Public Investors Arbitration Bar Association Vol. 11 No. 2 Summer 2004

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

Features And Columns

www.PIABA.org

The Bar Journal of the
Public Investors Arbitration Bar Association

From the Editor's Desk

by Andrew Stoltmann
PIABA Bar Journal
Editor-in-Chief
Maddox Hargett & Caruso
10 LaSalle Street, 35th Floor
Chicago, IL 60603
312.606.5200
Stoltmann1234@hotmail.com

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.

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Fall, 2004 issue of *PIABA Bar Journal* is September 10, 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.

1. One inch margins top, bottom and sides.
2. Single Space text; double space between paragraphs.
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.
7. Attachments should be a clear, quality copy suitable for reproduction.
8. Attachments requiring reprint permission should be submitted with written authorization from the prior publisher.
9. PIABA reserves the right edit or reformat materials as required.

Submissions may be sent by e-mail to Robin Ringo at rsringo@piaba.org or Andrew Stoltmann at stoltmann1234@hotmail.com.

By mail, send submissions to:

PIABA
Attn: Robin Ringo, Exec. Dir.
2415 A Wilcox Drive
Norman, OK 73069
Office: 1.405.360.8776
Toll Free: 1.888.621.7484
Fax: 1.405.360.2063
E-Mail: PIABA@PIABA.ORG
Website: www.PIABA.ORG

President's Message

Charles W. Austin, Jr.

One of the few perquisites of the PIABA presidency is the quarterly license to editorialize on the front page of this publication. I was inspired by Seth Lipner's personal history of the founding of PIABA in this issue's *I Love New York (Law)* column to chime in with comments of my own on the subject.

PIABA was borne of self-preservation and survival against the onslaught of arguably the most powerful industry in the world intent on depriving its customers of any meaningful opportunity to redress their grievances.

The "Purposes and Objectives" of PIABA are set forth in Article III of its By-Laws:

"The purposes and objectives of PIABA are as set forth in the Articles of Incorporation and are as follows: 'To promote the interests of the public investor **in securities arbitration** by:

(1) Protecting public investors from abuses prevalent **in the arbitration process**;

(2) Making securities **arbitration** just and fair; and

(3) Creating a level playing field for the public investor in securities **arbitration**'"

I have been a member of PIABA since shortly after its founding, and I don't remember the purposes and objectives of this organization ever being any different. These purposes and objectives are in recognition of the post-*McMahon* reality that mandatory arbitration of most customer-member disputes is here to stay and the belief that - if PIABA does its job of "leveling the playing field for the public investor in arbitration" - arbitration can actually be what it was always intended to be: a relatively inexpensive, expeditious and equitable mechanism through which customers can resolve their disputes with the securities industry.

PIABA is at an extreme disadvantage in terms of money, resources and influence. In short, it is all we can do on a day-to-day basis to fulfill our mission statement. Nevertheless, no one can deny that numerous positive changes have been made in securities arbitration over the last decade; changes which - but for PIABA's efforts against all odds - would undoubtedly not have been made. As one noted observer and commentator on the securities arbitration process recently commented to a large audience, "PIABA has become a force to be reckoned with."

The explosive growth in PIABA's membership over the last few years and its relative success in "leveling the playing field" in arbitration have deluded many into overestimating PIABA's influence and resources. Demands are being made on PIABA - by members and

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.

non-members alike - to exhaust its limited resources and expand its mission statement to include lobbying for unilateral customer choice of court vs arbitration and to weigh in on every issue that conceivably touches upon investor protection - no matter how remote the issues may be to PIABA's purposes and objectives. I believe that succumbing to these delusions of grandeur by attempting to expand and transform PIABA's mission is a mistake that will ultimately and in short order diminish PIABA's effectiveness in the little world in which it operates.

PIABA can not afford to become "a jack of all trades and master of none." It can not afford to be distracted by issues and causes which, while perhaps noble and just in their own right, are not directly relevant to PIABA's mission of promoting and protecting customer rights **in arbitration**.

PIABA's efforts must remain consistent, persistent and focused. The efforts of this organization over the last 13 years have in many instances been the only thing preventing customers of the securities brokerage industry from being abused twice. For this reason alone, PIABA's mission can not afford to change. The welfare of public investors depends upon us staying the course.

ProfLipner's I Love NY (Law) Column: Some Thoughts on Arbitration, Arbitration Practice and PIABA

By Seth Lipner

Seth E. Lipner is Professor of Law at the Zicklin School of Business, Baruch College, in New York. He is one of the original PIABA Directors, a two-time Past President of PIABA and the organization's Secretary. He is also a member of Deutsch & Lipner, a Garden City, New York law firm. Until recently, Mr. Lipner served on the Board of Editors of Securities Arbitration Commentator. His email address is proflipner@aol.com and he can be reached at 646-312-3595 or 516.294.8899

Instead of the usual discussion of New York law in this space, this column contains some reflections as I approach the 20th anniversary of my first securities arbitration.

PIABA

In 1990, a group of us, led by Stu Goldberg, invented PIABA, defined its mission, and set this juggernaut in motion. We could not have conceived what it would become.

PIABA's mission was, and still is, to improve arbitration and improve representation of investors in arbitration. Our mission does not include opposing arbitration as a method of dispute resolution, because the inventors believed arbitration helps little guys fight big corporations through its efficient and expeditious nature. Stu wrote: "In litigation, 10% of an attorney's time is spent on productive endeavors, 90% on the unproductive; in arbitration, the percentages are reversed." We believed that then, and we believe it now. How else could individual practitioners fight the large, powerful financial service companies in individualized cases?

Only Boyd Page had a "firm" of lawyers doing arbitration; PIABA thus was run out of his office (and a checkbook) for the first 5 years or so. We advocated for improvements, but mostly we fought for credibility with the SEC, the SROs and the regulators, and with the press and the public. Equally important, we organized and we educated each other. We have achieved success in each area. Now we have an office, a staff and over 800 members. We are an influential group within our corner of the world, but our influence is, unfortunately, very limited outside it. With a few exceptions, neither the politicians nor the public at large seem to care much about individual investors who are aggreived.

Those of us who advocate "voluntary" rather than "mandatory" arbitration have, on the surface, a good idea. But it is a mirage. The Supreme Court has spoken decisively on the issue. Anyone who believes this Court might reverse *McMahon* and its progeny had best review the roster of Justices. The Congress has never been interested in the subject, but even if the arbitration/FAA world were turned upside down, I believe the securities industry would then remove arbitration as an option.

No system gives a plaintiff complete control over the choice of forum, *viz.* to go to a jury where it suits them, or to arbitration when the courthouse seems unfavorable. Such an approach, in today's litigious environment, is suicide for the defendant. So when it comes to dispute resolution, it is one or the other. Even though before *McMahon* investors had the option of court or arbitration, investors cannot turn back that clock.

None of this is to say arbitration is great, or that SRO arbitration is even a good method of dispute resolution. But I continue to believe it is better than most alternatives (although I have sometimes advocated a return to dueling). But those who think there is a dispute resolution panacea awaiting their clients in the courts will learn quickly that the grass isn't greener over there. Litigation sucks. Federal litigation (spelled "diversity of citizenship") sucks even more. Litigation brought by individuals against big corporations is a financial nightmare, and can, if the corporation wants it to, virtually endless. The price of getting to that beloved jury is quite high, and the barriers erected by courts and tort-reform minded legislatures are quite substantial.

Arbitration is rough, frontier-style justice. It comes at the price of precision and procedural safeguards. But arbitration has, over the years, served many of our clients interests in ways in which the court system could not. Some, of course, liked the "dueling" idea, too.

So I continue to believe that investors, especially small ones, would suffer if arbitration disappears. PIABA's mission thus was, and is, to improve arbitration, and we work toward that every day (even though it is never easy). Where arbitration is broken, we will put all our efforts into trying to fixing it. There are plenty of areas to work on, so we'll be busy.

ARBITRATION AND ARBITRATION PRACTICE

When it comes to arbitration, an attorney must approach every case individually, based on the investor, the investments, the broker, and the firm -- in that order. Neither cookie-cutters nor magic formulae exist.

Securities cases differ from product liability cases, and they are different from slip and falls. Those basic tort cases are the equivalent of two ships passing in the night that collided. Where they were coming from and where they were going is irrelevant.

But securities arbitrations are relationship cases, not accident cases. What happened before, what happened during, and in some cases, what happened after are all presumptively relevant. In a special case you may argue that they are not, but it is an uphill battle. Even if a lawyer think these things are not relevant, the arbitrators almost certainly think they are. And a lawyer must consider the predisposition of the decision-maker when making his presentation.

At this moment, with so many tech-wreck cases pending, the stakes are tremendous. Each one of us who tries a case before arbitrators is being tested:

- ➔ by the arbitrators - who will hear more cases, but are forming opinions now;
- ➔ by the securities firms, who are evaluating results for future action;
- ➔ by your adversaries, who, if they think they can beat you, won't recommend future settlements;
- ➔ by the press, who we know are watching.

Another thing the arbitrators probably believe, whether it is correct or not, is that the investor bears some personal responsibility to monitor his broker and his investments. It can thus be dangerous to take the position that a client never needs to read a statement or a prospectus. Of course, at the same time, no one would expect an individual to read every entry or every page, or to appreciate subtleties or technical jargon, etc. But when clients say they didn't read statements at all, it is an issue that arbitrators expect to be addressed.

The same is true of mitigation of damages. The previous paragraph notwithstanding, arbitrators invariably place too much responsibility on investors to discover fraud or incompetence and stop it. But that doesn't mean the investor doesn't have to explain it.

Arbitration is tricky. It sometimes seems that the arbitrators expect the brokers to shade the truth (or lie), and don't find against them just because they did. But the investor must tell the truth, and the truth must state a claim. One deviation by Claimant, and, for some reason, the chances of winning go way down. No matter how unfair that is, it is a lesson to impress upon every client.

The skills that make a trial attorney successful are not necessarily all suited to arbitration. Techniques like calling broker and manager as your first two witnesses are useful in arbitration, but make the average trial lawyer uncomfortable. Not only are there different skills, there is a different audience – the arbitrators. A few suggestions for those in transition:

- ➔ Don't feel hemmed in by the pleading; be adaptive at the hearing. There is a great deal you didn't know when you filed; that you couldn't have known because it happened "behind the curtain". There is a lot you will learn at the hearing that you didn't learn in discovery. Use all of it.
- ➔ Make maximum use of the documents, or lack thereof; the documents are your deposition – use them to keep the witness from straying and inventing; when the respondent says it has no documents, accept that statement in discovery, but then hammer it in the hearing, where it counts.
- ➔ Stipulate on damage arithmetic; make your damage pitch on close, rather than through an expert. Arbitrators seem to hate experts.
- ➔ Don't demonize your adversary if you can avoid it. Proving negligence is usually enough. And don't yell fraud if you can't prove it clearly. Arbitrators usually don't hate brokers. Don't try to make them (even if they should).
- ➔ Be sure to answer the question "why would a broker do that?" You know you will hear it on Respondent's close. Then be ready to answer their second defense "so what's wrong with that?"

<u>CONCLUSION</u>

PIABA has done an incredible amount to improve arbitration advocacy. Its educational activities, the resources it makes available to its members, and the ability it gives its members to compare notes, communicate with each other, share ideas and work together does exactly what the inventors wanted - to "level the playing field" in securities arbitrations.

We have started to level what was once a virtually-vertical playing field. List selection and the end to administrative appointments, the right to punitive damages, the advent of the pre-hearing conference to set dates, and changes to the eligibility rule, the arbitrator definition, and numerous other improvements came because people in PIABA worked hard for them. Without those people, and without PIABA, those changes would never have occurred. There is still a lot more to do.

But no matter how level or tilted the field, investor advocates must play hard on that field, and they must play within the lines, even when the lines aren't where equity and justice ought to draw them.

Caveat Emptor, Haruspexs and Industry Taradiddles: Suitability and 'Financial Informed Consent'-Brokers' Minimal Obligation to Inform Investors of Material Risks PRIOR to Generating Risk Tolerance and Investment Objective Forms

By Bradley R. Stark and James S.H. Null

Bradley R. Stark, MA, MSF, JD
Adjunct, Department of Finance,
Florida International University,
Miami, Florida (305) 662-6697
stark2@bellsouth.net
James S.H. Null, JD
jshnull@yahoo.com

Summary

The brokerage industry has fiduciary obligations that forbid misrepresentation and require full disclosure. Unfortunately these obligations can be skirted by obtaining signed risk tolerance and investment objective forms accepting high risk (high commission) products. This violates the doctrine of suitability, which in the securities industry amounts to informed consent. The majority of investors are financially illiterate. Transgressions are made possible when the Finance principles needed to satisfy 'Financial Informed Consent' are not articulated. Risk Tolerance and Investment Objective documents are not tools of risk management. Creating misleading documents is a violation of SEC and NASD record keeping regulations. Some of the minimal requirements of 'Financial Informed Consent' will be discussed in this paper.

Uninformed Consent: The Lack of Investor Knowledge

Retail brokerage clients rely heavily upon the advice of their brokers. Seldom does a broker articulate to an investor the fundamental principles of Finance needed to make informed decisions about risk tolerance and realistic investment objectives. Brokers thus encourage the purchase of more risky (high commission) investments by being selective with disclosures to the investor.[1] A survey by The Securities Industry Association found that Sixty-two percent of all investors surveyed in 1999 stated they that they desired average or below average risk.[2] This number rose to 68 percent in the 2002 survey.[3]

This survey also found that fifty-eight percent of all investors stated that "they rely on professional financial

[1] For example, when soliciting clients, brokers are fond of citing the dramatically reduced returns that result if an investor is out of the market for the 10, 20, 30, or 40 best days over a time period such as 5 to 10 years. This fact is accurate, but lacks full disclosure. "As a counterexample, this article shows the dramatically enhanced returns if the investor is in cash for a similar number of the worst days." John D. Stowe, *A market timing myth,* Journal of Investing, Winter 2000 at 55. The point is that the "probabilities of picking the best or worst days out of a larger number days are shown to be minuscule. In fact, the probability of winning a lottery, or even several lotteries in a row, is better than the probability of replicating the investment results these firms are discussing." *id.* One other conclusion to be drawn from this data is that active management of a portfolio is not productive, data certainly not mentioned during customer solicitations.

[2] The Investment Company Institute and Securities Industry Association, Equity Ownership in America, *Demographics of Equity Investors* 12 (2002), *at* <http://www.sia.com/research /pdf/equity_owners02.pdf>. It must be remembered that this survey polled investors of all ages, the average being mid-to-late 40s. Younger investors would be seeking higher risk.

[3] *Id.*

advisers when making equity purchase and sales decisions."[4] In 2002 40% of brokerage clients looked to the broker as the "most" important source of information, down from 43% in 2001 the previous year.[5] "As in the past, a large proportion of investors agree [sic] that the securities industry should be doing more to educate the public about how to make good investments. Eighty-two percent agree in 2003, the same as in 2002. In the three previous years the figures were 84% (2001), 81% (2000), and 78% (1999)".[6] Under the title of "big problems" the study found that "(f)orty-six percent cite insufficient disclosure of risks to investors as a big problem, up from 45% in 2002 and 34% in 2001."[7]

The financial illiteracy of retail investors is illustrated by the John Hancock Financial Services[8] annual survey of investors.

> *consistent with past surveys, most participants have only minimal active involvement with their plans…*
>
> - *More than half spend no more than twenty minutes a month planning for retirement or managing/monitoring investments;*
> - *More than half say they don't have time to manage their retirement investments; and*
> - *Nearly half say they have little or no investment knowledge and less than 20 percent consider themselves relatively knowledgeable (the numbers have gotten consistently worse with each survey)…*
> - *Nearly 45 percent think money market funds contain stocks and less than 10 percent know they contain only short-term investments; and*
> - *Less than 25 percent know the best time to invest in bonds is prior to a decrease in interest rates.*[9]

Further, this survey found that "40 percent of respondents say they don't know what to expect for average annual returns for stocks, bonds, money market and stable value investments for the next five and 20 years. Of the 60 percent who believe they do know, their expectations remain overly optimistic."[10]

An AARP survey found, among investors over 45 years of age, that 48% did not understand that diversification of assets reduces risk. Forty-three percent believed that

---

[4] *Id.* at 16.

