time horizon of ten years, taxes could get complicated. To defer taxes further, investors must take an in-kind distribution. [20] This option, the industry claims, will allow an investor to control the timing of when they sell their shares and incur capital gains taxes. [21] However, the implications of this option are problematic. A client would have shares of between 20 to 35 stocks in various amounts in their account. The investor would have to manage these holdings and pay additional commissions to sell them.

A second option may be a tax-deferred rollover. In a tax-deferred rollover, no gains are recognized for stock sold in the terminating trust, which are repurchased in the new trust. However, in order to take advantage of this option, a new series must be available.

Breakpoints

UITs, like mutual funds, offer breakpoints. Van Kampen Focus Portfolios Series 405 details the following discounts for large quantity purchases –

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[17] This fund is used for illustration purposes only and does not use a technology style index.

[18] First Trust Portfolios, "Advantages of the Defined Portfolio" at http://www.ftportfolio.com.

[19] These rules do not apply to qualified retirement accounts.

[20] An in-kind distribution is an election by the investor to not have the assets of the liquidated, but to have the stock or securities distributed as stock.

[21] First Trust Portfolios, "Advantages of the Defined Portfolio" at http://www.ftportfolio.com.

Transaction Amount	First Year Sales Charge
Less than $25,000	4.95%
$50,000-$49,999	4.75%
$50,000-$99,000	4.50%
$100,000 -$249,000	4.00%
$250,000 - $499,999	3.50%
$500,000 - $999,999	2.50%
$1,000,000 or more	1.25%

These reduced sales charges for quantity purchases apply only to purchases made by the same person or family on the same day and only from the same dealer. In other words, if a broker spreads the purchases over several days, the breakpoints will not be applied.

Concentration

In the guide "What Is a Unit Investment Trust?" published by the Investment Company Institute, one of the "Key Features" attributed to UITs is Diversification:

A UIT diversifies its holdings by purchasing a variety of stocks or bonds. The

> trust's diversified investment portfolio helps reduce an investor's risk by offsetting potential losses from some securities with potential gains in others. The average investor might find it expensive and difficult to construct a portfolio of individual securities as diversified as that of a UIT. [22]

This description is misleading. While UITs do hold a variety of stocks, many of the UITs sold in the late '90s were sector portfolios. These portfolios are inherently concentrated. This risk is typically noted in the prospectus. For example, Morgan Stanley's Tele-Global Trust Series A prospectus states-

> When stocks in a particular industry make up 25% or more of the portfolio, it is said to be 'concentrated' in that industry, which makes the portfolio less diversified. [23]

Concentrated portfolios had devastating consequences to many investors holding UITs when the technology market collapsed in 2001.

Passive Management

Equity Unit Investment Trusts employ a "buy and hold" strategy. This strategy is claimed to be beneficial, because it provides an alternative to investing in funds, where securities may be continually traded, or investing in individual stocks, which may be riskier, time-consuming and costly. [24] Investors in UITs, unlike those in mutual funds, will know exactly what stocks they own, thereby eliminating the element of uncertainty, according to the industry. But while there are arguments for and against passive management versus active management, the "buy and hold" strategy, coupled with the set term dates of UITs,

[22] Investment Company Institute, "What is a Unit Investment Trust?" at http://www.ici.org

[23] Morgan Stanley, "Equity Investor Fund Concept Series Tele-Global Trust 2000 Series A," 02/16/2000

[24] www.morganstanleyindividual.com/investmentproducts/unittrusts/

can create more uncertainty and greater risk because the portfolio cannot be adjusted for market changes during the term of the trust. More importantly, there are alternative products available to investors with these concerns that are passively managed, less expensive and have no term restrictions.

Alternative Products

Exchange Traded Funds: Exchange Traded Funds (ETFs) are similar to UITs in that they are unmanaged and hold a basket of stocks, but with considerably lower fees. Most ETFs are Unit Investment Trusts, and represent a portfolio of common stocks that closely track the performance of a specific index—broad market, sector or international. ETFs are listed and traded on a public exchange. The tax implications of ETFs are identical to those of ordinary stocks. [25]

Index Funds: Index funds use an investment approach that seeks to track the investment returns of a specified stock or bond market benchmark, or index. Indexing is a "passive" investment approach, emphasizing broad diversification and low portfolio trading activity. [26] Index funds are normally no-load funds, which will rarely be recommended by a broker. However, even index funds that have a sales charge may cost the customer less than UITs.

To illustrate the difference in costs of investing in an ETF, Index Mutual Fund and a UIT, I will compare the costs of investing $100,000 in QQQ, an ETF that tracks the Nasdaq 100, Morgan Stanley's Nasdaq-100 Index Fund, and Morgan Stanley's Technology Index Portfolio. [27] The sales charges have been adjusted for breakpoints.

	Cost	**Term**
QQQ	$1,078 [28]	Indefinite
Morgan Stanley Nasdaq-100 Index Fund A – share Sales charge 3%	$3,000	Indefinite
Morgan Stanley Technology Index Portfolio Sales charge 3.80%	$3,800	Two years

[25] An ETF is an index investment crossed with an exchange-listed corporate security and an open-ended mutual fund. ETFs represent ownership of a portfolio of common stocks that closely track the performance of a specific index, either broad market, sector or international.

[26] Low cost is a key advantage of index funds. An index fund should pay only minimal advisory fees, keep operating expenses at the lowest possible level, and keep portfolio transactions costs at minimal levels. So, index funds leave a larger share of the pie for investors.

[27] These investment have similar holdings.

[28] This commission could be significantly reduced if purchased through a discount broker.

The increased popularity of the ETFs has not gone unnoticed by the sponsors of UITs. These companies now offer a variety of trusts that invest directly into the ETFs. For example, Van Kampen offers its Roaring 2000 Portfolio, which has a two year term, a sales charge of 4.5%, and invests in ETFs thought to be favored by business pundit Harry S. Dent, Jr. [29] The trust invests in a handful of index funds in the financial, healthcare and technology sector. Under the heading "special considerations," Van Kampen itself acknowledges that:

> ...by investing in other funds, the trust incurs greater expenses than you would incur if you invested directly in the funds. [30]

In other words, for the privilege of Van Kampen selecting 12 preexisting ETFs that could be purchased directly, a customer pays 4.5% sales charge for a two-year term.

Considering these facts, how did so many portfolios end up with large purchases in UITs? As with most products, examining the commissions paid to the brokers and the fees paid to the sponsors provides the answer. These are products that are sold, not bought.