[5] Securities Industry Association, Annual SIA Investor Survey Investor's Attitudes Towards the Securities Industry 2003, 58 (Nov. 2003), *at* <http://sia.com/publications/pdf/Investorsurvey2003.pdf>.

[6] *Id. at 16.*

[7] *Id*. This study also found that fifty-five percent of customers saw "as a big problem the lack of internal controls to prevent irresponsible or wrongful actions, compared to 54% in 2002 39% in 2001 and 33% in 2000."*id.* at 15. In addition, "(s)ixty-six percent cite as a big problem the industry's reluctance to punish wrongdoers, compared to 68% in 2002 and 41% in 2001."*id*.

[8] Thanks to C. Thomas Mason, Esq. CFP for some valuable references.

[9] Press Release, Wayne Gates, General Director, Market Research and Development, John Hancock Financial Services Survey: For Most Americans, Early Retirement Dreams Evaporating (May 24, 2004) *at* <http://www.johnhancock.com/company/newsroom/most_recent/john_hancock_401k_survey_early_retirement_dreams_evaporating_05_24_04.html>.

[10] *Id.*

Mutual Funds are insured by the FDIC and "only (41%) consumers correctly report that a 'no-load' mutual fund involves no sales charge but does have maintenance fees the consumer must pay." [11] These results are echoed in a recent Merrill Lynch survey. [12]

The Federal Reserve has become increasingly concerned about the financial illiteracy of investors, as the following quote illustrates.

As history has shown, the rate of change and the pace of innovation will only continue to increase within consumer retail markets. This is true of retail financial markets as well. The net result of these changes is that an ever-increasing number of consumers will be able to access an ever-increasing number of financial products. That scenario suggests both increasing benefit and increasing risk for consumers of financial products. When they are appropriately evaluated and used financial products allow an increasing number of people to achieve financial goals previously considered out of reach. In contrast, inappropriate or careless use of financial products can put a consumer in a deep financial hole from which it can be both difficult and time consuming to recover. [13]

The U.S. Securities and Exchange Commission (SEC) has similar concerns. Its "primary mission…is to protect investors and maintain the integrity of the securities markets. As more and more first-time investors turn to the markets to help secure their futures, pay for homes, and send children to college, these goals are more compelling than ever."[14]

Thus it is clear that, in the majority of cases, retail investors will openly admit to being financial illiterates. [15]

These financial illiterates look to their broker for guidance. Alone investors do not posses the requisite tools with which to make an informed decision as to their risk tolerance and

---

[11] Sislena Grocer Ledbetter, *2003 Consumer Experience Survey: Insights on consumer credit behavior, fraud, and financial planning,* AARP Knowledge Management, (October 2003), *at* <http://research.aarp.org/consume/cons_exp_1.html>.

[12] Press Release, Merrill Lynch, Employer Plan Management for the Merrill Lynch Retirement Group, Merrill Lynch Announces Results of "retirement Preparedness Survey" (Aug. 12, 2003) ("Hayes noted a two-fold problem that needs to be solved — a lack of basic investment knowledge and a lack of financial advice and planning. 'For the second year in a row, we were alarmed to discover that over half of the Americans surveyed believe that 401(k) accounts are guaranteed by law. No such guarantee exists,' she said."), *at* <http://www.merrilllynch.com/about/press_release/08122003-1_ml_announces_pr.htm>; *See also* 1999 N.Y. Att'y Gen. Elliott Spitzer, *From Wall Street to Web Street: A Report of the Problems and Promise of the Online Brokerage Industry* (1999), *at* <http://www.oag.state.ny.us/investors/1999_online_brokers/full.pdf> *(containing a survey of financial literacy among online investors).*

[13] Governor Mark W. Olson, Increased Availability of Financial Products and the Need for Improved Financial Literacy, At the America's Community Bankers 2003 National Compliance and Attorney's Conference and Marketplace, (Sept. 2003), *at* <http://www.federalreserve.gov/boarddocs/speeches/2003/20030922/default.htm>.

[14] *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity* (Dec. 1999), *at* <http://www.sec.gov/about/whatwedo.shtml>.

[15] Dr. John Kenneth Galbraith's famous phrase, frequently quoted by Wall Street professionals, sounds a similar clarion. "We have two classes of forecasters: Those who don't know -- and those who don't know they don't know." Tom Herman, *Your money matters: Weekend report: How to profit from economists' forecasts,* Wall St. J., Jan. 22, 1993.

realistic investment objectives. Thus the salient question is, has the broker and brokerage firm sufficiently instructed the retail investor on the realities of Finance so as to make an informed decision on a course of risk tolerance and realistic investing objectives?

Informed Consent: From Past to Present

The doctrine of informed consent is a creation of 20th century. It began in medicine and has been extended to other professions. The parallels to suitability, as the securities industry evolved from caveat emptor towards greater transparency and fiduciary obligations, are obvious.

Prior to informed consent,[16] pioneers of medicine like Hippocrates and Benjamin Rush espoused paternalistic approaches that regarded the doctor as the sole decision maker. [17] Rush's beliefs "about the necessities of absolute physician authority over the patient" [18]were the standard. The American Medical Association 1847 Code of Ethics advised doctors not to make gloomy predictions and "avoid all things which have a tendency to discourage the patient and to depress his spirits." [19]

Common law evolved to require surgeons to obtain consent to avoid committing a battery. This right consisted of no more than a right to refuse treatment. [20] "There was no right for patients to decide, after having been properly informed, whether an intervention was agreeable to them in light of its risks and benefits as well as available alternative." [21]

Gradually judges expanded patient rights[22] following Justice Benjamin N. Cardozo. He stated in 1914 that "every human being of adult years and sound mind has a right to determine what shall be done with his own body." [23] Judges were becoming increasingly concerned that, "without any disclosure of risks, new technologies had been employed which promised

[16] *See generally* Emmanuel O. Iheukwumere, *Doctor, Are You Experienced? The Relevance of Disclosure of Physician Experience to a Valid Informed Consent*, 18 J. Contemp. Health L. & Pol'y 373 (2002).

[17] *Id.* at 375-376.

[18] *Id.* at 376.

[19] Sheldon F. Kurtz, *The Law of Informed Consent: From "Doctor is Right" to "Patient Has Rights*", 50 Syracuse L. Rev. 1243, 1244 (2000) (*quoting* Code of Ethics of the American Medical Association (1847), ch. 1, art. I (Duties of Physicians to Their Patients). Until 1980 the American Medical Association did not incorporate informed consent into its cannons. *Id*. at 1244-1245.

[20] Jay Katz, The Silent World of Doctor and Patient 49 (1984) [hereinafter The Silent World of Doctor and Patient].

[21] *Id.*

[22] *See* Jay Katz, *Informed Consent – Must it Remain a Fairy Tale?*, 10 J. Contemp. Health L. & Pol'y 69, 77 (1994).

[23] Alan Meisel, *Managed Care, Autonomy, and Decision Making at the End of Life*, 35 Hous. L. Rev. 1393, 1400 (1999) (*quoting Schloendorff v. The Society of New York Hospital*, 105 N.E. 92, 93 (N.Y. 1914)).

great benefits but also exposed patients to formidable and uncontrollable harm."[24] The first case to describe a model for informed consent was *Salgo v. Leland Stanford Jr. University Board of Trustees*,[25] holding that doctors must inform patients of any facts necessary to make an informed decision.[26] The informed consent paragraph was taken, without attribution, from an amicus curiae brief submitted by the American College of Surgeons.[27]

The modern approach to informed consent grew from "the proceedings of the Nuremburg trials the 1940's and the exposure of unethical research practices…in the 1960's and 1970's."[28] Today a form of informed consent exists in every jurisdiction in the United States. "The impetus for change in traditional patterns of communication between doctors and patients came not from medicine but from the law."[29] This has also been true in the securities industry and other fields.

Generally informed consent requires that:

> The patient should make his or her own determination on treatment. The physician's obligation is to present the medical facts accurately to the patient or to the individual responsible for the patient's care and to make recommendations for management in accordance with good medical practice. The physician has an ethical obligation to help the patient make choices from among the therapeutic alternatives consistent with good medical practice….Social policy does not accept the paternalistic view that the physician may remain silent because divulgence might prompt the patient to forego needed therapy.[30]

The principles of informed consent have been replicated in a host of other industries. For example, lawyers have adopted rules that govern professional conduct[31] guaranteeing that clients have exclusive control of important choices. The ABA Model Rules of Professional Conduct define informed consent as "the agreement by

---

[24] Katz, *supra* note 21, at 77.

[25] 317 P.2d 170 (Cal. Dist. Ct. App. 1957). It is generally understood that the ruling in *Salgo* also coined the phrase "informed consent."

[26] *Id.* at 181.

[27] The Silent World of Doctor and Patient, *supra* note 19, at 60.

[28] Carel B. Ijsselmuiden & Ruth R. Faden, Medical Research And The Principle of Respect For Persons In Non-Western Cultures, in The Ethics Of Research Involving Human Subjects: Facing the 21st Century 282 (Harold Y. Vanderpool ed., 1996).

[29] Katz, *supra* note 21, at 77.

[30] Code of Ethics of the American Medical Association (1981), E-8.08 (Informed Consent), <http://www.ama-assn.org/apps/pf_new/pf_online?f_n=browse&doc=policyfiles/HnE/E-8.08.HTM&&s_t=&st_p=&nth=1&prev_pol=policyfiles/HnE/E-7.05.HTM&nxt_pol=policyfiles/HnE/E-8.01.HTM&>. The American Medical Association also recommends procedures to communicate with patients. *See* American Medical Association, Office of the General Counsel, Informed Consent (1998), <http://www.ama-assn.org/ama/pub/category/4608.html>.

[31] States have adopted, and frequently modified, a formulation of either the Model Rules of Professional Conduct or the Model Code of Professional Responsibility.

a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."[32] Attorneys are required to consult with clients during representation[33] and explain matters necessary to permit informed decisions.[34] For example, clients decide whether to settle a claim.[35] The criminal defendant decides whether to enter a plea, testify, or waive trial by jury and this decision is confirmed by a judge.[36]

Real estate brokers incur civil liability for intentional misrepresentations or omissions.[37] The National Association of Realtors instruct that brokers "shall avoid exaggeration, misrepresentation, or concealment of pertinent facts relating to the property or the transaction."[38] Brokers are also prohibited from self-dealing with a client without properly administered informed consent.[39] Federal regulation requires academic research provide informed consent.[40] The Food and Drug Administration (FDA) first issued rules in 1966 that borrowed heavily from the Helsinki Declaration.[41] Accountants are required to "maintain objectivity and integrity shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to other."[42] Architects are instructed to "be candid and truthful in their

---

[32] Model Rules of Prof'l Conduct R. 1.0(e) (2002).

[33] Model Rules of Prof'l Conduct R. 1.4(a)(2) (2002).

[34] Model Rules of Prof'l Conduct R. 1.4(b) (2002).

[35] Model Rules of Prof'l Conduct R. 1.2(a) (2002).

[36] *Id.*

[37] Note, *Imposing Tort Liability on Real Estate Brokers Selling Defective Housing*, 99 Harv. L. Rev. 1861, 1862 (1986).

[38] David Cole, *Beyond Unconstitutional Conditions: Charting Spheres of Neutrality in Government-Funded Speech*, 67 N.Y.U. L. Rev. 675 n.284 (1992) (*quoting* National Association of Realtors, Code of Ethics and Standards of Practice Art. 9 (1989), *reprinted in* Codes of Professional Responsibility, 145, 147 (Rena A. Gorlin ed., 2d ed. 1990)).

[39] Anne T. Corrigan, Note: *A Paper Tiger: Lawsuits Against Doctors for Non-Disclosure of Economic Interests in Patients' Cells, Tissues, and Organs*, 42 Case W. Res. L. Rev. 565 n.52 (*quoting* D. Barlow Burke, JR. Law of Real Estate Brokers §§ 4.2-.3 (1982 and Supp. 1991)).

[40] 21 C.F.R. § 50.25(a). The Food and Drug Administration informed consent regulations "are not intended to preempt any applicable Federal, State, or local laws which require additional information to be disclosed for informed consent to be legally effective."21 CFR § 50.25(c).

[41] Bernard Barber, Informed Consent in Medical Therapy and Research 43 (1980). This regulation affected the use of new drugs on humans and defined informed consent. *Id.*

[42] Cole, *supra* note 38 at n.277 (*quoting* American Institute of Certified Public Accountants, Code of Professional Conduct Rule 102 (1988), *reprinted in* Codes of Professional Responsibility 3, 10 (Rena A. Gorlin ed., 2d ed. 1990)).

professional communications."[43] Engineers are directed to "issue public statements only in an objective and truthful manner. Engineers shall be objective and truthful in professional reports, statements or testimony. They shall include all relevant and pertinent information in such reports, statements or testimony."[44] Certified Financial Planners have a duty to "offer and perform services in the field of financial planning in an honest and forthright manner. A member shall disclose to the client all information material to his/her professional relationship, including, without limitation, all actual or potential conflicts of interest."[45] For insurance representatives the American Institute for Property and Liability Underwriters recommends that "[a] CPCU should neither misrepresent nor conceal a fact or information which is material to determining the suitability, efficacy, scope or limitations of an insurance contract or surety bond."[46] The ethical requirements of a clinical psychologist parallel those of the medical profession.

The brokerage industry also has fiduciary obligations that forbid misrepresentation and require full disclosure. These obligations can be manipulated by obtaining inaccurate risk tolerance and investment objective forms without full disclosure of known risks. This violates the doctrine of informed consent. This transgression is perpetrated if the information needed to satisfy 'Financial Informed Consent' is withheld. Some minimal requirements of 'Financial Informed Consent' will be the focus of the remainder of this paper.

'Financial Informed Consent' is a Prerequisite to Obtaining Investment Objectives and Risk Tolerance Documents[47]

Brokerage firms are fond of saying that markets are

[43] *Id.* at n.279 (*quoting* American Institute of Certified Public Accountants, Code of Professional Conduct Rule 102 (1988), *reprinted in* Codes of Professional Responsibility 31, 35 (Rena A. Gorlin ed., 2d ed. 1990)).

[44] *Id.* at n.280 (*quoting* National Society of Professional Engineers, Code of Ethics for Engineers Rule 3, 3a (1986), *reprinted in* Codes of Professional Responsibility 69, 70 (Rena A. Gorlin ed., 2d ed. 1990)).

[45] *Id.* at n.281 *(quoting* The Institute of Certified Financial Planners, Code of Ethics and Standards of Practice Part I.A. (1988), *reprinted in* Codes of Professional Responsibility 77, 77 (Rena A. Gorlin ed., 2d ed. 1990)).

[46] Id. at n.283 (*quoting* American Institute for Property and Liability Underwriters, Code of Professional Ethics G3.1 (1979) (amended 1983, 1984), *reprinted in* Codes of Professional Responsibility, 111, 116 (Rena A. Gorlin ed., 2d ed. 1990)).

[47] John C. Bogel embraced these realities of Finance and created the industry of index tracking funds with the Vanguard Funds. *E.g.* John C. Bogel, Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor (2000).

unpredictable and inherently risky.[48] This is accurate but an incomplete statement.[49] Finance possesses the tools to manage the risks associated with unpredictable market fluctuations.[50] Thus merely stating that 'markets are unpredictable and risky' is a meaningless statement with no context. ***The ability to manage these risks MUST be conveyed to a retail customer before they can make an informed decision on their risk tolerance and investment objectives.*** Every market participant would welcome unrealistic market returns, just as every medical patient would welcome miraculous healing without side effects. This is not reality and thus the uninformed ignorant expression of unrealistic investment desires is not carte blanche for recommending unsuitable and risky investment products. SEC and NASD enforcement actions punish brokers for the recommendation of unsuitable products, holding that the expression of unrealistic investment objectives by an investor is further evidence of

---

[48] Hurling through the air five miles above the earth at 600 miles per hour in unpredictable weather is also inherently risky. Cutting into a human being while alive is also inherently risky and possesses an element of the unpredictable. But both the airline and medical industries have learned how to manage these risks. The former is achieved through heavy federal regulation and the later by informing the patient of all the pertinent risks to obtain informed consent.