Dealer and Rep Commissions

Concessions for selling UITs are generous. As detailed in the Van Kampen Focus Portfolios Series 405 prospectus, dated September 24, 2003, brokers, dealers and others are allowed a regular concession or agency commission in connection with the distribution of Units during the initial offering period, as described in the following table:

If the funds are deposited pursuant to a rollover, the concession is 2.70%. Again, given that the average term of these trusts is two years, this rollover concession is added incentive for brokers to sell UITs allowing them to annuatize their business. [31]

Transaction Amount*	
Less than $24,999…………………	3.70%
$25,000 - $49,999…………………	3.50
$50,000 - $99,999…………………	3.25
$100,000 - $249,999………………	3.00
$250,000 - $499,999………………	2.75
$500,000 - $999,999………………	1.75
$1,000,000 or more………………..	0.90

[29] Harry Dent, Jr. is the author of several books on the future of business and technology including The Roaring 2000s. He has been speaking since 1988 and prior to that has been the CEO of several companies giving him the experience and background to be considered an expert. Harry received his MBA from the Harvard Business School.

[30] Van Kampen Focus Portfolios, Series 405 prospectus, dated September 24, 2003, at http://www.vankampen.com/products/uit/ROAR/ROARover.asp

[31] Donald Jay Korn, Financial Planning, March 1, 1999.

There are added volume sale concessions based on total initial offering period sales of all UITs during a quarterly period.[32] Preferred Distributors receive an additional reallowance of 0.10% of the Public Offering Price per unit.[33]

In addition to these concessions, sponsors can provide a number of added incentives intended to further compensate registered representatives who sell its UITs:

- Broker-dealers, banks and/or others can participate in programs in which they receive awards for registered representatives who have sold a minimum number of units.
- Sponsors may reallow an amount, not exceeding the total sales charges, on sales generated at the public offering price by registered representatives of broker-dealers, banks and/or others.
- The sponsor in its discretion may pay fees to qualifying entities for certain services or activities that are primarily intended to result in sales of Units of the Portfolios.[34]

Sponsor Compensation

Compensation to the Sponsors is considerable. While the following is not an exhaustive list, the Sponsors receive:

- A gross sales commission equal to the total transactional sales charge applicable to each transaction.[35]
- The creation and development fee.[36]
- Sponsors' Profits both from the initial offering and secondary market transactions.[37]

In addition to these costs, Sponsors receive compensation for bookkeeping, administrative

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[32]

Initial Offering Period Sales During Quarterly Period	**Volume Concession**
$2 million but less than $5million……..	0.025%
$5 million but less than $10 million…..	0.050
$10 million but less than $50 million….	0.075
$50 million or more…………	0.100

[33] The "Preferred Distributors" include the following firms and their affiliates: A.G. Edwards & Sons, Inc., Citigroup Global Markets Inc., Edward D. Jones & Co, Morgan Stanley DW Inc., UBS Financial Services Inc., and Wachovia Securities, Inc.

[34] Van Kampen Focus Portfolios, Series 405 prospectus, dated September 24, 2003, at http://www.vankampen.com/products/uit/ROAR/ROARover.asp

[35] The combination of the initial and deferred sales charges comprises the "transactional sales charge".

[36] The creation and development fee compensates the Sponsor for the creation and development of each Portfolio.

[37] "The sponsor will realize a profit or loss as a result of the difference between the price paid for the Securities by the Sponsor and the cost of the Securities to the Portfolios on the Initial Date of Deposit as well as on subsequent deposits….In maintaining a secondary market, the Sponsor will realize profits or losses in the amount of nay difference between the price at which Units are purchased and the price at which Units are resold (which price includes the applicable sales charge) or from a redemption of repurchased Units at a price above or below the purchase price." – Van Kampen Focus Portfolios, Series 405 prospectus, dated September 24, 2003, at http://www.vankampen.com/products/uit/ROAR/ROARover.asp

services and miscellaneous expenses.

Conclusion

Contrary to industry claims, there seems to be little advantage to owning UITs. Given the alternative investments available, one would be hard pressed to conclude that UITs offer favorable tax treatment or are cost effective to own. The high compensation to the brokers and the fees generated by the sponsors make it obvious why brokers and their firms love to sell UITs, but investors would be well advised to scrutinize the costs and risks of owning them.

Goliath Refuses to Yield

By Mark A. Tepper

Mark Tepper is a securities lawyer in Fort Lauderdale, Florida. He is the principal of Mark A. Tepper, P.A. He has practiced securities law since 1977. He served as Chief Trial Counsel for the Bureau of Investor Protection and Securities for the New York At torney General and was Vice Chairman of the Special Projects committee and an active lecturer for the North American Securities Administrators Association. He has represented private clients since 1988. His email address is matepper@ bellsouth.net and he can be reached at 954-961-0096

Stock traders say, the trend is your friend. But it has not been friendly to Merrill Lynch. The recent trend in confidentiality orders is that Merrill Lynch has been ordered to produce its compliance and supervision manuals without a confidentiality order. Similar orders have been entered against other broker dealers. The trend supports the conclusion that manuals are ordinary business records that have previously been disclosed without a confidentiality order.

Successful counsel have reported that Merrill Lynch produced its manuals or portions of them pursuant to these orders. Disclosure of confidential material is a waiver of a claim of confidentiality, but Goliath refuses to yield. In spite of the record of its public disclosure, Merrill Lynch continues to fight for blanket confidentiality orders for its ordinary business records. The following arguments were drafted in opposition to a request for a confidentiality order relating to compliance and supervision manuals. We acknowledge the assistance received from many PIABA members in compiling the following arguments and authorities:

Claimant's Opposition to Respondent's Improper Insistence on a Confidentiality Order

Respondent's demand for a burdensome confidentiality order to protect ordinary business records is unreasonable. Rules protecting confidential records do not apply because Respondent's business manuals and related materials are not confidential. Respondent knows they are not confidential or proprietary. Respondent has disclosed its internal supervision and compliance manuals to other parties without a confidentiality agreement which places them in the public domain.

In its motion, Respondent did not disclose to the Chairperson that Respondent has previously been ordered to produce the same records to other parties without a confidentiality agreement. [1] A proposed order is attached which conforms with the text of previous orders denying Respondent's request for the same confidentiality order. (Exhibit 1). Grounds for denying Respondent's frivolous motion are discussed below.

Respondent's Manuals Are Not Confidential

Claimant has made a routine request for ordinary non-confidential business manuals under section II and Document Production list 1,

[1] Respondent's counsel owes a duty of candor to the tribunal. Florida Bar Rule 4-3.3.

item 9 of the NASD Notice to Members 99-90 ("Discovery Guide"). According to the Discovery Guide, Respondent was required to produce its manuals and compliance memos in June, 2003, 30 days after the filing of its Answer. Respondent's refusal to produce them without an onerous confidentiality order is unnecessary, unsupportable and unfairly delays discovery.

Within the past six months, NASD Chairpersons have repeatedly held that Respondent's manuals and Compliance Memos are not confidential and are discoverable without a confidentiality agreement. See Order on Discovery, Crumpler v. Merrill Lynch et al., NASD Case No. 02-03178 (August 15, 2003); See Order on Discovery Hohlfelder v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., NASD Case No. 02-06771 (October 17, 2003); See Order on Discovery Bosley v. Merrill Lynch, et al., NASD Case No. 02-04965 (June 2, 2003); See Order on Discovery, Chiswell v. Merrill Lynch, NASD Case No. 02-04112 (March 18, 2003). (Exhibit 2).

On information and belief, a NYSE Chairperson also ordered Respondent to produce its manuals in discovery without a confidentiality agreement. Stapleton v. Merrill Lynch, NYSE No. 2002-09730. Other broker-dealers have also been ordered to produce their internal supervision and compliance manuals without a confidentiality agreement.[2] Respondent knows that its manuals are in the public domain and can no longer be confidential.

Respondent's counsel also represented Respondent in Chiswell, referenced above, when Respondent was ordered to produce its Manuals without a confidentiality agreement. See NASD Dispute Resolution Letter dated March 24, 2003, (Exhibit 2). Based on Respondent's prior disclosure of its Manuals in these other cases, Respondent's argument that its manuals are confidential is not supported by the facts.

In Miller v. Smith Barney Harris Upham, 85-86 Fed. Sec. L. Rep. & 92,498 (S.D.N.Y. 1986), the court addressed the confidentiality of brokerage compliance manuals. In that case, the court specifically held that brokerage compliance manuals are not confidential. In reaching that holding, the court noted, among other things, that a brokerage firm was required to develop and maintain compliance manuals by the SEC, NASD and New York Stock Exchange and that such manuals were routinely inspected by those regulatory bodies. The court noted that given "these external requirements to compile and make available internal regulations" the documents cannot be regarded as confidential or privileged. Id. (Exhibit 3).

Respondent has the Burden of Proof

The party seeking to impose the confidentiality order must show that a "clearly defined and very serious injury" will result if a confidentiality order is not issued and must provide the court with "information from which it can reasonably conclude that the nature and magnitude of the moving party's interests are such that a protective intervention by the court is justified." Koster v. Chase Manhattan Bank, 93 F.R.D. 471, 478 (S.D.N.Y. 1982)(quoting other cases). The court must then consider "whether the Order will prevent threatened harm, whether there are less restrictive means to preventing the threatened harm, the interests of the party opposing the motion and the interests of the public." Id.

The confidentiality issue was recently addressed in Dahdal

[2] See Order on Discovery, Balke v. Wachovia Securities, Inc, NASD Case No. 02-07295 (Sept. 23, 2003); See Order on Discovery, Gallucci v. Fleet National Bank, Case No. PC02-6837, Sup. Ct. of R.I. (July 16, 2003); See Order on Discovery, Sprengels v. Salomon Smith Barney, NASD Case No. 02-06064 (July 2003); See Order on Discovery, Mutter v. Salomon Smith Barney, NASD Case No. 02-03929 (June 2003); See Order on Discovery, Rich v. Salomon Smith Barney, NASD Case No. 02-03627 (Feb. 27, 2003); See Order on Discovery, Davis v. Raymond James, NASD Case No. 02-2803 (Jan. 28, 2003); See Order on Discovery, Miller v. Smith Barney, Harris Upham, 85-85 Fed. Sec. L. Rep. 492, 498 (S.D.N.Y. 1986).

v. Thorn Americas, Inc., 1997 U.S. Dist. Lexis 14 (D. Kan. 1997). In Dahdal, the defendants, like Respondent in this case, sought an Order restricting the disclosure of certain business manuals. The defendant argued that, “the manuals at issue contain proprietary and confidential business information which likewise should have restricted access.” The court held that the following standard should apply in deciding whether to enter a confidentiality order:

> **The party seeking a protective order has the burden** to show good cause for it. Sentry Ins. v. Shivers, 164 F.R.D. 255, 256 (D. Kan. 1996). To establish good cause, the party must submit "a **particular and specific** demonstration of fact, as distinguished from stereotyped and conclusory statements.” Gulf Oil Co. v. Bernard, 452 U.S. 89, 102 n. 16, 68 L. Ed.2d 893, 101 S. Ct. 2193 (1981). To limit the dissemination of items and information received in discovery, the movant must show "that disclosure of the information will result in a '**clearly defined and very serious injury**.’” See Zapata v. IBP, Inc., 160 F.R.D. 625, 627 (D. Kan. 1995) quoting Koster v. Chase Manhattan Bank, 93 F.R.D. 471, 480 (S.D.N.Y. 1982)).

Dahdal v. Thorn Americas, Inc., supra. (emphasis added).

After articulating the applicable standard, the court denied the requested protective order. The court concluded that the defendant did not meet its burden of showing "good cause" for keeping the documents secret and did not present adequate evidence that disclosure would result in "a clearly defined and serious injury." The court stated:

> Defendant has shown no good cause, however, for any further protection. A conclusory statement that proprietary, confidential business documents deserve special protection does not suffice. Business documents as a category do not qualify as intrinsically confidential and personal. Their disclosure does not necessarily cause a clearly defined and serious injury. Some business documents may be confidential or personal. The party seeking to protect them, however, bears the burden to show that. There are many types of business documents and manuals, some of which necessitate protection and some that do not. The court will not enter a blanket protective order protecting all documents in this case. To obtain an order protecting the confidentiality of business documents, the movant must do more than simply state that such documents are proprietary and confidential.

Dahdal v. Thorn Americas, Inc., supra. (emphasis added) (Exhibit 4).

Respondent has done nothing more than state that its manuals are "proprietary documents [that] are central to [its] operations, quality control, and business." Respondent’s argument is both conclusory and, as a matter of law, does not present adequate evidence.[3]

[3] “A conclusory statement that proprietary, confidential business documents deserve special protection **does not suffice**.” Dahdal, 1997 U.S. Dist. Lexis 14 (D. Kan. 1997)(emphasis added). Reed v. Bennett, 193 F.R.D. 689, 691(D. Kan. 2000)(denying party’s protective order, stating “As drafted, the proposed protective order would protect any document defendant reasonably contends contain proprietary and confidential information... By failing to identify specific documents or types of documents to be protected within the proposed protective order, defendant fails to meet the good cause standard.”

What makes these documents confidential, proprietary, and valuable remains unexplained.[4] If Respondent's manuals were confidential and disclosure would cause serious harm, its top management would be filing affidavits to prove it. The absence of affidavits from Respondent's management shows that Respondent knows that its manuals are neither confidential nor proprietary.

Respondent has not proved good cause. There is no evidence that Respondent will suffer serious harm. There is no specific demonstration of fact, only conclusory statements. Respondent has not proved that any portion of its manuals contain any trade secrets.[5] Respondent's legal citations do not prove the existence of any trade secret in its manuals.