[49] The brokerage industry invites increased regulation by failing to properly inform its retail customers of known risks and skirting the intent of current regulations. The history of Wall Street is littered with flagitious conduct, defalcation and baksheesh. Though the securities industry has tenaciously fought every form of regulation, clinging dearly to its history of caveat emptor, increased investor participation and thus clients for Wall Street has resulted from each increase in regulation that decreased risks and costs in the markets. *E.g.* B. Mark Smith, Towards Rational Exuberance 118-125 (2001).

[50] Federal Reserve Chairman Alan Greenspan credits the unprecedented resilience of the financial markets, after the recent market collapse, as evidence of the ability to manage risks. "Because risks *can* be unbundled, individual financial instruments now can be analyzed in terms of their common underlying risk factors, and risks can be managed on a portfolio basis. Concentrations of risk are more readily identified, and when such concentrations exceed the risk appetites of intermediaries, derivatives can be employed to transfer the underlying risks to other entities. As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient. Individual institutions' portfolios have become better diversified." Remarks by Chairman Alan Greenspan May 8, 2003 Corporate Governance (May 8, 2003), *at* <http://www.federalreserve.gov/boarddocs/speeches/2003/20030508/default.htm>.

unsuitability.[51] Because of the lack of stare decisis in the securities arbitration process we must look to SEC and NASD enforcement actions for guidance on interpreting suitability.

What follows are well established principles of Finance that any retail investor must know to make

[51] In these cases the argument that the client was a sophisticated investor or wanted the unsuitable level of risk undertaken, was rejected. *E.g.* "*See John M. Reynolds*, 50 S.E.C. 805, 809 (1992) (regardless of whether customer wanted to engage in aggressive and speculative trading, representative was obligated to abstain from making recommendations that were inconsistent with the customer's financial situation), amended on other grounds, Exchange Act Rel. No. 30036A (Feb. 25, 1992), 50 SEC Docket 1839. *See also Venters*, 51 S.E.C. at 294-95 (notwithstanding client's interest in investing in speculative securities, broker had duty to refrain from recommending such investments when he learned about his customer's age and financial situation)" *James B. Chase*; Rel. No. 47476 n.23 (Mar. 10, 2003), *at* <http://www.sec.gov/litigation/opinions/34-47476.htm>.

The following cases cite to *Reynolds* and *Venters* with approval and note that acquiesce of an investor to unsuitable investments is irrelevant. *Wendell D. Belden,* SEC Rel. No. 47859 (May 14, 2003) ("The test for whether Belden's recommended investments were suitable is not whether Book acquiesced in them, but whether Belden's recommendations to him were consistent with Book's financial situation and needs."), *at* <http://www.sec.gov/litigation/opinions/34-47859.htm>; *William C. Piontek,* SEC Rel. No. 8344 (Dec. 11, 2003) ("The test for whether Piontek's recommendations were suitable is not whether Dean or Hamby acquiesced in them, but whether his recommendations were consistent with their respective financial situations and needs."), *at* <http://www.sec.gov/litigation/opinions/33-8344.htm>; *NASD Regulation Inc., Office of Hearing Officers Dep't of Enforcement v. Stein*, Disciplinary Proceeding No. C07000003, 2001 NASD Discip. LEXIS 11 (Mar. 6, 2001) ("For purposes of this decision, the Panel assumes that EA was not naïve and that she knowingly authorized or acquiesced in all of the transactions, knowing the risks involved. Stein's reliance on such facts nevertheless does not constitute a defense to a charge of making unsuitable recommendations." A fine and one year suspension was imposed in Stein.), <http://www.nasdr.com/pdf-text/oho_dec01_15.txt>; *NASD Regulation Inc., Office of Hearing Officers Dep't of Enforcement v. Mazzei, et. al*., Disciplinary Proceeding No. C10970120 (June 24, 1998) ("But even if RB did change his investment goals from growth and income to 'aggressive growth' that circumstance, standing alone, would not constitute a defense. Respondent's responsibility goes beyond mechanical obedience to all customer demands."), <http://www.nasdr.com/pdf-text/oho_dec98_03.txt>.

Similarly, a Customer's Prior transactions are not relevant to a suitability determination. *See District Bus. Conduct Comm. No. 7 v. Wayne B. Vaughan*, NASD No. C07960105, 1998 NASD Discip. Lexis 47 (NAC, Oct. 22, 1998). ("Even if Vaughan had explained the risks to VB, the securities he recommended for her account would still have been unsuitable. The SEC has made clear that even in those situations where a customer seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile."*id.*) Vaughan was suspended from the industry for 20-30 days. *In re Application of Larry Ira Klein*, *52 S.E.C. 1030* (1996), ("Klein argues that his recommendation to James on her earlier investment in a high-yield bond fund somehow supports the suitability of his recommendation to her of the TWA notes. We previously have rejected this argument. *See In the Matter of the Application of Douglas Jerome Hellie*, 50 SEC 611, 613 (1991) (*Holding:* prior transactions irrelevant in suitability determination)."*id.*

Robert Joesph Kernweis, NASD Disc. Pro. No. C02980024 (Feb. 16, 2000), *at* <http://www.nasdr.com/pdf-text/oho_dec00_04.txt> held that "Even though FPG was a speculative investor, this did not relieve R. Kernweis of the obligation to ensure that his recommendations were suitable for the client given the client's financial situation, needs, and other security holdings. NASD Conduct Rule 2310 requires that a registered representative, when recommending investments, determine that such investments are suitable for the customer." *id.*

That the broker acted in good faith is not a defense. *Holland, JR. v. SEC*, 105 *F.3d 665 (*9th Cir. Ct 1997). *"See Peter C. Bucchieri*, 52 S.E.C. 800, 804 n.9 (1996) (noting that customer's graduate degree from Harvard did not make him a sophisticated investor)." *James B. Chase*, Rel. No. 47476 (Mar. 10, 2003) n.25, *at* <http://www.sec.gov/litigation/opinions/34-47476.htm>.

an informed decision about their risk tolerance and investing objectives. These principles are not controversial. These are the fundamentals of Finance found in any undergraduate Finance text on Securities Analysis. Any argument that a retail investor understood the risks of investing without understanding these fundamental principles of Finance is balderdash.[52] This minimal list would need to be augmented with other basic facts and principles relevant to the specific circumstances of the investor, market, investment products and so forth.

Active Management: It is well known in Finance that active management of a portfolio under performs the market indexes, on a risk adjusted basis, the vast majority of the time.[53] To be 95% sure that skill and not random events caused a portfolio manager to beat the market index, a portfolio manager would have to beat the market index by 1% for 308 years or for a lifetime by 12%.[54] Statistically, the 5 year investment returns of financial newsletters explained only 6% of the future return.[55]
Economic forecasts are equally flawed. Every year the Wall Street Journal publishes a piece that catalogues these dismal Wall Street predictions. "'You really can't say enough bad things about how bad the consensus has been in forecasting interest rates,'" says Stephen K. McNees, an economist at the Federal Reserve Bank of Boston who also analyzed data from the Journal's surveys. 'As an investor, you clearly would

[52] This material could be useful cross-examination material when a broker claims that a client asked for risky investments. For example, many of these minimal principles were articulated in a Salomon Smith Barney publication produced for the retail customer. Letter from Salomon Smith Barney, Secrets of Investing in a Chaotic Market (Nov. 2000) (on file with PIABA).

[53] E.g. Arnold Wood, *Fatal Attraction for Money Managers*, Financial Analysts Journal, (May-June 1989) (Examines why professional money managers are "so consistently poor at our profession"). The majority of the money managed in the financial markets is institutional money. The 'smart' money does not trade as aggressively or actively as most individual brokers. Charles Keenan, Institutional Investor International Edition, Investing: Portfolio Strategy, *Adding a bit of zest: enhanced indexing attempts to blend the best traits of passive and active investment styles. It's proved to be a popular combination* (Apr. 2003). Similarly, the most actively traded group of institutional investors, and arguable the more skilled Hedge Fund managers, faired poorly. Greg Jensen & Jason Rotenberg, Bridgewater Associates, Inc., *Bridgewater Daily Observations* ("When we strip many hedge fund "strategies" from the beta that underlies them, we find that quite often, they are not wearing any clothes at all…".) (Feb. 2004). "Institutional investors have a comparative advantage. They can better bear short- to intermediate-term active risk. They need not add value every month, every quarter, or even every year. Their liabilities are far more diversified across time than the liabilities of most individual investors. They are therefore in a better position to profit from the short-term risks that the individual investor finds difficult to bear." Robert Arnott; & Max Darnell, Journal of Investing, *Active versus passive management: framing the decision* (Spring 2003).

[54] Mark Hulbert, *The Misuse of Past-Performance Data, in* The Psychology of Investing 152-4 (1999).

[55] *Id.*

[56] Tom Herman, *Your money matters: Weekend report: How to profit from economists' forecasts,* Wall St. J., Jan. 22, 1993; *See also* Jon E. Hilsenrath, *Where are the good forecasters when you really need them? The Economy: Forecasters' Vision Clouds During Turning Points* Wall St. J., Jul 1, 2002 ("Economists from the Federal Reserve Bank of Atlanta recently studied the past 16 years of The Wall Street Journal's forecasting surveys and found that economic prognosticators are at their worst when the economy is at a turning point, just when some sound advice on the outlook is most useful.").

have done much better flipping a coin or assuming that rates would remain unchanged."[56] Economic forecasts are touted since 50% of the variation of a company's income is explained by the variations in the aggregate income of the economy.[57] It is well known that earnings and intrinsic value drive equity prices.[58] Investors must be advised of the historical returns of equities.[59] Similarly, investors should be advised that Mutual Funds have underperformed the market indexes, even without taking into account the increased costs associated with Mutual Funds such as back and front end load fees.[60]

Thus the very premise of paying a broker rather than buying inexpensive index tracking stocks, of trying to outperform the market indexes, is inherently risky and requires full disclosure prior to any decision to accept such risk.

Diversification: Known as the 'Rule of 100',[61] an investor should have as a percentage of their portfolio, approximately the same number as their age, in bonds or cash. The allocation between stocks and bonds is

---

[57] *E.g.* Nicholas Gonedes, *A Note on Accounting-Based and Market-based Estimates of Systematic Risk*, Journal of Financial and Quantitative Analysis (June 1975).

[58] *E.g.* John Y. Campbell & Robert Shiller, *Stock Prices, Earnings and Expected Dividends,* Journal of Finance, 661-676 (July 1988) (Price/earnings ratio averaged over 30 years explains over 57% of the annual return of the market index).

[59]

	Comp	**Arith**	***Risk***	**Div Yld**	**Comp**	**Arith**	***Risk***
1926-1997	**10.6**	12.6	*20.4*	**4.6**	**7.2**	9.2	*20.4*
1946-1997	**12.2**	13.4	*16.7*	**4.3**	**7.5**	9.0	*17.3*
1966-1981	**11.5**	12.9	*19.5*	**4.1**	**-0.4**	1.4	*18.7*
1966-1997	**11.5**	12.9	*17.0*	**3.9**	**6.0**	7.5	*17.1*
	TOTAL	**NOMINAL**	**RETURN %**		**TOTAL**	**REAL**	**RETURN %**

Historical Equity Returns
Comp = compound annual return, Arith = arithmetic average of annual returns
Risk + standard deviation of arithmetic returns
Jeremy J Siegel, Stocks for the Long Run the definitive guide to financial market returns and long-term investment strategies 13 (1998)

[60]

	All Funds	Wilshire 5000	S&P 500	All Funds-Wilshire 5000
1971-1997	**11.86%**	**13.12%**	**13.16%**	**-1.44%**
1984-1997	**18.83%**	**15.91%**	**16.99%**	**-2.52%**

Equity Mutual Fund and Benchmark Returns: Annual Compound Return, Excluding Sales and Redemption Fees Jeremy J Siegel, Stocks for the Long Run the definitive guide to financial market returns and long-term investment strategies 273 (1998)

[61] *E.g.* Fleet, Balancing Your Retirement Account, *Rule of 100-a simple approach*, *at* <http://www.thesystemsgroup.com/downloads/401k/Balancing%20Your%20Retirement%20Account%20(Rule%20of%20100).pdf> (Feb.13, 2002).

the most important decision that can be made about a portfolio.[62] The stocks must also be well diversified.[63]

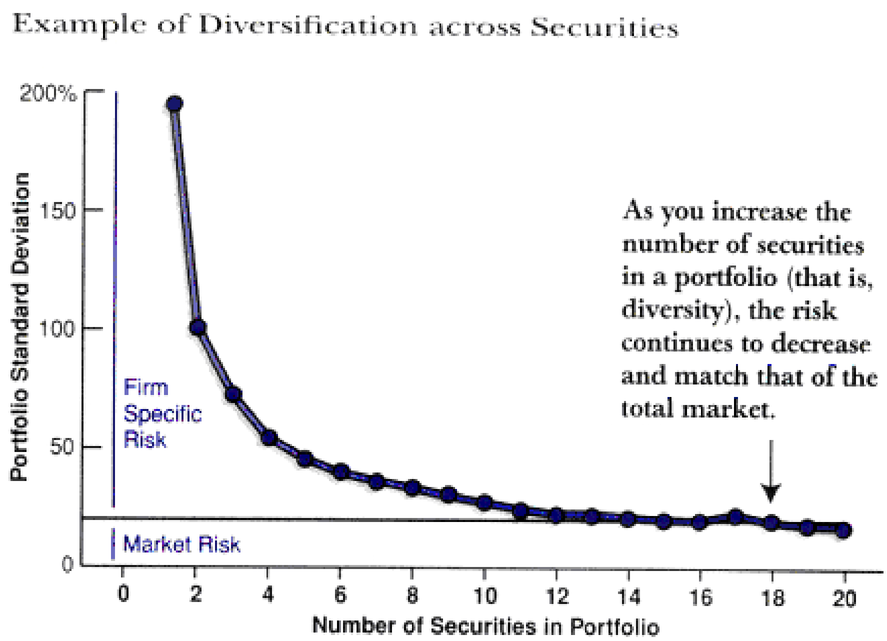
The majority of the movement of a stock price is a function of the over all movement of the market itself. The remainder of movement is a function of first the specific industry and finally the particulars of the company itself. This concept is easy to grasp. The purpose of diversification is to diversify away all of the industry and firm specific risk. This leaves only the market risk, also known as the systematic risk, as not diversifiable. A diversified portfolio should have no more risk than the market risk.

Thus the ability to 'pick stocks' is a limited skill mostly dependent upon the future movement of the market itself. Any deviation from the

[62] *E.g.* Gary P. Brinson et al., *Determinants of Portfolio Performance*, Financial Analysts Journal 26 (Jul-Aug 1986) ("A study of 91 large US pension plans was conducted to determine the effects of investment policy, market timing, and security selection on their total return and the variability of that return. A simple framework is provided based on a passive, benchmark portfolio representing the plan's long-term asset classes, weighted by their long-term allocations. Results of data from 1974-1983 indicated that investment policy dominated market timing and security selection and explained on average fully 93.6% of the total variation in actual plan return.")*id*. *See also* Roger G. Ibbotson & Paul D. Kaplan, *Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?* Financial Analysts Journal 26 (Jan.-Feb. 2000) (validating the findings of Brinson).

[63] Modern Portfolio Theory shows that it is not the number of different stocks that are owned in a portfolio that creates diversification but rather how each stock is correlated with the other stocks in the portfolio. These concepts of diversification are well accepted and were first articulated over 52 years ago in 1952, by Dr. Harry Markowitz. He shared the Nobel Prize for this work. *Stocks concentrated within the same industry do not diversify a portfolio.*

The stocks used to generate the portfolio shown in the graph were generated randomly.