The rationale behind requiring good cause for confidentiality orders is clear. Confidentiality orders are disfavored by the law. The purpose of discovery is to ensure that a trial or arbitration is "less a game of blindman's bluff and more a fair contest with the basic issues and facts disclosed to the fullest practicable extent." <u>United States v. Proctor & Gamble Co.</u>, 356 U.S. 677, 682 (1958).

Given the applicable legal standards, it is evident that no justification exists for requiring the Claimants in the present case to enter into a burdensome confidentiality agreement. Indeed, it is clear that the only reason that Respondent is seeking that confidentiality order is to improperly prevent the Claimants' counsel from "comparing notes" with other attorneys to determine if the documents produced by Respondent are complete and contain all of the information relevant to this case.

"Courts 'should be extremely skeptical about any rule that silences an [attorney's voice].'" <u>Koster</u>, <u>supra</u>. at 476 (citation omitted). The importance of allowing the Claimants' attorney to speak with other attorneys about the documents is evident from developments in this case. Claimant's counsel has already learned that Respondent is proposing to produce manuals in this case that do not contain all of the information needed by the Claimant. Attorneys handling other cases against Respondent have informed the Claimant's counsel that Respondent has supplemented its Compliance Manuals with numerous compliance memos that deal with a variety of compliance topics. If the attorneys in those other cases had been forced to enter into confidentiality agreements similar to the one that Respondent is seeking to impose in the present case, counsel for those parties could not have conveyed that

[4] "Painting the word 'Bull' on the side of a cow does not change that animal's gender." <u>Johnson v. Florida</u>, 382 So. 2d 693, 694 (Fla. 1980)(dissenting opinion). See footnote 2.

[5] Respondent's Compliance Manual does not even come close to meeting the definition of a trade secret as defined by the <u>Uniform Trade Secrets Act</u> (the "Act"), nor has it articulated any rationale as to why the panel should consider it to be protected as a trade secret in this case. Such is Respondent's burden. The Act defines a trade secret as "a formula, pattern, compilation, program, device, method, technique, or process, that:

> 1. Derives **independent economic value**, actual or potential, from not being generally known to, **and not being readily ascertainable by proper means** by, other persons who can obtain economic value from its disclosure or use, and
> 2. Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

See, e.g. Fl. Stat. Ann. Ch. 688.002 (2003)(emphasis added). See also, <u>Black's Law Dictionary</u>, 1039 (Abridged 6th ed. 1991).

important information to counsel in the present case.

Respondent is not seeking to impose a confidentiality agreement because it is truly concerned about the confidentiality of the information in its Compliance Manuals. Rather, Respondent wants to force each person who has a claim against Respondent to fight to obtain every relevant document. In addition, Respondent wants to prevent opposing counsel from knowing whether it has obtained all of the pertinent information. In essence, Respondent wants to make it as difficult and burdensome as possible for each claimant to prosecute their claim. This panel should not facilitate Respondent's cover-up of its misconduct by forcing the Claimants to enter into a confidentiality agreement.

Respondent's Case Law does not Prove Respondent's Manuals are Confidential

Respondent's reliance on Bercow v. Kidder Peabody & Co., 39 F.R.D. 357 (SDNY 1965) is misplaced. The court in Bercow did not rule that all supervisory and compliance manuals were confidential, only the manual before the Court. Its ruling was limited to an "operations manual" and "Security Releases" that were written over 40 years ago. The manual reviewed in Bercow was not the Respondent's manuals in this case. It was a different manual. The ruling in Bercow is limited to its facts and does not relieve Respondent from its burden of proving that its manuals are confidential, which it has failed to do. As interpreted by Respondent, Bercow is inconsistent with the well settled legal standard for obtaining a confidentiality order absent proof of good cause. As explained earlier, this standard has been approved by the United States Supreme Court.

Respondent's reliance on Boehme v. E.F. Hutton & Co., Inc., 1987 WL26811 (S.D.N.Y.) also misses the mark. Boehme is not even a securities fraud case. It is a sexual harassment claim. The fact that in different circumstances a company proved that its particular manuals contained confidential information is no evidence that, in the current circumstances, Respondent's manuals contain any confidential information.

Respondent similarly attempted to keep all relevant evidence secret when it was being investigated by New York Attorney General Elliot Spitzer. Respondent marked virtually every page of its documents that it produced to Spitzer's office as, "Confidential" or, "Proprietary," including its analyst policy and procedures manual. Respondent thus tried unsuccessfully to "keep the lid on" its alleged criminal violations. Attorney General Spitzer's response was the same as the one this panel should adopt in the present case: he flatly rejected Respondent's demand for secrecy, and released the documents publically.

Allowing Respondent to Unilaterally Determine Relevance is Improper

Respondent's manuals and compliance memos are relevant to prove that Respondent did not follow its own procedures. Evidence that Respondent did not follow its own procedures proves Respondent's failure to supervise [6], making it liable to Claimant for statutory damages. [7]

The Court in Miller explained the importance of the manuals and memos requested by Claimant:

> **Only disclosure of the**

[6] See Edwin Kantor, 51 S.E.C. 440, 446 (May 20, 1993) (holding "that reasonable supervision requires 'strict adherence' to internal company procedures,....").

[7] See section 517.211 Fla. Stat. of the Florida Investor Protection Act.

> **material facts of the contents of the manuals relating to internal supervisory procedures and compliance will reveal the possible extent of the firms' liability under state law.**
>
> **... other cases have based findings of liability on material contained in the internal procedural manuals.** See Hecht v. Harris, Upham & Co., 283 F.Supp. 417, *modified in* 430 F.2d 1202 (9th Cir.1970). The internal manuals described in (b) above must be disclosed.)

Miller, supra. at *5 & *7 (emphasis added).

Respondent has not produced a single page from its manuals, the table of contents, the index or its list of compliance memos.[8] This is not a case where Respondent has been asked to spend vast amounts of time or manpower scouring its files for material that is not of any significance to the issues. There is nothing burdensome about producing the manuals in their entirety. Indeed, it would be easier to produce whole manuals than to produce redacted versions that delete supposed "irrelevant" materials.

Respondent has overstepped its attorney powers by seeking the "judicial" power to unilaterally determine the relevance of Claimant's requests for its manuals.[9] Respondent's demand is equivalent to asking the fox to guard the chicken coop.

The intent of Respondent's motion for a confidentiality order is to obtain an unfair litigation advantage and devalue the claim. If granted, the confidentiality order unfairly prevents Claimant from comparing production with other counsel to verify the accuracy of production and gives Respondent unilateral control over relevance determinations. This is a blatant conflict of interest. With the checks and balances removed, Respondent can withhold unfavorable records without fear of exposure. Respondent's proposed order creates the appearance of impropriety and should be denied by the Chairperson.

Respondent's Proposed Confidentiality Order is Burdensome

Respondent asserts that Claimant should return all of Respondent's documents at the end of trial. Respondent wants to impose a burdensome task and cost on Claimant that serves no purpose. These manuals are not confidential because they have been disclosed to third parties without a confidentiality agreement, and therefore makes the task of returning Respondent's documents unnecessary.

Respondent's proposed confidentiality order would limit Claimant's ability to compare Respondent's production with other Claimants, providing Respondent with the opportunity to conceal critical, unfavorable evidence in its possession.

Conclusion

[8] In a footnote, the Boehm court stated that Defendant had initially refused to produce any documents. The court stated that this refusal was "disingenuous at best, deliberately dilatory at worst." Boehm v. E.F. Hutton & Co., Inc., 1987 WL 26811, *3 (S.D.N.Y.). Six months ago when the Panel was not available, as a compromise, Claimant provided Respondent with a confidentiality agreement that conformed with the Discovery Guide to avoid delay in receiving Respondent's manuals which were critical to Claimant's hearing preparation. Incredibly, Respondent still refused to provide its manuals. Thereafter, Claimant withdrew its agreement since, under the circumstances, Respondent's manuals were not confidential as a matter of law.

[9] Reed, 193 F.R.D. at 691(denying party's protective order, stating "Under [the protective order] term's, defendants could unilaterally choose to designate any such document as 'confidential'...By failing to identify specific documents or types of documents to be protected within the proposed protective order, defendant fails to meet the good cause standard."

Contrary to Respondent's argument, applicable principles of law and the Discovery Guide do not support Respondent's motion for a confidentiality order. Respondent's manuals are not confidential because they have been previously disclosed to third parties, without a confidentiality agreement, and contain no trade secrets. Respondent has failed to meet its burden of proving good cause for the extraordinary remedy of limiting Claimant's use of discovery with a confidentiality order.

Wherefore, Claimant requests that the Chairperson DENY Respondent's Motion for Entry of a Confidentiality Order, and that the Chairperson follow the decisions of other NASD Arbitration Chairs who considered the same arguments, and order Respondent to produce its manuals, updates, and compliance memos without a confidentiality agreement since Respondent's manuals are relevant to the Claimant's pending claim of failure to supervise and are not confidential. See proposed order attached (Exhibit 1).

Expert's Corner: Out Of Pocket Sum or OOPS

By John Lyman

John Lyman has been serving as an expert in suitability and damages and consultant in securities arbitrations since 1990. He has been engaged for a fee in more than 1,500 securities disputes and has testified at arbitrations and in court more than 60 times. Mr. Lyman's firm, Securities Trading Analysis & Research, Inc., prepares numerical account analysis, damages calculations, spreadsheet graphics and other exhibits, and provides litigation support for mediations and hearings.

This calculation, not invented by respondents but vigorously promoted by their legal counsel, is not, and cannot be, relevant to any securities claim. To consider this sum in any tort is to give credit, in the way of reduced wrongdoing, to the perpetrator for all the transgressions he did not commit. It is merely a scheme created by those charged with defending iniquitous transgressors and intended solely to minimize the liability for misconduct perpetrated on investors and this scheme has no place in the process of finding justice for investors who are victims of fraud or misconduct.

As a layman, there is no State or Federal law that I know of that even contemplates such a perverse way of viewing wrongs. This concept of reducing harm with lack thereof is not included in any legitimate discussion of righting the wrongs charges in securities arbitration or any other forum with the duty of dispensing justice.

This calculation lumps together all of the good conduct with the bad and therefore provides credit to the miscreant for the investments and other items unrelated to the transgressions and that were not an instrument of the misconduct.

If a burglar fails to take all of your money, should his punishment be reduced by the amount he failed to steal from you? That is exactly what happens in this convoluted method of viewing the misconduct.

Only after adding punitive interest and or the time value of the lost money is the income from an investment considered by State and Federal law. But the punitive interest and time value of the lost funds are not part of the OOPS.

All of the methods widely recognized by the State and Federal courts recognize each violation as a separate and individual act in a securities misconduct case, just the same way they do for criminal cases. Can you imagine a defense attorney attempting to tell a jury that his client should benefit from all of the muggings he could have perpetrated but was apprehended before he could accomplish them?

The rules of the NYSE and NASDR as well as the SEC, when contemplating the appropriate behavior of members and their representatives, say that each separate recommendation and transaction should be weighed by the industry representative and his supervision. They unmistakably view each unsuitable investment and fraudulent statement as a separate charge of misconduct. The rules require that each investment be viewed in relation to the whole picture of that particular investor's situation. But the

rules do not make allowance for the 'on balance' view of the conduct. A suitability or fraud violation is a separate and independent wrongful act and is not related in any way to other wrongful acts. Nor is the individual transgression related to infringements that could have taken place but did not.

This perversion of justice is helped by another concept that is just as backward. The whole idea that 'everyone lost money' after the tech bubble burst is just another shallow dodge invented by respondents.

I am certain that you all have cases involving investors for whom preservation of capital should have been a primary investment objective and in whose accounts the equity portion of the asset allocation in the account grew in direct proportion to the "irrational exuberance" in the stock markets, as described by the chairman of the Federal Reserve.

It is prudent investment guidance for almost every investor to own some equities all of the time, but most retirees and others who cannot replace lost capital should not have owned more than 25% equities at any time and should never have owned any the of high flying tech sector. Historically, the portfolio consisting of 24% equities and 76% fixed income is the least volatile as described in Ibbotson's and Associates analysis titled "Stocks and Bonds – Risk Versus Return". This analysis does not include volatility introduced by speculative investments; it simply demonstrates the wisdom of proper asset allocation.

The appropriate way of dealing with the stock market bubble is to maintain the asset allocation by selling stocks as they grew in value, to reduce their proportion of the account, and reallocating those funds to bonds or some other part of the equation.

Many of these retired investors should not have been allowed, by their financial advisors to even consider taking part in the speculative stock market boom. Therefore, it was a violation of the investor's suitability requirements to even own the volatile small capitalization stocks that collapsed when the bubble burst. Let alone allowing and even recommending a significant percentage of their net worth participating in the tech bubble.

Yet, what we hear from respondents is that we all lost money in the down market and therefore, the arbitrators should reduce the award by some amount proportional to the market decline. These people should never have even been exposed to the volatility that is a known factor in the small capitalization stocks sector.

I can imagine that most arbitrators, given their status in life, must have some investments, and therefore probably rode the bubble up and down and so they are sympathetic with the concept of sharing that bitter pill with the investing public. But the point here is that, if the asset allocation (marketing tool) models proposed by the industry (they all had a publicly available model); none of the major wire houses had more than 65% equities at any time during the great bull market. Yet the same firms allowed hundreds of thousands and maybe millions of their clients to allocate close to 100% to not only equities but to the most volatile of the equities available in the market. This is in direct contravention to their professed asset allocation model. Had these accounts included the proper asset allocation, they would have participated in the 30% total return of bonds that followed the bursting of the tech bubble.