Douglas Hearth & Janis K. Zaima, Contemporary Investments, 2nd ed. 379 (1998).

'Rule of 100' is suspect. As a group, retail investors have consistently held an average of 45% in bonds and cash, roughly the average age of survey respondents. [64]

The weak track record of Wall Street 'Research' not a recent event:[65] A broker should inform the retail customer that its Analyst Buy Recommendations far exceed Sell recommendations? For example, one study found this ratio to be 15 to 1. [66] Brokerage firms title these recommendations 'Research', thus any caveats should be clearly articulated.

What makes this fact all the more relevant is that ***some brokerage firms forbid their brokers from recommending the sale of stocks that are on the recommended list***. For example, The Morgan Stanley Dean Witter & Co. MSDW Compliance Guide 1999 Solicitation Policy, states "Financial Advisors should not solicit transactions in securities that are contrary to the opinion of MSDW Research (i.e., soliciting purchase of a security when MSDW's opinion is either "hold" or 'Neutral,' or soliciting sale of a security that is rated either 'strong buy' or 'outperform')." Similarly, the Prudential Securities, Compliance Policies & Procedures, Section 6, Solicitation of Orders Policy (Aug. 1998), states "Financial Advisors are discouraged from soliciting "sell" orders against Research Department's 'hold' or 'buy' ratings. However, such solicitations are permitted provided the recommendation is suitable for the client and the Research Department's opinion is disclosed to the client."

Suitability as 'Financial Informed Consent': There is an industry obligation to make investments suitable given the financial circumstances of the investor, under state law, NASD and SEC regulations. A broker should reveal the existence of this legal requirement to the retail customer and verify the requisite background

---

[64] ***Percent of Investor Portfolios allocated to Cash, Bonds and Bonds Funds***

	2003	**2001**	**2000**	**1999**	**1998**
CDs, Cash, Money Markets	22%	26%	28%	25%	25%
Bond Mutual Funds	7%	11%	11%	11%	11%
Individual Bonds	7%	8%	8%	8%	8%
Total Cash and Bonds	**36%**	**45%**	**47%**	**44%**	**44%**

* Question not asked in 2002
Securities Industry Association, Annual SIA Investor Survey Investor's Attitudes Towards the Securities Industry 2003, 58 (Nov. 2003), *at* <http://sia.com/publications/pdf/Investorsurvey2003.pdf>.

[65] Forgetting the Analyst Conflicts that has led to recent multi-billon dollar fines, analyst 'Research' has long been flawed. "For example, Michael Sandretto of Harvard and Sudhir Milkrishnamurthi of M.I.T. completed a massive study of the one-year forecasts of the 1,000 most widely followed companies… Financial forecasting appears to be a science that makes astrology look respectable." Burton G. Malkiel, A random walk down Wall Street including a life-cycle guide to personal investing 169-170 (1999).

[66] *E.g.* Kent L. Womack, *Do brokerage analysts' recommendations have investment value?* Journal of Finance 51 (Mar. 1996). *See also* Roni Michaely, *Conflict of interest and the credibility of underwriter analyst recommendations*, The Review of Financial Studies 653 (1999) (analysts recommendations associated with underwriting underperformed nonaffiliated analysts).

information.[67] By failing to reveal this legal obligation of suitability, a broker can convince the financial illiterate that he or she is at fault for any loses. This risk management ploy, traducing the unsuspecting customer, reduces the number of arbitration claims.

Conclusion

Fundamental to any contract is a 'meeting of the minds', particularly when a party has fiduciary obligations, to fully disclose material facts so that the beneficiary can make informed decisions regarding known risks.

There is a well developed body of law associated with medical doctors, psychologists, real estate brokers, academic research, lawyers, Certified Financial Planners, Architects, Engineers and insurance representatives that describes the informed consent required prior to any action. Securities regulators also impose similar disclosure requirements. Mere consent, without full disclosure of pertinent facts, does not satisfy this requirement.

The pertinent facts and principles in this article are well known to market professionals, are part of any disclosure that claims to be informative, but are not always fully disclosed. Merely stating that markets

[67] *Dean Witter Reynolds, Inc.*, SEC Rel. No. 34-41145, 69 SEC Docket (CCH) 725 (Mar. 8, 1999) (broker willfully committed "violations of Section 17(a) of the Exchange Act and Rule 17a-3 there under because he regularly falsified information on Dean Witter's books and records, including the following: (1) account documentation containing untrue and exaggerated information about customer investment objectives, investment experience, assets, and occupations"), <http://www.sec.gov/litigation/admin/34-41145.txt>. *See also In the Matter of James F. Novak*, 47 S.E.C. 892, 898-899 (Apr. 8, 1983) *(*"The requirement that records be kept embodies the requirement that such records be true and correct...In an industry that presents so many opportunities for abuse and overreaching, and depends so heavily on the integrity of its participants, Novak's behavior cannot be countenance.")*id.* "Merrill Lynch was also a respondent in these proceedings, charged with failing to exercise proper supervision over Novak. We accepted its offer of settlement before hearings were held herein."*id.*

The Commodities Futures Trading Commission more heavily regulates how risk tolerance and investment objective forms are obtained. These many cases are a fertile resource. *E.g. Johnson v. First Commodity Corp. of Boston*, CFTC Docket No. 86-R28, 1987 CFTC LEXIS 308 (July 22, 1987) (client was "instructed that once she received the documents, she was to call him so he could advise her how to fill the documents out…advised the complainant that the enclosed Risk Disclosure Statement was merely a formality. He also told the complainant that a compliance officer would call and she should answer 'yes' to every question."). *Johnson v. First Commodity Corp. of Boston* held that "It is true, as the respondents argue, that the complainant signed a Risk Disclosure Statement as required by Reg. § 1.55 and that she orally acknowledged she was aware of the risk. However, an executed risk disclosure statement is a minimum standard and rendered ineffective by fraudulent promises of tremendous gains and low risk with little or no time to reflect."*id. See also Metzger v. Commodity Resources, Inc.*, CFTC Docket No. R81-1161-82-43, 1986 CFTC LEXIS 654, Comm. Fut. L. Rep. (CCH) P23,023 (Apr. 8, 1986) (risk tolerance documents "must be concise and understandable to the inexperienced trader; and the disclosure document must be conspicuously brought to the customer's full attention when it is transmitted to him' (42 Fed. Reg. 44742, 44747)….The Commission recognized that the risk disclosure document 'will be of limited effectiveness if it is lengthy and complex.' Such a 'lengthy document simply will not be carefully read by many customers' (42 Fed. Reg. 44742, 44748). When it issued Section 1.55 as a final rule, the Commission again emphasized that the disclosure statement was "intended to alert customers to some of the risks inherent in futures trading' (43 Fed. Reg. 31886, 31888). The brevity and simplicity of the required document were designed to make the document conspicuous to the customer.").

are inherently risky and unpredictable does not satisfy the fiduciary obligation of fully informing a retail customer. It is fiduciary obligations and 'Financial Informed Consent' associated with suitability that separates the brokerage industry from being mere salesmen of disposable items such as shoes and paper products. Suitability obligations allow the brokerage industry to call itself a 'profession'. The professional obligation of 'Financial Informed Consent' benefits all parties. [68]

[68] An unsuitable investment product is an inefficient deployment of capital. It harms the markets, as well as being a loss for the individual investor. It fosters increased regulation, an anathema to the industry.

From the Lone Star State: Brokerage Firm Liability for Recommendation of Money Managers

By Samuel Benton Edwards

Sam Edwards is a partner in the law firm of Shepherd, Smith & Edwards, L.L.P. located in Houston, Texas. Mr. Edwards and the other members of his firm have a nationwide practice devoted to helping investors recover wrongful losses from brokerage firms and have represented thousands of customers from many states in their desire to aid the public investor. Mr. Edwards can be reached at (800) 259-9010 or sedwards@sselaw.com.

I. Introduction

One of the most noticeable recent trends in the brokerage industry is the increased recommendation that customers use professional money managers in the investment of clients' assets. Brokers are often encouraged to push these managers on clients as a means of "stabilizing" the broker's income and allowing the broker to focus on "asset gathering" rather than watching the market. Moreover, such a strategy allows brokers to share in the management fees of an account without actually managing any of the assets. [1]

The firms have publicly touted the use of money managers as beneficial for customers since it allows customers to gain access to professional investment advisors that, supposedly, have no incentive but to increase the value of the account without client concerns over transaction fees (no churning). However, firms have been more private in acknowledging the more important and insidious drive behind this new strategy: the avoidance of liability. In recent months, many national brokerage firms have attempted to disclaim liability by arguing brokerage firms are not responsible for the decisions of any third party, outside money manager. Additionally, several of the major wire houses have placed language in their money manager agreements with customers requiring the customer to indemnify and hold the firm harmless for any losses suffered in managed accounts. Ultimately, if this strategy prevails, brokerage firms will be able to collect large fees (sometimes over 3% of assets held) for doing virtually no work while insulating themselves from liability for the brokerage firm's own wrongdoing. The purpose of this article is to help PIABA members combat these agreements and the brokerage industry's transparent attempt to escape liability.

II. Liability for the Recommendation of a Money Manager

a. Suitability

The primary claim for most securities cases involving money managers is that the selection of the manager was unsuitable for the client. Applying basic suitability analysis to the selection of an advisor should make for a successful claim.

i. Rolf

One of the initial cases discussing the subject of brokerage firm liability for the

[1] With managed accounts, brokerage firms typically charge the client a fee ranging from 1% to 3% for "carrying" the account and paying the money manager. Surprisingly, most of the money is kept by the firm (managers get as little as 50 basis points), even though the firm is not managing the account.

losses of an independent money manager is *Rolf v. Blyth, Eastman Dillon & Co.*[2] Rolf, a wealthy Ohio ophthalmologist who was described by the Court as someone who was "[l]ong an investor and an aggressive trader in the stock market," had been a Blyth, Eastman Dillon & Co. ("BEDCO") customer for several years. When his broker retired, he was assigned a junior account representative. Concerned that his new broker was incapable of managing such a large account, Rolf requested that an independent investment advisor manage his savings, rather than the junior broker. Based on that request, the junior broker "supplied the names of two investment advisors." After interviewing each of the money managers, Rolf chose a young, aggressive investment advisor who was considered "the 'new breed' of young money-managers" and executed a broad discretionary authorization agreement with the advisor.[3] Rolf then contacted the BEDCO broker, agreeing to leave his account with BEDCO in return for the firm's supervision of the new money manager.

Over the next several months, the manager engaged in numerous trades, most of which resulted in large losses. When Rolf complained to the BEDCO broker about the losses, the broker "began to assume the posture that he was a mere 'order taker,'" but he also gave assurances of confidence in the manager and the investment decisions the manager was making. Ultimately, the assurances were not well founded, as the money manager made numerous fraudulent transactions and overly aggressive and speculative purchases.

In deciding that the broker and his firm were liable for the losses, the Court concluded that, while neither the broker nor the firm were aware of the fraudulent activities, they were "of course knowledgeable that many of the securities purchased for Rolf were highly speculative, 'high-fliers.' Nevertheless, neither [the broker] nor BEDCO ever identified any security as unsuitable for Rolf." *Id* at 43. Clearly, the Court felt the broker and BEDCO were under an obligation to continue their suitability analysis, even though the customer's funds were being managed by an independent money manager. Additionally, the Court determined that the broker's recommendation of the manager and reassurances of the abilities of the money manager resulted in participation in the fraud committed against Rolf. Specifically, the Court held that the broker "by virtue of assurances of confidence in [the manager] and in [the manager's] investment decisions … participated in and lent assistance to the fraud upon Dr. Rolf." *Id* at 44.

Under the precedent of *Rolf*, trading authorization maintained by a third party, such as a money manager or independent investment advisor, does not relieve a broker of its duty to the client. Rather, the broker and his firm must only recommend suitable money managers, continue to have an obligation to evaluate the suitability of the transactions in an account held with the firm and must not give baseless reassurances that the manager "knows what he is doing," lest the firm be held liable for the manager's indiscretions.

ii. <u>Other Decisions</u>

Other decisions involving money managers have affirmed the broker and his firm's continuing duties to customers despite the existence of an independent money manager. The S.E.C. affirmed the continuing duties of a broker in an early case involving a money manager in

---

[2] *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F2d. 38 (2d. Cir.), *cert. denied*, 439 U.S. 1039 (1978).

[3] Sounds similar to the "new economy" argument put forth in many "tech wreck" cases.

the decision of *In Re: William I. Hay*.[4] In *Hay*, a money manager holding a power of attorney engaged in unsuitable and speculative trading, cross-trading, self-dealing and defrauded clients whose stocks were traded through respondent's brokerage firm. The broker in the *Hay* proceeding asserted virtually the identical defenses many of the firms are arguing in their current motions to dismiss, including that the broker was fully authorized to accept the directions from the money manager, that the money managers never directly advised the clients and that the power of attorney insulated the broker from all direct brokerage duties to the clients. The S.E.C. rejected these defenses finding them to be without merit. Ultimately, the S.E.C. concluded that the broker had a duty to either not accept the orders from the money manager or inform the clients of the speculative and financially unsound nature of the investments. *See also*, *In re Merrill Lynch*, CCH Fed.Sec.L.Rep., at 83258 (1982) (setting forth the S.E.C.'s position that a broker which knows that the trading in a customer's account by a third party is inconsistent with the customer's finances and investment objectives has an obligation to act).

iii. <u>NYSE Rule 405</u>

As we are all aware, the New York Stock Exchange's "Know Your Customer" rule requires brokers to "learn the essential facts relative to every customer" to make suitable recommendations for security purchases. *NYSE Rule 405(1)*. However, Rule 405 is not limited to *recommended securities purchases*, and, in fact, contains language which requires the suitability analysis to extend to all transactions, including those made by a money manager. Under Rule 405, brokers must "[u]se due diligence to learn the essential facts relative to … **every order** … **and every person holding power of attorney** over any account accepted or carried by such organization." *NYSE Rule 405(1) (emphasis added).*[5]

The lower court in *Rolf* also relied upon the language in Rule 405 to support its conclusion that broker/dealers are responsible for losses in managed accounts. As the Court pointed out, "defendants are unable to point to any language in the NYSE rules which indicates that the duties of a broker are lessened when an investment adviser handles the account. Indeed, the language of Rule 405(1) which requires the broker to discover all pertinent facts with respect to the adviser indicates to this court that due diligence is required in this situation also." *Rolf v. Blyth Eastman Dillon & Co., Inc.,* 424 F.Supp. 1021, 1039 (D.C.N.Y. 1977).

In applying Rule 405(1), it is clear that brokerage firms have an obligation to only enlist the services of suitable money managers and to continue to evaluate the suitability of transactions as long as the brokerage firm carries the account.

iv. <u>Arbitration Awards</u>

One of the difficulties in writing on securities issues is, of course, that the law does not develop as openly because of the arbitration process. It becomes even more difficult considering that arbitrators are taught not to give reasoned awards. However, on occasion, a

[4] *In Re: William I. Hay*, 19 S.E.C. 397 (1945).

[5] NASD suitability guidelines are not nearly as helpful since the language of Rule 2310 is limited to "recommendations" for securities transactions. Under the rule, "[i]n **recommending** to a customer **the purchase, sale or exchange of any security**, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer …." NASD Conduct Rule 2310(a) (**emphasis added**). Therefore, if the firm being sued is not an NYSE member or the broker is not a member, the suitability obligation imposed by SRO's is not as strong.

panel feels it is necessary to give a rationale behind its decision. While those cases do not provide *binding precedent*, they can be very persuasive with other arbitrators.