And now, when these same investors have been crushed by the inevitable market reversal, respondents take the position that uses the gains from all investments, including income from bonds that they didn't even recommend. They do this not because there is any legal precedent or even logical explanation, but merely to reduce their liability exposure. When you take this logic to its end, the insanity of it all becomes clear.

The retired person makes up a large part of the public investor population and they represent an even larger part of those with arbitration claims. These people always wanted safe secure income, whether they were able to clearly communicate that to their industry representative or not. Even if they could not do so, the facts of their particular financial situation should have put them in that category no matter what the registered representative thinks he heard them say. Safety of principal with income is what is appropriate, and that is what these investors would be able to achieve with the proper asset allocation model.

When these retired investors buy a corporate or government bond, they get the promise of a stipulated income that they can withdraw, without reducing their principal. Bond investors, also get something else, they get, at least the promise of, the return of their principal at a specified date.

After all, since there are really only three ways to invest;
1. You can loan money to a corporation or government agency (bonds);
2. You can buy a share in the corporation (stocks) which allows you to share in the profits and growth of that corporation;
3. Or you can buy hard assets like real estate, precious metals, antiques, art or collectibles or commodities such as oil, farm products or industrial supplies such as iron ore or coal.

All other investments, including mutual funds, Unit Investment Trusts, limited partnerships, and the literally thousands of other investment products, are nothing more than derivatives of one or more of these three. All of these derivative products are created by the securities industry to make trading them easier, but also to increase fees and commissions beyond the cost of the transactions. I do not hold the position that they should not exist; they do play an important role in improving the ways for capital to efficiently go where it is most needed. I am only pointing out that investing is not really as complicated as industry insiders would have the investing public believe.

Only the individual bond investment (not bond mutual funds or other bond derivatives) promises the return of the intact principal. The bond investor can expect to spend the interest income from this loan and expect the return of his principal at a fixed date known at the time of the loan.

As you all already know, the registration of all securities and disclosure of pertinent financial and other data is required by the Securities Act of 1933 to be in a prospectus available to the investor to permit informed analysis of the potential investment. The Act also contains antifraud provisions prohibiting false representations and disclosures. Therefore, one could argue that the OOPS is a violation of the 1933 Act, since the OOPS changes the investment after the fact, and is not appropriately disclosed in the prospectus.

Respondents want to change that agreement after the fact. They want to say, after a claim has been filed and they are exposed to a liability, that the income received by the investor and spent by the investor, which was the arrangement under the original understanding, is now 'principal' to be used to offset capital losses, and by the way, respondent's liability. Incredibly, respondents attempt to include any and all income or capital gains ever incurred during the life of the relationship with that investor. Respondents will also include income and gains on other accounts at the firm held by the investors and members of the investors' family. Under this logic, no investor can ever expect back any more than they put into the account.

Respondents also include any dividend or capital gains on other stock positions, even if they were delivered into the account after being recommended and purchased at another firm. Even after the investor pays taxes on the income or gain, respondents still find the gain and the income eligible to reduce their liability if a claim is filed.

Respondents also include dividend income and capital gains from equities in the account to help reduce their liability whether they recommended them or not. Even after the investor pays taxes on the earnings respondents still consider the full amount of gain as eligible for reducing their liability.

The falsehood of this argument becomes clear when you carry it to its conclusion. Under this logic, a registered representative can make any foolish investment and generate any commission as long as the account value does not fall below the level of cumulative deposits to date. Under this logic, there is no such thing as unsuitable investments or fraud or misconduct, at least there is no penalty for these contraventions, as long as the account stays at or above the cumulative deposits.

If arbitrators allow this to happen, it would, and should, become a serious threat to the economy of the country because, if they do not put a stop to this, no one in their right mind would ever invest.

If arbitrators consider this logic, any gain of any kind, over the amount deposited, including investment income on which taxes have been paid, now becomes eligible to be counted against any losses from misconduct. As you can see there are serious faults in the logic of this calculation of damages. Arbitrators should not even allow this upside down logic into the evidence.

To do so is unfair, to say the least, and creates a threat to the immense economic strength of this great country. Investors would simply stop investing. If Americans stop investing, and they would if they believed that this is the justice they can expect, then corporations and governments would soon lose the ability to raise capital for any purpose and we would be back to an agrarian economy where everyone is occupied with acquiring enough food and shelter. There would soon be no capital to invest or need for capital.

We all know what the industry rules and State and Federal laws say about violations and how they are to be treated. To even consider the Out of Pocket Sum theory is to dismiss all of the investor protection laws ever created by any State, Federal government or regulatory agency. The only rule left would be caveat emptor. Any profits you are lucky enough to have achieved can be converted into commissions without recourse on your behalf.

The question for arbitrators when doing justice in the arbitration should not be 'Did the plaintiff lose more than they earned?', nor should it be, 'Did they lose more than others?' but 'Should their asset allocation have even allowed them to invest in these volatile securities?' and 'On whose shoulders does the industry place the burden of suitability?' and 'Who had the experience, industry knowledge and ability to make the suitability decision?'.

Arbitrators clearly need to be educated on results of following the respondents twisted and perverted logic. They also need to be better educated on the asset allocation concept and the suitability issues that are raised when they consider justice for investors. These suitability issues should include the amount of assets allocated to volatile equity securities when the investor really needed safety and income, and not did the investor ask to invest in them. It would be fair and appropriate, in my opinion for arbitrators to assume that the investor does not have the ability to make suitability decisions unless and until respondents can prove that the investor was more knowledgeable than the industry representative and his supervisors.

After all, it is the representative and not the investor who is required by law to prove their knowledge of suitability standards. The investor is not the one licensed and regulated and paid for recommending, or even allowing the transaction.

This writer hopes that some of these ideas and arguments make it into more complaints and opening and closing

statements. I believe the arbitration panelists are not well informed and therefore are too often influenced by these false and salacious arguments.

In my opinion, respondents are predictable. You can count on them emphasizing the out of pocket sum theory and you can count on them trying to shift the responsibility for suitability onto the shoulders of the uninformed, and often mislead (victim of fraud), investor. No compliance manual, state or federal law or regulatory agency places the burden of suitability on the investor.

These regulations and open disclosure allow for the free flow of capital. The regulatory agencies are pillars of the great American economic strength because they allow for the investor to place trust in the system. Without trust in the fairness of the investment world which includes the arbitration process, these pillars would crumble, because it would destroy the last vestiges of trust still left with the security industry.

Without that trust, placed by the public investor in the securities industry and in the securities arbitration process, this great apparatus of the American economy would quickly come grinding to a halt because there would soon be no capital to invest. Capital could not efficiently find its way to where it is needed most. America would no longer be the leader of the world's economy and, for that matter, the world economy and progress would be put in reverse. Oops.

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.

Elizabeth Boomer v. Morgan Stanley Dean Witter
NYSE Case No. 2002-01079

Claimant asserted the following causes of action: breach of contract, breach of fiduciary duty, negligence, fraud, unauthorized trading, violations of the Texas Deceptive Trade Practices Act and failure to supervise involving unsuitability, excessive trading in the Claimant's. account. This claim involved the trading in Morgan Stanley mutual fund B shares. Claimant requested compensatory damages, interest, costs, punitive damages and attorneys fees.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims.

1. The panel found Respondent liable to Claimant for $152,883 in compensatory damages plus prejudgment and post judgment interest.

2. The panel found Respondent liable to Claimant for $101,922 in attorneys fees and $25,000 in expert witness fees and costs.

3. The panel found that Respondent violated both Federal and state securities laws and effected unauthorized, unsuitable and excessive trades in Claimant's accounts. In addition the panel found that Respondent made misstatements and omissions in connection with the purchase of securities and failed to supervise stockbroker Ms. Stine.

This award is significant and is a make whole award involving Morgan Stanley's sale of proprietary B share mutual funds. The award is also significant for the panel's findings of fact against Morgan Stanley.

Claimant's Counsel -
Tracy Pride Stoneman, Attorney at Law
Respondent's Counsel -
David Seide, Esq. of Morgan Stanley
Claimant's Expert –
Douglas J. Schulz
Respondent's Expert - None
Hearing Situs –
Dallas, Texas
Arbitrators -
Carroll Johnson
Irving Faught
M. Earp

Bonnie J. Dahl, et al. v. Robert W. Baird & Co., Inc. and Torey Jacobs
NYSE Case No. 2002-011196

Claimants asserted the following causes of action: misrepresentation, breach of fiduciary duty, breach of contract, negligence, gross negligence, recommendations of unsuitable investments and negligent supervision with respect to the sale of a variable annuity. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees.

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

1. The panel found Respondents liable to Claimant Bonnie J. Dahl for $215,000 in compensatory damages, $25,600 in attorneys fees and $10 ,000 for expenses.

2. The panel found Respondents liable to Claimant Christina Dahl $128,000 in compensatory damages, $25,600 in attorneys fees and $10 ,000 for expenses.

3. All forum fees were assessed against Respondents.

Respondent Baird argued that there were no damages because of the death benefit component of the variable annuity. The award represents a full return of capital for Christina Dahl.

Claimants' Counsel -
Jack Hudson, Esq. of Williams, Blackburn, Hudson & Maharry
Respondents' Counsel –
Gregory Wille, Esq. of Wille, Gregory & Lundeen LLP
Claimants' Expert –
John Duval
Respondents' Expert - None
Hearing Situs –
Omaha, Nebraska
Arbitrators -
Frederick Cassman
Herbert Channick
James Pittenger

Wendell A. Gresham v. A.G. Edwards & Sons Inc. et al.
NYSE Case No. 2002-010352

Claimant asserted the following causes of action: breach of fiduciary duty, negligence, violations of NASD and NYSE rules, breach of contract, common law fraud, misrepresentation and violation of the Georgia Securities Act of 1973 with respect to investments in technology stocks. Claimant requested compensatory damages, interest, costs, punitive damages and attorneys fees.

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

1. The panel found Respondents liable to Claimant for $284,908.43 plus $400,000 in punitive damages, $239,717.95 in attorneys fees and $25,000 in costs.

2. The panel based its finding of liability on Respondents fraud and breach of fiduciary duty.

This is a make whole award. The punitive damages assessed were equal to the amount of the NYSE sanction of A.G. Edwards for sales practice violations. After the award was issued Respondents moved to vacate the award, but later voluntarily dismissed the petition to vacate and paid the award.

Claimant's Counsel -
Edward G. Dovin, Esq. of Gard Smiley Bishop & Dovin LLP
Respondents' Counsel –
Peter J. Anderson, Esq. and James Browning, Esq.
Claimant's Expert –
Dan McAuliffe
Respondents' Expert - None
Hearing Situs –
Atlanta, Georgia
Arbitrators -
Harvey R. Linder
William Marsh
Frank Warren Moore

Robert C. Hoover, et al. v. Morgan Stanley and Michael Foreman
NYSE Case No. 2002-010487

Claimants asserted the following causes of action: unauthorized trading, unsuitability, negligence, churning and failure to disclose. Claimants mortgaged their home at the request of their broker Michael Foreman who guaranteed a 12 percent return if he would invest with him. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims, costs and an expungement of Michael

Foreman's CRD record.

1. The panel found Respondents liable to Claimants for $1,332,386 in compensatory damages and $600 for the hearing deposit.

2. The panel found that after September 1999 respondent Michael Foreman breached his fiduciary duty to the claimants by trading in unsuitable securities without their prior knowledge. The panel recommended that Morgan Stanley review its supervisory procedures in the Oakland office.

This award is a significant because of its size as well as the finding that Morgan Stanley's supervisory procedures in the Oakland branch office needed further review. Claimant's case was based in large part on the unauthorized and extensive trading in Morgan Stanley B share mutual funds.

Claimants' Counsel –
  Theodore Griffinger, Jr., Esq. of Stein & Lubin LLP
Respondents' Counsel –
  Eric Wallis, Esq. of Crosby, Heafey, Roach & May
Claimants' Expert –
  Ed Esborn
Respondents' Expert –
  John Maine
Hearing Situs –
  San Francisco, California
Arbitrators -
  Kenneth Brown
  Ross Cannon
  Laurel Littman Gothelf

Sallie LaHue et al. v. Prudential Securities, Inc., et al.
NASD Case No. 02-00538

Claimants asserted the following causes of action: breach of fiduciary duty, fraud, negligence, negligent supervision and violations of the Colorado Securities Act. The causes of action related to the alleged excessive and unsuitable trading by Sucoff while employed by Prudential and KSH Investment Group, Inc. Claimants requested compensatory damages, interest, costs, punitive damages 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. Respondent Sucoff requested an expungement of the arbitration from his CRD.

Prior to the hearing Respondent KSH Investment Group, Inc. settled with Claimants. The hearing proceeded against Respondents Prudential and Sucoff.

1. The panel found Respondent Prudential liable for $164,004 in compensatory damages, 8 percent interest from August 1, 1999 to August 5, 2003 and post judgment interest at 8 percent.

2. The panel found Respondent Sucoff liable for $40,287 in compensatory damages, 8 percent interest from August 1, 1999 to August 5, 2003 and post judgment interest at 8 percent.

3. The panel denied Sucoff's request for an expungement.

The award is significant for the panel's imposition of interest damages in addition to the compensatory award.