Earlier this year, a Florida panel gave such a reasoned award in an independent money manager case identical to the cases all PIABA members are seeing and will continue to see in the future. *See William A. Warde v. A.G. Edwards & Sons, Inc. & William Tabone*, NASD Case No. 03-00452 (March 30, 2004).[6] In *Warde*, the Panel was faced with the question of whether a broker and his firm were liable for the losses caused by an independent money manager. According to the award, Mr. Warde was claiming losses "in connection with the recommendation by Respondents that Claimant should invest his funds with the Roxbury Capital Management Large Cap Growth money management program …." Among other claims, Mr. Warde was alleging the "unsuitable recommendation" of a money manager and "violation of the Florida Securities and Investor Protection Act." Respondents A.G. Edwards and William Tabone denied any wrongdoing and also argued that the Florida Securities and Investor Protection Act did not apply since the "conduct did not involve the purchase or sale of securities." A.G. Edwards raised the additional defense that the claims should fail because "the contract documents between Claimant and Respondent A.G. Edwards expressly exculpated the Respondents and indemnified them from loss occasioned by the activities of the recommended money manager."

After a hearing on the merits, the Panel decided in full favor of the Claimant, awarding compensatory damages, costs and remanding the issue of attorney's fees to a court of competent jurisdiction. More importantly, the Panel specifically ruled "Respondents are found liable for damages as a result of their failure to recommend a suitable money management program …." Additionally, the Panel stated it "expressly finds that the contract documents between Claimant and Respondent A.G. Edwards do not exculpate the Respondents and do not indemnify them from loss occasioned by their recommendations of a money manager …."[7]

For suitability claims, this decision marks a total victory. Not only did the Panel use specific language finding that the suitability obligation extends to the recommendation of an independent money manager, but as discussed in more detail in Section II of this article, the Panel's ruling derailed the brokerage firm argument that their "hold harmless" clauses work to deny claims of unsuitable recommendations.

b. Breach of Fiduciary Duty

Although the range of the duty may differ, in most jurisdictions, including Texas, a broker is considered a fiduciary of his customers. *See Rauscher Pierce Refusnes v. G.S.W.,* 923 S.W.2d 112, 115 (Tex. App. – Houston [14th Dist.], 1996, no writ); *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523 (5th Cir. 1987) *cert. denied*, 487 U.S. 1205 (1988) (stating "we hold that a broker does owe his client a fiduciary duty."). Moreover, the fiduciary duty of an agent or broker to his principle is hornbook law. *See* RESTATEMENT (2D) OF AGENCY § 425 (agents employed to make, manage, or advise on investments have a fiduciary obligation); *see also Southland Lloyd's Ins. Co. v. Tomberlain*, 919 S.W.2d 822, 831 (Tex. App. – Texarkana 1996, writ denied).

[6] Claimant was successfully represented by Florida PIABA member Richard J. Lantinberg of Cooper Ridge & Lantinberg, in Jacksonville, Florida.

[7] The Panel also ruled that the Florida Securities and Investor Protection Act did apply to Mr. Warde's claims arguing that the statute applies "not only to the sale or purchase of securities, but the 'rendering of investment advice.'"

As a result, an additional claim members may assert is breach of fiduciary duty for the recommendation of an unsuitable money manager.

i. Gochnauer

In *Gochnauer v. A.G. Edwards,* the Eleventh Circuit addressed the issue of whether the recommendation of an unsuitable money manager constituted a breach of the fiduciary duty owed to the customer.[8] The Gochnauers were moderately sophisticated investors with conservative investment objectives. At the time of meeting the money manager, the majority of the Gochnauer's savings were invested in municipal and corporate bonds. Mr. Gochnauer asked his A.G. Edwards broker for recommendations that could "yield more rewarding financial returns." *Gochnauer,* 810 F.2d at 1044.

The broker "recommended the Gochnauers consider option writing" through a "self-styled investment advisor." *Id*. The broker explained that he had known the "manager" for many years and he was aware that the man had been very successful in the options market.[9] Ultimately, the Gochnauers agreed to sign over discretionary authority to this manager while maintaining their account with A.G. Edwards.

In the process, the Gochnauers were given a prospectus concerning options writing which specifically acknowledged the risky nature of options trading. Additionally, the Gochnauers signed a contract with the manager stating he would have full discretion, would be engaging in options trading (which they purportedly understood to be risky) and included language indicating "there were no other parties to the agreement." *Id*.

When the account was opened, the manager immediately sold all of the Gochnauer's bonds and began purchasing speculative options. Over the next year, the manger lost virtually all of the money in the Gochnauer's account. Much of the losses were a direct result of the commissions charged, totaling over one third of the damages. The Gochnauers subsequently sued A.G. Edwards, the broker and the manager. A.G. Edwards and the broker argued they could not be liable for the actions of the manager since they were not parties to the contract and made no decisions concerning the transactions.

The Court disagreed, holding that the broker "breached his fiduciary duty to the Gochnauers when he advised them and assisted them in hiring [the manager] and in establishing the speculative options account."[10] *Id*. at 1050. Additionally, the Eleventh Circuit agreed with the lower court's analysis for causation stating "but for the breach of duty, the plaintiffs

[8] *Gochnauer v. A.G. Edwards & Sons, Inc*., 810 F.2d 1042 (11th Cir. 1987).

[9] This case is more egregious than what most attorneys will see as, unbeknownst to the Gochnauers, the manger was not actually an experienced and registered investment advisor, but rather, an A.G. Edwards customer who the broker knew to be a successful options trader. While the Court decided this was an obvious material omission, the Gochnauers testified they would likely have used the advisor even if told this information, and therefore, the Court determined the reliance issue did not exist for a violation of securities laws.

[10] The Court did not deal with the contract issue whereby A.G. Edwards disclaimed liability since it was not a party to the contract. The rational of this seems to be that, since a fiduciary obligation was owed, the fact that neither A.G. Edwards nor the broker were parties to the contract is irrelevant in a breach of fiduciary claim as it does not relieve them of any obligation previously owed.

would not have experienced the heavy losses ….” *Id*.

This “but for” analysis can be very helpful in many of our cases as attorneys should be able to successfully argue that “but for” the broker’s recommendation of this particular money manager, the client would not have sustained the “heavy losses” complained of in the *Statement of Claim*. Moreover, the analysis of the Court makes it clear that it is a breach of fiduciary duty to recommend an unsuitable money manger.

ii. Additional cases

A few other cases have addressed the issue of fiduciary liability for the actions of independent money managers. In *Kaufman v. Merrill Lynch*, the Maryland District Court refused to grant Merrill Lynch’s Motion to Dismiss a money manager case on the grounds that liability could exist both by Merrill Lynch’s inaction in stopping the wrongful trading as well as recommending the manager through its “approved list.” *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F.Supp. 528, 536 (D.Md. 1978). *See also, Ruiz v. Charles Schwab & Co., Inc.,* 736 F.Supp. 461, 464 (S.D.N.Y. 1990) (finding that the “execution of a limited power of attorney does not relieve Schwab of all of its responsibilities to investors.”)

III. Waiver Provisions in Money Manager Contracts

Aware that panels and juries may well impose suitability and fiduciary standards for the recommendation of money managers, brokerage firms are placing language in money manager contracts in which the firm purports to disclaim all responsibility for the managed account and the client agrees to hold the broker and firm harmless for the manager’s actions. Many of us are being forced to fight the language of these “boiler-plate” contracts in improper motions to dismiss.

a. Validity of Disclaimers of Liability

Under Texas law, agreements to waive or limit liability are generally enforceable.[11] *See Allright, Inc. v. Elledge*, 515 S.W.2d 266, 267 (Tex. 1974); *Interstate Fire Ins. v. First Tape, Inc.,* 817 S.W.2d 142, 145 (Tex. App. – Houston[14th Dist.] 1991, writ denied). However, the NASD “fair dealing” requirement as well as public policy concerns should limit the use of such agreements in customer and brokerage firm relationships.

i. Fair dealing with customers

As the NASD explains in its Conduct Rules, “[i]mplicit in all member and registered representative relationships with customers and others is the **fundamental responsibility for fair dealing**.” *NASD Manual -- Conduct Rules, IM-2310-2(a)(1) (emphasis added)*. In drafting the “hold harmless” clauses in money manager agreements, brokerage firms are clearly attempting to use their clients’ trust to avoid liability. It should be successfully argued that these clauses take advantage of unsuspecting customers and result in very “unfair dealing” with the public. Having contractually agreed to deal fairly with all customers, brokerage firms should not be allowed to place these self-serving clauses in their contracts.

ii. Public Policy Considerations

Under Texas law, agreements to limit liability are void if they are against public policy. Such agreements are typically against public policy if there is a disparity of bargaining power between the parties. *See Fox Elec. Co. v. Tone Guard Sec., Inc.*, 861 S.W.2d 79, 83 (Tex. App. – Fort Worth 1993, no writ.).

[11] Some states, California for example, have statutory language which outlaws certain “hold harmless” agreements. *See, e.g.*, CAL. CIV. CODE § 1668 (“All contracts which have for their object, directly or indirectly, to exempt one from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the public policy of the law.”)

A disparity of bargaining power exists when one party has no real choice in accepting the terms of the agreement. *See Crowell v. Housing Auth. of Dallas*, 495 S.W.2d 887, 889 (Tex. 1973) (holding that such disparity existed where low income tenant had no choice but to accept lease terms to get decent housing accommodations). Claimants' attorneys should be able to argue successfully that customers have no choice but to sign these unfair agreements if they wish to invest. As a result, any provisions limiting liability are invalid.

While Texas courts have not considered the issue in relation to brokerage agreements, courts outside of Texas have addressed this specific issue finding that such waiver provisions in brokerage agreements are against public policy and thus invalid. For example, a California appellate court found a provision in an E.F. Hutton contract whereby the customer agreed to hold the brokerage firm "free and harmless from any responsibility or loss" void as against public policy. *See Blankenheim v E.F. Hutton & Company, Inc., 217* Cal.App.3d 1463, 1471-1472 (1990).

b. Fair Notice Requirements for Disclaimers of Liability

Under Texas law, disclaimers of liability must meet certain requirements which provide fair notice to the party that they are waiving certain rights. The basic question is whether "a reasonable person against whom it is to operate ought to have noticed it." *Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 510 (Tex. 1993). Texas courts have developed two specific standards to determine if fair notice has been given in the "express negligence doctrine" and the "conspicuousness requirement." [12]

i. Express Negligence Doctrine

The "Express Negligence Doctrine" states that a party seeking indemnity from the consequences of that party's own negligence must express that intent in specific terms within the four corners of the contract. *Ethyl Corp. v. Daniel Const. Co.*, 725 S.W.2d 705, 707-708 (Tex. 1987). In cases involving money managers, the negligence issue is related to the recommendation of a particular money manager. Under the Express Negligence Doctrine, brokerage firms are required to disclose the fact they are seeking to avoid negligence on this issue. Fearful of action on the part of the regulatory bodies, brokerage firms will likely never include such direct language in their contracts. As a result, Texas attorneys can successfully argue the waiver is ineffective.

ii. Conspicuous Requirement

In order to disclaim liability under a contract, Texas' conspicuousness requirement mandates "that something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it." *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 482 S.W.2d 841, 83 (Tex. 1972). Under the Texas Uniform Commercial Code ("U.C.C.") conspicuous is defined as, "printed heading in capitals …." TEX. BUS. & COM. CODE ANN. § 1.201(1) (Vernon Supp. 2002). Alternatively, the language in the body of a form can be conspicuous "if it is in larger or other contrasting type or color." *Id*.

Since the "hold harmless" provisions in most broker/dealer agreements are buried deep in boilerplate language, almost never in

[12] Other states have similar rules requiring that the waiver put a reasonable person on notice. *See, e.g., Westlye v. Look Sports, Inc.*, 17 Cal. App.4th 1715, 1736, 2 Cal.Rptr.2d 781 (1993) ("[A] contract or provision which does not fall within the reasonable expectations of the weaker or 'adhering' party will not be enforced against him.")

bold or larger type and rarely identified in a separate heading, it stands to reason that a lack of conspicuousness argument may be successfully asserted.[13]

c. Limitations on Disclaimers of Liability

Many statutory and common law claims have "anti-waiver" provisions or case law supporting that the cause of action cannot be waived by agreement. If an attorney asserts any of the following claims, among others, for their clients, they should be able to successfully argue the contractual provisions being asserted are void.

i. Fraud

It is well settled law that a party cannot contract away liability for his own fraud as any such exculpatory clauses are void as against public policy. *See Rep. Bank Dallas v. First Wis. Nat. Bank*, 636 F.Supp. 1470, 1473 (E.D. Wis. 1986) (following the Restatement (Second) of Contracts and holding that exculpatory clauses meant to avoid liability for one's own fraud are void as against public policy).

ii. Breach of Fiduciary Duty

Under Texas law, a fiduciary cannot validly contract with a beneficiary to exclude its fiduciary obligations because such an agreement is contrary to public policy. *See Maykus v. First City Realty and Financial Corp.,* 518 S.W.2d 887, 893-894 (Tex. Civ. App. – Dallas 1974, no writ). As discussed above, brokers are fiduciaries for their customers. Any attempt to avoid the obligations imposed as a matter of law to fiduciaries is void as against public policy.

iii. Texas and Federal Securities Acts

Most securities acts, including the Federal and Texas Acts, have anti-waiver provisions which do not allow parties to freely contract away the protection of the law. The federal securities laws specifically outlaw any provisions waiving their protections. Under the SECURITIES EXCHANGE ACT, "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Exchange Act] or of any rule or regulation thereunder, or of any rule of any exchange required thereby shall be void." THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. § 78cc(a).

The protections of the TEXAS SECURITIES ACT, much like the Federal statute, cannot be waived. Under the Section titled "Waivers Void," the TEXAS SECURITIES ACT states, "A condition, stipulation, or provision binding a buyer or seller of a security or a purchaser of services rendered by an investment adviser or investment adviser representative to waive compliance with a provision of this Act or a rule or order or requirement hereunder is void."[14] TEX. REV. CIV. STAT., ARTICLE 581-33L.

iv. Deceptive Trade Practices Act

The TEXAS DECEPTIVE TRADE PRACTICES ACT ("DTPA") specifically forbids contractual provisions purporting to waive the protection provided in the Act. "Any waiver by a consumer of the provisions of this subchapter is contrary to public policy and is unenforceable and void." TEX. BUS. & COM. CODE ANN. § 17.42 (a). The DTPA provides an exception to this

[13] This limits Respondents' typical argument that "the customer is responsible for reading the contract." Under Texas law, brokerage firms cannot bury these "hold harmless" agreements in money manager contracts and then argue it is the customer's fault for not reading the contract.

[14] Most other states which follow some form of the Uniform Securities Act contain similar language. *See, e.g.*, the California Corporate Securities Law of 1968 which states "Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law … is void." CAL. CORP. CODE § 25701.

general rule, allowing waiver, as long as (1) the waiver is in writing and signed by the consumer, (2) the consumer is not in a significantly disparate bargaining position and (3) the consumer is represented by counsel in seeking or acquiring the goods or services at issue. TEX. BUS. & COM. CODE ANN. § 17.42 (b). Additionally, the waiver must be in a section specifically identifying that it is a waiver of rights and the type must be conspicuous, in bold and at least 10 points in size. TEX. BUS. & COM. CODE ANN. § 17.42 (c). Of course, these exceptions are virtually never met when a client signs an agreement with a firm for an independent money manager, and therefore, the purported waiver is invalid.

IV. Conclusion

The application of basic suitability and fiduciary duty principles to managed accounts should result in the imposition of liability on the referring broker. Additionally, indemnity agreements in managed money accounts are void as to many causes of action and difficult to impose in many cases. As managed money grows in popularity, it will become increasingly important for PIABA to develop a unified front imposing liability on the brokerage industry which is getting rich while attempting to avoid liability.

Another Serpent on Wall Street-The WorldCom Fraud

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 Attorney 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](mailto:matepper@bellsouth.net) and he can be reached at 954-961-0096.

Like the serpent in the Garden of Eden who beguiled Eve into eating the forbidden fruit, Salomon Smith Barney ("SSB"), now known as Citigroup Global Markets, Inc. stands accused by investors of being a Wall Street serpent. SSB is alleged to have beguiled its brokers into recommending WorldCom to their customers by using misrepresentations and omitting material facts. Investors argue that SSB placed its own self-interest ahead of the interests of its customers.

Investors have some powerful arrows of evidence in their quivers, which were used during the class action to give SSB the shivers. However, unlike the serpent who was condemned to crawl on his belly for eternity because of its sins, SSB is still negotiating its penalty.

This article summarizes some of the fraud allegations and arguments by investors against SSB related to its recommendation to purchase WorldCom. The allegations have been collected from court filings, regulatory findings and newspaper articles.

Investors argue that SSB fraudulently induced its customers to purchase and hold WorldCom stocks by providing them with recommendations and analyst reports from Jack Grubman, SSB's star telecommunications analyst, that were infected by undisclosed conflicts of interest, contained misrepresentations and omitted material facts. SSB misrepresented WorldCom's financial condition and failed to disclose the illegal <u>quid pro quo</u> relationship between SSB and WorldCom. Had that self-serving arrangement been adequately disclosed, it would have been apparent that Grubman's positive reports about WorldCom and recommendations to buy WorldCom was not reliable advice from an independent analyst and trustworthy brokerage house.

The illegal <u>quid pro quo</u> arrangement was that SSB and its agents would issue positive analyst reports about WorldCom, provide WorldCom senior executives with valuable IPO shares, and loan WorldCom's CEO, Bernard Ebbers, ("Ebbers") hundreds of millions of dollars in exchange for WorldCom's investment banking business and the substantial revenue and personal compensation that the business generated for SSB and its agents.

SSB and its parent, Citigroup, had a strong financial interest in propping up the price of WorldCom stock. WorldCom was one of SSB's largest fee generating clients. WorldCom was an extremely desirable client because it engaged in so many acquisitions, generating significant banking business. Grubman's positive analyst reports played a significant role in assuring that SSB would retain WorldCom's lucrative investment banking business. SSB even reconfigured Ebbers' WorldCom margin debt[1] which avoided selling Ebbers' WorldCom stock. Had Ebbers been forced to sell, it would have negatively impacted the price of WorldCom stock.

SSB Failed to Disclose its Illegal <u>Quid Pro Quo</u> Relationship with WorldCom

SSB and Grubman on the one hand and WorldCom and Ebbers on the other, had a close and self-serving relationship from which both sides derived substantial benefit. WorldCom's securities prices were artificially inflated by Grubman's reports. He was SSB's star telecommunications analyst and consistently encouraged investors to buy WorldCom securities. An August 2002 Time magazine article reported that "Grubman was the ax, the one man who could make or break any stock in [the telecommunications] industry."

SSB and Grubman were well remunerated for their support of WorldCom. Between October 1997 and February 2002, SSB received a significant portion of WorldCom's investment banking business, for which WorldCom paid $107 million over the course of twenty-three deals. Grubman's compensation was directly tied to SSB's investment banking business. In 2001 alone, Grubman claimed compensation for his involvement in ninety-seven investment banking transactions which together generated $166 million in revenues. When he attended Ebbers' wedding, he charged the trip to the investment banking department. Grubman's importance to SSB is reflected in his compensation. Between 1998 and 2002 Grubman made about $20 million per year and when he resigned from SSB in August 2002, he received a severance package of $32 million plus forgiveness of a $19 million loan.

In exchange for WorldCom's lucrative business, SSB provided Ebbers and other WorldCom senior executives with valuable IPO shares.[2] SSB's corporate sibling, the Traveler's Insurance Company ("Travelers"), secretly lent Ebbers hundreds of millions of dollars, which were secured in part by Ebbers' WorldCom stockholdings.[3] And, SSB published Grubman's relentlessly positive, but materially false, reports about WorldCom.

SSB Misrepresented the Financial Condition of WorldCom

The accounting fraud at WorldCom involved, among other things, the improper classification of $3.8 billion in ordinary costs as capital expenditures in violation of generally accepted accounting procedures which led to WorldCom's overstatement of earnings. In 2000, Grubman adopted a new accounting model designed to omit the influence of capital expenditures, a key element of WorldCom's accounting fraud. This model was initially adopted for WorldCom alone among all of the telecom companies Grubman followed.

SSB and Grubman knew, or by the exercise of proper due diligence should have known, that WorldCom's financial condition was deteriorating. In early 2001, WorldCom badly needed to raise money and approached Citibank, and others about refinancing a $3.75 billion line of credit. The Citibank loan approval memo, dated March 2001 discussed WorldCom's negative cash flows for fiscal 2001, 2002 and 2003. According to the memo, WorldCom's negative free cash flow, essentially how much more it would spend than it took in, was expected to be $1.4 billion in 2002 and 2003. The proceeds from a planned 2001 $11.8 billion note offering were going to be used to refinance $9 billion in debt, including $3 billion in short-term notes that were issued in 2000 but were coming due in 2001. Despite internal views about the financial deterioration of WorldCom, Citibank approved the loan. The March 2001 loan approval memo noted that Susan Mayer, former treasurer of WorldCom, had told Citigroup that if it committed $800 million to the $3.75 billion line of credit for WorldCom, Salomon Smith Barney would be awarded a coveted role as co-manager of the big note deal, earning $20 million in investment banking fees. (New York Times, 3 Banks Had Early Concern About WorldCom Finances, March 17, 2004).

SSB had an Interest in Propping Up the Price of WorldCom

SSB had an interest in propping up the price of WorldCom because WorldCom was a leading fee generating client. SSB's asset management group owned more than 45 million shares of WorldCom for its clients and when Grubman was at his most influential, SSB's brokerage unit controlled 13% of the trading in WorldCom. If SSB was to continue to underwrite WorldCom stock and bond offerings and earn fees from trading WorldCom, it was necessary to fraudulently support its price. SSB also lent Ebbers $560 million which was, in part, secured by WorldCom stock. (See, New York Times, When Citigroup Met WorldCom, dated May 16, 2004).

When the price of WorldCom was declining in the summer of 2000, SSB reconfigured Ebbers' WorldCom debt to prevent the margin sell off of his shares which would have caused the price of the stock to drop. Citibank agreed to take a $10 million unsecured exposure on the loan before any stock would be sold.

"SSB provided personal financial assistance to Mr. Ebbers as a means of enhancing the probability that SSB would keep a preferred position in receipt of WorldCom business, including investment banking and stock option business, and also as a means of avoiding sales of Mr. Ebbers' stock, which would adversely affect WorldCom's stock price." Thornburgh Report.[4]

SSB's failure to disclose the illicit quid pro quo relationship between SSB, Grubman, WorldCom and its officers and the false and misleading description of WorldCom's financial condition in Grubman's analyst reports illegally propped up the price of WorldCom stock.

SSB and Grubman Knew Grubman's WorldCom Analyst Reports were Fraudulent

[4] Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, In re WorldCom, United States Bankruptcy Court, Southern District of New York, Case No. 02-13533, (AJG).

Investors argue: SSB knew that Grubman's analyst reports were not the work of an objective researcher. In addition to Grubman's ratings being driven by investment banking at SSB, he functioned as an insider at WorldCom. Grubman attended at least two meetings of WorldCom's Board of Directors concerning the acquisition of MCI and Sprint, and advised WorldCom regarding a contemplated acquisition of Nextel.

An allegation has surfaced that Grubman helped conceal WorldCom's financial problems by scripting Ebbers' statements for certain earnings conference calls. In regard to a scheduled February 7, 2002 earnings conference call, during the beginning of February 2002, Grubman sent Ebbers and/or Sullivan a series of e-mails instructing them to vouch for WorldCom's liquidity, accounting and business model, despite his understanding of the financial deterioration of WorldCom. Grubman published a corresponding research note that same day assuring investors that "WorldCom [had] addressed all issues surrounding liquidity, etc. of which there are none."

In a June 2001 e-mail to Kevin McCaffrey, SSB's head of U.S. research management, Grubman confirmed his knowledge that his buy recommendations were unreliable when he admitted:

> **Most of our banking clients are going to zero and you know I wanted to downgrade them months ago but got a huge pushback from banking. I wonder of what use bankers are if all they can depend on to get business is analysts who recommend their banking clients.**

At about the same time, Grubman e-mailed a research colleague about an upcoming dinner meeting at which he expected to hear two senior investment bankers complain about some of his recent commentary on telecom stocks. Grubman again confirmed his knowledge of his allegedly fraudulent practices: "Screw [the investment bankers], We should have put a sell on everything a year ago." (Emphasis added).

Investors argue that adequately disclosing the illicit relationships between WorldCom and SSB would have made it apparent to investors that SSB's and Grubman's analyst reports and recommendations were not reliable advice from an independent analyst and trustworthy brokerage house.

SSB senior management knew that Grubman had been corrupted and was not functioning as an independent analyst and knew that their analyst reports were improperly affected by pressure from SSB investment bankers. <u>NYSE Hearing Panel Decision, 03-72</u>. "In a February 22, 2001 memo, the [SSB] head of Global Equity Research told the managing directors in the U.S. equity research division that the global head of SSB's private client (i.e., retail division) said **SSB's 'research was basically worthless'. . . ."** <u>Id</u>. (Emphasis added). SSB's continued recommendation to buy and/or hold WorldCom despite its knowledge of the falsity of the analyst reports was a reckless disregard for the truth.

SSB and Grubman have also been the subject of government and regulatory investigations. SSB was one of ten investment banks, and Grubman one of two individual analysts who entered into a global settlement arising from joint investigations conducted by the SEC, the New York State Attorney General's Office and others into the undue influence of investment banking on securities research. Citigroup, SSB's parent, agreed to pay $400 million in settlement, including $150 million in penalties and $150 million in disgorgement. Citigroup, which includes SSB, agreed to pay $2.65 billion to settle class action claims by investors that SSB misrepresented WorldCom's financial condition and omitted to disclose its <u>quid pro quo</u> relationship with

WorldCom to investors.

Conclusion

The above allegations are disturbing because they reflect a breakdown of institutional controls that unfairly victimized thousands of investors. The above described allegations raise questions about the wisdom of Congress having repealed the Glass-Steagall Act, one of the key stock market reforms to follow the 1929 market crash. Without regulation, the temptation of huge investment banking fees was irresistible, focusing attention on the need for strict enforcement of investor protection statutes together with a strong regulatory presence.

Manifest Disregard in the Second Circuit

By: Stanley T. Padgett

Stanley T. Padgett is an AV rated attorney in Tampa, Florida who regularly represents public customers as a part of his practice. He graduated with honors from Duke University School of Law in 1982 and has practiced in Tampa since then with the firm Morgan, Padgett Law Group, P.A. Mr. Padgett also practices in the areas of construction and business litigation. Mr. Padgett's law partner, Mark Morgan, is a medical doctor and practices in the areas of medical negligence, serious personal injury and wrongful death. Mr. Padgett can be reached at 800.390.1800 or 813.223.1133. His email address is padgett@mpalaw.com.

Those who regularly represent claimants in securities arbitrations recognize that receipt of an arbitration award is not the end of the story. All too frequently, it is the beginning of an odyssey through the federal court system where the broker/dealer seeks to have the arbitration award vacated. Indeed, in the words of one United States District Judge, "this court's experience suggests that the manifest disregard standard is, nonetheless, the argument of choice for movants seeking to set aside an arbitration award." Success Systems, Inc. v. Maddy Petroleum Equipment, Inc., 2004 U.S. Dist. LEXIS 7968 (D. Conn. May 3, 2004).

The Second Circuit has created an almost insurmountable standard for vacation of an arbitration award on grounds of manifest disregard of the law. That standard suggests that courts should be more willing to impose sanctions on unsuccessful litigants and their lawyers in those matters pursuant to Fed. R. Civ. P. 11, Fed. R. App. P. 38, 28 U.S.C. § 1927 or the Court's inherent powers.[1] Only in that way would arbitration truly become final, and provide even some of the benefits for which claimants are giving up the right to trial by jury.

I. THE STANDARD OF REVIEW ON APPEAL IS DE NOVO

"We review de novo a district court's decision to vacate an arbitration award for manifest disregard of the law, as it turns entirely on questions of law." Hoeft v. MVL Group, Inc., 343 F.3d 57, 69 (2d Cir. 2003). "In reviewing a district court's confirmation of an arbitral award, we review legal issues de novo and findings of fact for clear error." Banco de Seguros v. Mutual Marine Office, Inc., 344 F.3d 255, 260 (2d Cir. 2003). "When a party challenges the district court's review of an arbitral award under the manifest disregard standard, we review the district court's application of the standard application of the standard de novo." The GMS Group, LLC v. Benderson, 326 F.3d 75, 77 (2d Cir. 2003) (citing Greenberg v. Bear, Stearns & Co., 228 F.3d 22, 28 (2d Cir. 2000)).

II. JUDICIAL REVIEW FOR MANIFEST DISREGARD IS EXTREMELY LIMITED[2]

[1] See, e.g., Chambers v. NASCO, Inc., 501 U.S. 32, 111 S.Ct. 2123, 115 L. Ed. 2d 27 (1991).

[2] Manifest disregard is a judicially created addition to the limited review of arbitration awards permitted under 9 U.S.C. § 10.

In a series of recent opinions, the Second Circuit explained the limited judicial review of an arbitration award for manifest disregard of the law. See Hoeft, 343 F.3d 57 (2d Cir. 2003); Hardy, 341 F.3d 126 (2d Cir. 2003); Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383 (2d Cir. 2003); GMS, 326 F.3d 75 (2d Cir. 2003); Westerbeke Corp. v. Daihatsu Motor Co., 304 F.3d 200 (2d Cir. 2002). In GMS, the court stated:

> We have recently provided an extensive and comprehensive recapitulation of our case law in this area, and, thus, we will not repeat it here. Briefly, however, and as a general matter, it is well established that, under the manifest disregard standard, it requires "more than a mistake of law or clear error in fact finding" to disturb an award. Nor is the failure of the arbitrators to understand the law, or to apply it appropriately, sufficient. Manifest disregard can be established only where a governing legal principle is well defined, explicit, and clearly applicable to the case, and where the arbitrator ignored it after it was brought to the arbitrator's attention in a way that assures that the arbitrator knew its controlling nature.
>
> Insofar as delineating at baseline what will withstand manifest disregard review, especially where there is no written opinion, we have stated " '[i]f a ground for the arbitrator's decision can be inferred from the facts of the case, the award should be confirmed.' " In other words, if "any justification" can be gleaned from the record, as the district court noted, the award must be confirmed. We have also stated "we will confirm the award if we are able to discern any colorable justification for the arbitrator's judgment, even if that reasoning would be based on an error of fact or law."

Id. at 77-78 (emphasis added) (citations omitted).

In Westerbeke, the court noted that:

> The two-prong test for ascertaining whether an arbitrator has manifestly disregarding the law has both an objective and a subjective component. We first consider whether the "governing law alleged to have been ignored by the arbitrators [was] well defined, explicit, and clearly applicable." We then look to the knowledge actually possessed by the arbitrator. The arbitrator must "appreciate the existence of a clearly governing legal principle but decide to ignore or pay no attention to it." Both of these prongs must be met before a court may find that there has been a manifest disregard of law.

Westerbeke, 304 F.3d at 209 (citations omitted).

Those limitations were further explained in the GMS decision:

> We have repeatedly stressed that our review under the doctrine of manifest disregard is "severely limited." As the party challenging the award in this case, GMS bears the heavy burden of demonstrating the NASD arbitrators manifestly disregarded the law. "The showing required to avoid summary confirmation of an arbitration award is high." As noted above, in order to do so, it must show that "a governing legal principal is well defined, explicit, and clearly applicable to the case, and . . . the arbitrator ignored it after it was brought to the arbitrator's attention in a way that assures that the arbitrator knew its controlling nature."

GMS, 326 F.3d at 81 (citations omitted).

Under both GMS and Westerbeke, factual findings of an arbitration panel are not subject to independent judicial review. GMS, 326 F.3d at 79 (citing Westerbeke); Westerbeke, 304 F.3d at 213 n.9. That makes perfect sense, since in reviewing a jury verdict, the court must presume that all conflicts in the evidence were resolved in favor of the prevailing party, and that the prevailing party is entitled to all reasonable inferences to be drawn from the evidence. McCarthy v. New York City Technical College, 202 F.3d 161, 165 (2d Cir. 2000). Given the extraordinarily limited judicial review permitted of arbitration awards, certainly no lesser standard applies to an arbitration panel's findings of fact.