Claimants' Counsel -
  Alan C. Friedberg, Esq. of Pendleton, Friedberg, Wilson & Hennessey
Respondents' Counsel –
  Christine Button, Esq. of Kirkpatrick & Lockhart on behalf of Prudential Securities, Inc., n/k/a Prudential Equity Group, Inc., and Scott E. Sucoff; and Carolyn J. Fairless, Esq. Of Wheeler Trigg & Kennedy on behalf of KSH Investment Group, Inc. and Scott E. Sucoff
Claimants' Expert - None
Respondents' Expert - None
Hearing Situs –
  Denver, Colorado
Arbitrators -
  Thaddeus J. Tecza, PhD, Public/Chairman
  Vincent P. Fitzgerald, CPA, Public
  Raymond N. Mitchell, Industry

Howard Lowentheil v. Merrill Lynch Pierce Fenner & Smith, Inc.
NYSE Case No. 2002-010534

Claimant asserted the following causes of action: fraud, breach of fiduciary duty, negligence, violations of

the Martin Act, New York consumer protection and 10(b) of the 1934 Securities Exchange Act. The claim involved allegations by a sophisticated real estate developer who purchased shares of InfoSpace between June 2000 and November 2001 and was based on the investigation of Merrill Lynch by New York Attorney General. Claimant requested compensatory damages, interest, costs, punitive damages and attorneys fees.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims.

1. The panel found Respondent Merrill Lynch liable to Claimant for $109,045 in compensatory damages.

This award is a significant finding of liability against Merrill Lynch based on the conduct of Merrill Lynch in issuing biased research on InfoSpace. Claimant was able to prove that if he had been aware of Merrill Lynch's internal email that he would never have bought stock in InfoSpace.

Claimant's Counsel –
Stephen Luk, Esq. of Shustack Jalil & Heller
Respondent's Counsel –
Thomas Weisenbeck, Esq. and Edwin A. Ziph, Esq. of Bressler Amery & Ross
Claimant's Expert –
Bob Grosnoff
Respondent's Expert - None
Hearing Situs –
New York, New York
Arbitrators -
Joan Loeb
Howard Breindel
Robert Allen

Marshall Realty PTE Ltd. v. Morgan Stanley Dean Witter
NYSE Case No. 2002-010858

Claimant asserted the following causes of action: breach of fiduciary duty owed because Respondent invested and recommended securities and the use of leverage in a manner which created risks in excess of those represented to Claimant. Claimant also alleged negligence, negligent supervision and failure to diversify. Claimant requested compensatory damages, interest, costs, punitive damages and attorneys fees.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims.

1. The panel found Respondent liable to Claimant for $250,289 in compensatory damages plus interest of $14,167.

This is the claim upon which the fact pattern for the PIABA October 2003 annual meeting was based.

Claimant's Counsel -
Herbert Deutch, Esq. of Deutsch & Lipner
Respondent's Counsel –
James Yellen, Esq.
Claimant's Expert –
Professor Linda Allen
Respondent's Expert - None
Hearing Situs –
New York, New York
Arbitrators -
Jerome Levy
Michele Mangiaracina
Jeanne Miller

Sarah Virgadamo v. Financial Network Investment Corporation and Luki Lucreia Styskal Vail
NASD Case No. 02-05708

Claimant asserted the following causes of action: breach of fiduciary duty, fraud, deceit, omission of material fact, fraudulent concealment, negligent misrepresentation, breach of implied covenant of good faith and fair dealing, suitability, violation of federal and California securities laws, violation of California Civil Code and Business and Professions code, violations of NASD rules, breach of written contract and failure to supervise. The wrongful conduct involved the purchase and sale of various individual securities in Claimant's IRA account. Claimant requested compensatory damages, interest, costs, punitive damages and attorneys fees.

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

1. The panel found

Respondents liable to Claimant for $147,000 in compensatory damages, and $1,575 in costs.

2. The panel found Respondents liable to Claimant for $51,450 in attorneys fees pursuant to *U.S. Offshore, Inc. v. Seabulk Offshore, Ltd.*, 753 F. Supp. 86, 92 (S.D.N.Y.) and *Marshall & Co., Inc. v. Duke*, 114 F.3d 188 (11th Cir. 1997)

The award represents a return of 100 percent of the Claimant's out of pocket loss plus attorneys fees requested in Claimant's arbitration brief. During the course of the arbitration process on a motion to compel taken by Claimant, the arbitration panel sanctioned Respondents $3,000 plus the forum fee hearing cost of $450. The award of sanctions was made notwithstanding the fact that between the filing of the motion to compel and the hearing on the motion, Respondents had produced all documents.

Claimant's Counsel -
Dennis R. Villavicencio, Esq. and Catherine L. Bailey, Esq. of Akins & Villavicencio, LLP
Respondents' Counsel –
Samuel L. Edgerton, III, Esq. of Nash & Edgerton
Claimant's Expert - None
Respondents' Expert - None
Hearing Situs –
San Diego, California
Arbitrators -
Robert C. Wright, Esq., Public/Chairman
Lou von Dyl, Public
Daphne D. Duverney, Esq., Industry

Christopher J. Wendling, et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.
NASD Case No. 02-00977

Claimants asserted the following causes of action: breach of fiduciary duty, misrepresentation, omission, failure to supervise, unsuitability, negligence and violations of the Washington State Securities Act, Washington Consumer Protection Act, NASD and NYSE rules. The allegations concern trading in incentive stock options in (ISOs) in Ariba, Inc. Claimants requested compensatory damages, interest, costs, tax offset, punitive damages and attorneys fees.

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

1. The panel found Respondent liable to Claimants for $1,510,000 in compensatory damages and $191,134.25 in attorneys fees pursuant to the CMA agreement and RCW 4.84.330 and *Herzog Aluminum, Inc. v. Gen A. Window Corp.*, 39 Wash. App. 188, 196-7 (1984).

2. The panel found Respondent liable to Claimants for $29,557.65 in costs.

The award involves the finding of liability against Merrill Lynch for an unsuitable exercise and hold strategy for ISOs. The award is also significant for the panel's holding that the CMA's agreement containing a one sided attorneys fee clause was reciprocal under Washington law.

Claimants' Counsel –
Al Van Kampen, Esq. of Rohde & Van Kampen
Respondent's Counsel –
James P. Lucking, Esq. of Bingham McCutchen LLP
Claimants' Expert –
Craig McCann (suitability) and Kaye Thomas (tax effect on stock option collars)
Respondent's Expert –
Christoperh Bjerke of Bates Private Capital
Hearing Situs –
Seattle, Washington
Arbitrators -
Peter L. Sill, Public/Chairman
Dante Lee Montoya, CPA, Public
William J. Chambers, Industry

Announcements From The PIABA Office

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Upcoming Events:

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

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.

New Members:

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