"The arbitrator's factual findings and contractual interpretation are not subject to judicial challenge, particularly on our limited judicial review of whether the arbitrator manifestly disregarded the law. Westerbeke, 304 F.3d at 214.

> Under the manifest disregard standard, however, the governing law must clearly apply to the facts of the case, as those facts have been determined by the arbitrator. "An arbitrator's factual findings are generally not open to judicial challenge, and we accept the facts as the arbitrator found them." "Under our limited scope of review of arbitration awards, we are bound by the arbitrators' factual findings . . . ."

Id. at 213 (citations omitted).

The United States Supreme Court has stated that in reviewing arbitration awards, improvident and even silly factfinding, "is hardly a sufficient basis for disregarding what the agent appointed by the parties determined to be the historical facts." United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 39 108 S.Ct. 364, 98 L.Ed. 2d 286 (1987) (upholding an arbitration award rendered pursuant to a collective bargaining agreement against a public policy challenge). In Misco, the Court also stated that, "[b]ecause the parties have contracted to have disputes settled by an arbitrator chosen by them rather than a judge, it is the arbitrator's view of the facts . . . that they have agreed to accept." Id. at 37-38.

In Duferco, the Second Circuit reaffirmed the extremely limited scope of judicial review for an arbitration award for manifest disregard.

> For us to vacate an arbitral award on the grounds of manifest disregard of the law – a step we very seldom take – we must be persuaded that the arbitrators understood but chose to disregard a clearly defined law or legal principle applicable to the case before them. The error must be so palpably evident as to be readily perceived as such by the average person qualified to serve as an arbitrator. Any plausible reading of an award that fits within the law will sustain it.
>
> . . .
>
> It is well established that courts must grant an arbitration panel's decision great deference. A party petitioning a federal court to vacate an arbitral award bears the heavy burden of showing that the award falls within a very narrow set of circumstances delineated by statute and case law. The Federal Arbitration Act (FAA), 9 U.S.C. § 1, et seq., which defines federal policy on arbitration proceedings, permits vacatur of an arbitration award in only four specifically enumerated situations, all of which involve corruption, fraud, or some other impropriety on the part of the arbitrators.
>
> In addition to the grounds afforded by statute, we permit vacatur of an arbitral award that exhibits a "manifest disregard of law."
>
> . . .
>
> Our view under the doctrine of manifest disregard is "severely limited." It is highly

deferential to the arbitral award and obtaining judicial relief for arbitrators' manifest disregard of the law is rare.

And, since 1960 we have vacated some part or all of an arbitral award for manifest disregard in . . . four out of at least forty-eight cases where we applied the standard . . . .

All of the four cases finding manifest disregard, except Halligan, involved an arbitral decision that exceeded the legal powers of the arbitrators. In those cases, it is arguable that manifest disregard need not have been the basis for vacating the award, since vacatur would have been warranted under the FAA. Our reluctance over the years to find manifest disregard is a reflection of the fact that it is a doctrine of last resort – its use is limited only to those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent, but where none of the provisions of the FAA apply. It should be remembered that arbitrators are hired by parties to reach a result that conforms to industry norms and to the arbitrator's notions of fairness. To interfere with this process would frustrate the intent of the parties, and thwart the usefulness of arbitration, making it "the commencement, not the end, of litigation."

Perhaps because we so infrequently find manifest disregard, its precise boundaries are ill--defined, although its rough contours are well known. We know that it is more than a simple error in law or a failure by the arbitrators to understand or apply it; and, it is more than an erroneous interpretation of the law. A party seeking vacatur bears the burden of proving that the arbitrators were fully aware of the existence of a clearly defined governing legal principle, but refuse to apply it, in effect, ignoring it.

The above principles, by extension, lead us to infer that the application of a manifest disregard standard involves at least three inquiries. First, we must consider whether the law which was allegedly ignored was clear, and in fact explicitly applicable to the matter before the arbitrators. An arbitrator obviously cannot be said to disregard a law that is unclear or not clearly applicable. Thus, misapplication of an ambiguous law does not constitute manifest disregard.

Second, once it is determined that the law is clear and plainly applicable, we must find that the law was improperly applied, leading to an erroneous outcome. We will, of course, not vacate an arbitral award for an erroneous application of the law if a proper application of law would have yielded the same result. In the same vein, where an arbitral award contains more than one plausible reading, manifest disregard cannot be found if at least one of the readings yields a legally correct justification for the outcome. Even where explanation for an award is deficient or non-existent, we will confirm it if a justifiable ground for the decision can be inferred from the facts of the case.

Third, once the first two inquiries are satisfied, we look to a subjective element, that is, the knowledge actually possessed by the arbitrators. In order to intentionally disregard the law, the arbitrator must have known of its existence, and its applicability to the problem before him. In determining an arbitrator's awareness of the law, we impute only knowledge of governing law identified by the parties to the arbitration.

> Absent this, we will infer knowledge and intentionality on the part of the arbitrator only if we find an error that is so obvious that it would be instantly perceived as such by the average person qualified to serve as an arbitrator. We undertake such a lenient subjective inquiry in recognition of the reality that arbitrators often are chosen for reasons other than their knowledge of applicable law, and that it is often more important to the parties to have trustworthy arbitrators with expertise regarding the commercial aspects of the dispute before them.

Duferco, Id. (citations omitted).

In vacating an NASD arbitration award, the District Court in Wallace v. Buttar, 239 F. Supp. 2d 388 (S.D.N.Y. 2003)[3], relied heavily on the manifest disregard of the evidence language from Halligan v. Piper Jaffray, Inc., 148 F.3d 197 (2d Cir. 1998). In Westerbeke, the Second Circuit stated that Halligan's suggestion that an award could be vacated when the arbitrators manifestly disregarded the evidence was dicta. Id. at 214 n.9. The Westerbeke court further limited Halligan's applicability to its facts.

> Halligan presented the special circumstance in which the arbitration tribunal did not issue a written explanation of its factual findings. The reviewing court was therefore placed in the situation of attempting to discern what possible findings the arbitrators *could* have made that would justify their disposition of the case. Unable to come up with any findings that would not 'strain credulity,' the court concluded that the court must have 'manifestly disregarded the law or the evidence or both.' Halligan does not stand for the proposition that factual findings put on the record by the arbitrator are subject to an independent judicial review, however.

Id. (emphasis in original).

Similarly, in the GMS case,[4] the party opposing confirmation of an arbitration award sought to rely on Halligan. The Second Circuit noted that Halligan involved claims under the federal anti-discrimination statutes and that both courts and commentators had expressed general misgivings about the effectiveness of arbitration procedures in the context of employment discrimination cases. Id. at 78-79. Indeed, "much of our discussion [in Halligan] was confined to the unique concerns at issue with employment discrimination claims. These concerns do not translate to the claims at issue in this case, [an appeal from an NASD arbitration award]." Id. The GMS court further noted that, "in Halligan, there was no underlying dispute about the controlling law . . . , there was no written opinion, and thus no findings of fact." Id. at 79 (emphasis in original).

In the absence of any findings of fact, the court was obligated to attempt to determine the relevant facts on its own, and in Halligan there was overwhelming and strong evidence of particular legally dispositive facts. Because the controlling law was undisputed and had been called to the attention of the panel, the court could only conclude that they disregarded it. Id.

III. RECENT MANIFEST DISREGARD CASES

In Hoeft v. MVL Group, Inc., 343 F.3d 57 (2d Cir. 2003),

[3] Wallace v. Buttar is the author's case and was argued before the Second Circuit on October 14, 2003. The Court has not yet ruled on the appeal.

[4] The GMS Group, LLC v. Benderson, 326 F.3d 75, 77 (2d Cir. 2003).

the court reversed a trial court decision that vacated an arbitration award for manifest disregard of the law. The underlying arbitration in Hoeft involved an application of generally accepted accounting principles, and the record contained evidence that GAAP provided more than one way to present the categories of expenses at issue. The Second Circuit contrasted the facts of Hoeft with those of a case in which it found manifest disregard of the law. See New York Telephone Co. v. Communications Workers of America Local 1100, 256 F.3d 89 (2d Cir. 2001) (holding that the arbitrator manifestly disregarded the law by "explicitly rejecting" binding Second Circuit precedent in favor of more recent decisions of other Circuits). Hoeft, 343 F.3d at 71 n.4.

Hardy v. Walsh Manning Securities, L.L.C, 341 F.3d 126 (2d Cir. 2003), is the only recent case in which the Second Circuit found that an arbitration award may have been rendered in manifest disregard of the law. In that case, a customer had received an arbitration award against Walsh Manning Securities and Skelly, its chief executive officer. The court affirmed the decision against Walsh Manning, but in a two to one decision, remanded the case to the arbitration panel for a clear statement of the basis on which it purported to hold Skelly liable to the customer. Although Skelly had the title of chief executive officer, he was actually an employee of the broker/dealer, and not an officer. In the Statement of Claim, the customer alleged that Skelly was primarily liable to him, and that he was liable in his capacity as chief executive officer under Section 20 of the Securities Exchange Act of 1934 and the common law theory of respondeat superior. Skelly claimed that he could not be liable under respondeat superior because he was an employee, and not an officer, of the broker/dealer.

The only basis of Skelly's liability stated in the arbitration award was secondary liability pursuant to respondeat superior. Since New York law was clear that a co-employee could not be vicariously liable as a fellow employee of a common employer, the court was unable to find another basis in the record for upholding the award.

After stating the Second Circuit's difficult standard for vacation of an arbitration award on grounds of manifest disregard, the court found that the standard had been satisfied in that case, "at least to the extent of warranting a remand of the Award to the Panel for clarification of what it intended regarding Skelly's liability." Id. at 130. In a strongly worded dissent, Judge Straub suggested that the majority paid only lip service to the appropriate standard of review of an ambiguous award, and should simply have affirmed the District Court's decision confirming the award.

District Court's in the Second Circuit appear to have received the message that challenges to arbitration awards on grounds of manifest disregard of the law should almost never be granted. See, e.g., Wedbush Morgan Securities, Inc. v. Robert W. Baird & Co, 2004 U.S. Dist. LEXIS 10056 (S.D.N.Y. June 3, 2004) (confirming an arbitration award); Prasad v. MML Investors Services, Inc., 2004 U.S. Dist. LEXIS 9289 (S.D.N.Y. May 27, 2004) (confirming an arbitration award); Bear Stearns & Co. v. 1109580 Ontario, Inc., 2004 U.S. Dist. LEXIS 8933 (S.D.N.Y. May 18, 2004) (confirming an arbitration award); Success Systems, Inc. v. Maddy Petroleum Equipment, Inc., 2004 U.S. Dist. LEXIS 7968 (D. Conn. May 3, 2004) (denying a motion to vacate and entering judgment for defendant); Huntington Hospital v. Huntington Hospital Nurses' Assoc., 302 F. Supp. 2d 34 (E.D.N.Y. 2004) (confirming labor arbitration award); Shanghai Foodstuffs Import & Export Corp. v. International Chemical, Inc., 2004 U.S. Dist. LEXIS 1423 (S.D.N.Y. Feb. 4, 2004) (confirming arbitration award); Ganguly v. Charles Schwab & Co., 2004 U.S. Dist. LEXIS 1433 (S.D.N.Y. Feb. 4, 2004) (confirming an arbitration award); Loew v. Kolb, 2003

U.S. Dist. LEXIS 17396 (S.D.N.Y. Sept. 30, 2003) (confirming an arbitration award); Atherton v. Online Video Network, Inc., 274 F. Supp. 2d 592 (S.D.N.Y. 2003) (confirming an arbitration award).

In the Success Systems case, the District Court attempted to distill from the Second Circuit decisions, the principles that govern a motion to vacate an arbitration award on grounds of manifest disregard of the law. The court listed those principles as follows:

> First, the party seeking to overturn the arbitral award bears the burden of demonstrating that the arbitrator manifestly disregarded the law. Furthermore, the showing required to void an arbitration decision on the ground of manifest disregard is quite high.
>
> Second, movant must establish more than a mistake of law on the arbitrator's part. A mere error of law or the failure of the arbitrators to understand or properly apply the law is insufficient. Thus, in Duferco, the court described the required showing as a "clear demonstration that the panel intentionally defied the law," and in Westerbeke, the court stated that the movant must demonstrate that the arbitrator "willfully flouted the governing law by refusing to apply it."
>
> Third, to make such a showing, the movant must satisfy two-pronged test that has both an objective and a subjective component. Both prongs must be satisfied before a court may find a manifest disregard of the law.
>
> The objective component requires the movant to demonstrate that the "governing law alleged to have been ignored by the arbitrators [was] well-defined, explicit, and clearly applicable." "As long as there is more than one reasonable interpretation of the governing law, the law is not well-defined, explicit, and clearly applicable, and an arbitrator cannot be said to have manifestly disregarded the law in rejecting either party's interpretation." The subjective component of the test looks to the knowledge actually possessed by the arbitrators and requires the movant to demonstrate that the arbitrator was aware of the existence of the clear legal principle and appreciated that it governed the case but nonetheless decided to ignore, or rule in defiance of, that clear governing legal principle. In assessing this prong of the test, courts should assume that the arbitrator is "a blank slate unless educated in the law by the parties." Since arbitrators frequently are laymen and not lawyers, ordinarily this means that "in determining an arbitrator's awareness of the law, [courts should] impute only knowledge of governing law identified by the parties to the arbitration. If the parties did not explicitly bring governing law to the arbitrators' attention, a court may [find] knowledge and intention conduct on the part of an arbitrator only if a court finds the legal error "so obvious that it would be instantly perceived as such by the average person qualified to serve as an arbitrator."
>
> Fourth and finally, underscoring that manifest disregard is about defiance or willful flouting of the law and not about mere legal errors, the Second Circuit has made it clear that a court must uphold an arbitrator's award against a manifest disregard challenge so long as the court can glean "even a barely colorable justification" for the award from the record. And that is true even if the reasoning underlying that barely colorable justification would itself reflect an error of fact or law.

In view of the stringent nature of these governing

> principles, it is hardly surprising that the Second Circuit has repeatedly emphasized the truly formidable burdens facing a party who wishes to challenge an arbitral award on manifest disregard of the law grounds.
>
> Success Systems, (citations omitted).

IV CONCLUSION

Only in the rarest of circumstances can one who reviews the recent case law hold a good faith belief that an arbitration award can be vacated for manifest disregard of the law. Unless and until courts hold litigants and their counsel to that high standard by imposing substantial monetary sanctions, motions to vacate on manifest disregard grounds will continue to be an arrow in the quiver of the securities industry in its continuing effort to frustrate injured public customers.

Registration Requirements for Foreign Broker-Dealers Doing Business in the United States

By Deokyoung Ko

Deokyoung Ko is a member of PIABA. He is an associate in Indianapolis office of Maddox Hargett & Caruso, P.C. which represents public investors in securities arbitrations and litigation matters. He can be reached at 317-598-2046 or email at dyko@mhclaw.com.

Introduction

The growth of information technology led U.S. and foreign investors to purchase or sell securities in different national exchanges. The financial markets in the U.S. are the largest in the world and very attractive to foreign broker-dealers. Many foreign broker-dealers want to have ready access to American investors even without having to set foot in the U.S., but they do not clearly grasp the importance of registration requirements under the Securities Act of 1934 (the "Exchange Act"). A fallacy that foreign broker-dealers commonly make is a belief that a foreign broker-dealer which deals with foreign securities is not subject to U.S. broker-dealer registration requirements. Recently, foreign broker-dealers target immigrants in the U.S. who are more comfortable with the securities in their home countries and trade foreign securities without registration.

This article examines registration requirements under Section 15(a) of the Exchange Act, outlines exemptions specifically created for foreign broker-dealers in Rule 15a-6 under the Exchange Act, and finally discusses the remedies under Section 27(b) of the Exchange Act.

Registration requirements under the Exchange Act

Section 15(a) of the Exchange Act generally requires that any broker or dealer using mails or any means or instrumentality of interstate commerce to induce or effect transactions in securities must register as a broker-dealer with the SEC.

Section 15(a)(1) of the Exchange Act makes it "unlawful for any broker or dealer…to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or induce or to attempt to induce the purchase or sale of, any security … unless such broker or dealer is registered … with the SEC." Section 3(a)(4) of the Exchange Act defines "broker" as "*any* person[1] engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Section 3(a)(5) of the Exchange Act defines "dealer" as "*any* person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys and sells securities for his own account, either individually or in some fiduciary capacity, but not as

[1] Section 3(a)(9) of the Exchange Act defines "person" as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government" without reference to nationality.

a part of a regular business."

Given the statutory languages, the terms "broker" and "dealer" clearly do not exclude foreign broker-dealers. In fact, the SEC has consistently taken a territorial approach that the definitions of "broker" and "dealer" do not refer to nationality, and the scope of these definitions include both domestic and foreign persons performing the activities therein.[2] Under the SEC's territorial approach, all broker-dealers physically operating within the U.S. that effect, induce or attempt to induce any securities transactions would be required to register as broker-dealers with the SEC.[3] Additionally, foreign broker-dealers that from outside the U.S., induce or attempt to induce trades by any one in the U.S. also must register with the SEC.[4]

Also, Section 3(a)(17) of the Exchange Act specifically defines "interstate commerce" to include "trade, commerce, transportation, or communication … between any foreign country and any State …" Given the broad definition of "interstate commerce," virtually any transaction-oriented contact between a foreign broker-dealer and U.S. securities markets or U.S. investors in the U.S involves interstate commerce and could trigger the broker-dealer registration.[5]

Thus, foreign broker-dealers have to comply with the registration requirements under Section 15 of the Exchange Act in particular where the broker-dealers' activities involve contacts with persons within the U.S. via telephone, mail, fax, or email, etc.

Exemptions provided to foreign broker-dealers under Rule 15a-6

Due to increasing integration of the world's securities markets and closer linkages between U.S. and foreign exchanges, many U.S. and foreign broker-dealers have developed and expanded international business. The securities of U.S. companies are traded abroad, and those of foreign companies are also traded in the U.S. Investors sought out foreign investments as a means of diversifying their portfolios.

As U.S. institutions increasingly invest in foreign securities that were primarily traded in foreign exchanges, foreign broker-dealers played a critical role for these U.S. investors.[6] Foreign broker-dealers provided research reports concerning foreign companies, industries and market environments for U.S. institutional investors and executed trades in foreign securities markets.[7] Also, the increasing cross-border activities of foreign broker-dealers demand the clarification of the application of U.S. registration

[2] Exchange Act Release No. 27017, Fed. Sec. L. Rep. (CCH) ¶ 80,236 (Jul. 11, 1989) (the "Adopting Release").

[3] *Id.* at 80,237.

[4] *Id.* at 80,238.

[5] *Id.* at 80,235 n.20.

[6] The internationalization of national securities market increased dramatically in the 1980s. Securities transactions by foreign investors in U.S. securities more than doubled between 1978 and 1982. U.S. institutions held in excess of $13 billion in foreign stocks in early 1980s, a significant increase from $2 billion in early 1970s. *See*, *Internalization of the World Securities Markets*, Exchange Act Release No. 21,598, Fed. Sec. L. Rep. (CCH) ¶ 83,795 (Apr. 18, 1985).

[7] Exchange Act Release No. 25801, Fed. Sec. L. Rep. (CCH) ¶ 89,191 (Jun. 14, 1988) (the "Proposing Release").

requirements to the activities of foreign broker-dealers.

In recognition of the growing internationalization of securities markets and the broad scope of registration requirements under Section 15 of the Exchange Act, the SEC, in July 1989, adopted Rule 15a-6 to provide exemptions from registration for foreign broker-dealers that have limited contacts with U.S. investors and securities markets. Specifically, the SEC's goals in adopting Rule 15a-6 are two-folds. First, the SEC anticipated that Rule 15a-6 enabled U.S. institutional investors to have a better access to foreign markets through foreign broker-dealers without jeopardizing the safeguards afforded by broker-dealer registration.[8] Second, the SEC believed that Rule 15a-6 would provide clear guidance to foreign broker-dealer about U.S. broker-dealer registration requirements.[9]

By virtue of these exemptions, unregistered foreign broker-dealers may (i) effect "unsolicited" securities transactions with U.S. persons; (ii) solicit and effect securities transactions for specified categories of counterparties including a registered broker-dealer or a bank acting as a broker-dealer, a foreign person temporarily present in the U.S., a U.S. person abroad, and supranational agency; and (iii) provide research reports to "major U.S. institutional investors" subject to certain conditions. In addition to foregoing exemptions, Rule 15a-6(a)(3) allows, solely from outside U.S., unregistered foreign broker-dealers to solicit and take orders for transactions from "U.S. Institutional investors" and "major U.S. institutional investors if, among other things, the account is maintained by a U.S. registered broker-dealer.

1. Unsolicited transactions

Rule 15a-6(a)(1) provides that where a foreign broker-dealer effects transactions in securities with or for persons which had not been "solicited" by the foreign broker-dealer, such transactions do not trigger the registration provisions of the Exchange Act. Although Section 15(a) of the Exchange Act does not distinguish between solicited and unsolicited transactions, the SEC does not believe that registration is necessary where U.S. investors have sought out foreign broker dealers outside the U.S. and initiated transactions in foreign securities markets on their own initiatives.[10] However, where a foreign broker-dealer actively solicits investors in the U.S., even U.S. investors for which it previously had executed unsolicited trades, the SEC believes that the foreign broker-dealer should register with the SEC.[11]

Notwithstanding the importance of the meaning of "solicitation," Rule 15a-6 does not contain the definition of solicitation. In the SEC's view, solicitation is a very broad concept that includes any affirmative effort to induce transactional business for the broker-dealer or its affiliates, covering from efforts to induce a single transaction or to develop an ongoing securities business relationship.[12] The following activities are regarded to be solicitation by the SEC: telephone calls from a broker-dealer to a customer

[8] Adopting Release at 80,232.

[9] *Id.*

[10] *Id.* at 80,238.

[11] Proposing Release at 89,194.

[12] Adopting Release at 80,239.

encouraging use of broker-dealer to effect transactions; advertising one's functions as a broker or a market maker in newspapers or periodicals generally circulated in the U.S. or any radio or television station whose broadcasting is directed into the U.S.; conducting investment seminars for U.S. investors; and recommending the purchase or sale of particular securities, with the anticipation that the customer will execute the recommended trade through the broker-dealer. [13] In light of the expansive, fact specific and variable nature of concept of solicitation, the SEC pointed out that it would address the question of solicitation on a case-by-case basis, consistent with the principles contained in the Adopting Release. [14]

Nonetheless, the SEC notes that key to determine solicitation is whether the foreign broker-dealer's contacts with U.S. markets reasonably may be viewed as attempting to induce an investor's purchase or sale of a security, and it also underlines that a narrow construction of solicitation would be inconsistent with the plain language of Section 15(a)(1) of the Exchange Act, which refers to both inducing or attempting to induce the purchases or sale of securities. [15]

2. Effecting transactions in securities with specified counterparties

Rule 15a-6 lists some counterparties whom all foreign broker-dealers may solicit and with whom they may engage in transactions without registration. The foreign broker-dealers are allowed to induce or attempt to induce the purchase or sale of any security by the following persons:

(1) a registered broker-dealer whether the registered broker-dealer is acting as a principal for its own account or agent for others[16];
(2) a bank acting in a broker-dealer capacity as permitted by U.S. law[17];
(3) supranational agencies including the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Monetary Fund, the United Nations and their agencies, affiliates, and pension funds[18];
(4) a foreign person temporarily present in the U.S. with whom the foreign broker-dealer had a "bona fide, pre-existing relationship before the foreign person entered the U.S.[19];
(5) an agency or branch of a U.S. organized entity permanently located the U.S; however, the transaction must be effected outside the U.S.[20];
(6) a U.S. citizen resident outside the U.S.,

---

[13] *Id*.

[14] *Id.* at 80,244.

[15] *Id.* at 80,239.

[16] Rule 15a-6(a)(4)(i).

[17] *Id.*

[18] Rule 15a-6(a)(4)(ii).

[19] Rule 15a-6(a)(4)(iii).

[20] Rule 15a-6(a)(4)(iv).

provided that the resulting securities transactions occur outside the U.S.[21]

3. Provision of research to major U.S. institutional investors

Rule 15a-6(a)(2) provides that all foreign broker-dealers may provide research reports, without involvement by a U.S. broker-dealer in the review, approval or distribution of the reports, to "major U.S. institutional investors"[22] and effect transactions. The SEC crafted this exemption in recognition that, in its view, the deliberate transmission of information, opinions or recommendations to investors in the U.S. could constitute solicitation.[23] Even where the foreign broker-dealer is allowed to provide research to major U.S. institutional investors, it should satisfy the following conditions:

(1) the research reports should not recommend the use of the foreign broker-dealer to effect trades in any security;

(2) the foreign broker-dealer does not initiate contact with those major U.S. institutional investors to follow up on the research reports, and does not otherwise attempt to induce securities transactions by those major U.S. institutional investors;

(3) the foreign broker-dealer does not provide research to U.S. persons pursuant to any expressed or implied understanding that those U.S. persons will direct commission income to the foreign broker-dealer; and

(3) if the foreign broker-dealer is associated with an U.S. registered broker-dealer, any trades with the foreign broker-dealer in securities discussed in the research reports must only be effected through the U.S. registered broker-dealer, not the foreign broker-dealer.

According to this exemption, where the foreign broker-dealer is dealing with major U.S. institutional investors, the foreign broker-dealer can do no more than send research reports without making any recommendation as to the use of the foreign broker-dealer, and then the foreign broker-dealer must wait until the major U.S. institutional investors approach and ask it to execute any transaction for such major U.S. institutional investors.

4. Inducing or attempting to induce transactions

[21] However, a foreign broker-dealer targets its selling efforts to "identifiable groups" of U.S. citizens such as military and embassy personnel, the exemption will not be applicable. *See*, Rule 15a-6(a)(4)(v).

[22] For the purpose of this exemption, a "major U.S. investor" means: (i) a U.S. institutional investor that has, or has under management, total assets exceeding $100 million; for this purpose an investment company's total assets include the assets of any family of investment companies to which it belongs; or (ii) a registered investment adviser with total assets under management exceeding $100 million. See, Rule 15a-6(b)(4).

[23] Adopting Release at 80,244.

with major U.S. institutional investors or U.S. institutional investors.

Rule 15a-6(a)(3) permits unregistered foreign broker-dealers to induce or attempt to induce the purchase or sale of a security by a U.S. institutional investor[24] or a major U.S. institutional investors if the following conditions are met:

(1) any resulting transactions with or for the U.S. institutional investor or major U.S. institutional investor must be executed through an U.S. registered broker-dealer[25];
(2) the foreign broker-dealer must provide the SEC, upon request or pursuant to agreements reached between any foreign securities authority, with any information or document within the control of foreign broker-dealer[26]; and
(3) the foreign associated person of the foreign broker-dealer who effects transactions with the U.S. institutional investor or major U.S. institutional investor must conduct all securities activities from outside the U.S., except that he may visit to the U.S. institutional investors or major U.S. institutional investors within the U.S. accompanied by an associated person of a registered broker-dealer that accepts responsibility for the foreign associated person's communications with the U.S. institutional investors or major U.S. institutional investors. [27]

Private cause of action under Section 29(b) of the Exchange Act

The foreign broker-dealer that fails to comply with the registration requirements under the Exchange Act would be subject to the SEC enforcement action under Section 15(a) of the Exchange Act. It also would potentially be subject to civil actions brought under Section 29(b) or antifraud sections of the Exchange Act and rules thereunder. The rescission action under Section 29(b) of the Exchange Act would be useful for the public investors who dealt with unregistered foreign broker-dealers.

Section 29(b) of the Exchange Act provides that, in relevant part:

"Every contract made in violation of any provision of this title or any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who not being a party to such contract, shall have acquired

---

[24] "U.S. institutional investor" means: (a) a registered investment company; or (ii) a bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan as defined in Rule 501(a)(1) of Regulation D under the Securities Act; a private business development company defined as in Rule 501(a)(2); an organization described in section 501(c)(3) of the internal Revenue Code, as defined in Rule 501(a)(3); or a trust defined in Rule 501(a)(7). *See*, Rule 15a-6(b)(7).

[25] Rule 15a-6(a)(3)(i)(A).

[26] Rule 15a-6(a)(3)(i)(B).

[27] Rule 15a-6(a)(3)(ii)(A)(1)(2).

any right thereunder with actual knowledge of the facts by reason of which making or performance of such contract was in violation of any such provision, rule, or regulation …"

Because Section 29(b) of the Exchange Act applies to the contract involved "prohibited transactions" which include the violations of registration provisions under the Exchange Act, innocent investors who had contractual privity with unregistered foreign broker-dealers are clearly within the class of persons this section intends to protect.[28] The innocent investors do not have to prove the connection between their injuries and the foreign broker-dealers' violations of registration requirements.[29] It should be noted that Section 29(b) of the Exchange Act does not automatically render the contract void. Rather, the contract is voidable at the option of the innocent victim.[30] Section 29(b) of the Exchange Act expressly provides that the offending contract and its performance shall be void as regards the violating party's rights. Given the plain language of Section 29(b) of the Exchange Act, the innocent victim can rescind the contract, sue for damages, or, if the contract is beneficial to him, forego these remedies, and enforce the contract's provisions.[31]

Conclusion

The registration requirements of the Exchange Act do not distinguish between foreign and domestic registrants. Therefore, foreign broker-dealers that, from outside the U.S., induce or attempt to induce trades by any person in the U.S. also must register. The foreign broker-dealers may be exempt from U.S. broker-dealer registration if they meet the conditions of Rule 15a-6 under the Exchange Act. Nonetheless, Rule 15a-6 exempts the foreign broker-dealers only from section 15(a) of the Exchange Act. The foreign broker-dealers should keep in mind that any offers or sales of securities comply with the registration provisions of the Securities Act of 1933, when applicable. The foreign broker-dealers exempt from registration by virtue of compliance with Rule 15a-6 still could be subject to the registration requirements established by state securities law.

---

[28] *See*, *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 559 (5th Cir. 1982).

[29] *See*, *Id.*

[30] *See*, Gruenbaum & Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 Geo. Wash. L. Rev. 1, 8 (1979).

[31] *Id*.

Summary of the Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products [1]

By William A. Fynes

William A. Fynes is a member of the law firm Bailey/Crowe & Kugler, based in Dallas, Texas. He can be reached at (214) 231-0547. His e-mail address is wfynes@bcklaw.com.

After having received a "large number of complaints from individual investors about variable insurance products" the SEC and the NASD conducted examinations of broker-dealers that sell variable annuities and variable life insurance products. They prepared a summary of their findings which was released on June 9, 2004. The report lists the areas examined: (A) Suitability, Sales Practices and Conflicts of Interest; (B) Supervision; (C) Disclosure; (D) Books and records; (E) Training and then lists "weak" and "sound" practices found. This summary will concentrate on the "weak practices" found, although in the appropriate case, it will obviously be helpful to cross-examine the broker about all the "sound" practices listed in the report which were not followed.

A. Suitability, Sales Practices and Conflicts of Interest

The report begins by noting that "a broker-dealer recommending a variable product to an investor must assess the investor's financial status, investment objectives and other relevant information to determine if the product is suitable" pursuant to NASD Rule 2310 and IM 2310-2. It also notes that because of the complexity of variable annuities and variable life insurance products, NASD has provided additional guidance in Notice to Members ("NTM") 96-86, 99-35 and 00-44. It states that recommendations to buy variable products have been made without the broker-dealer taking into account all sorts of factors which, had they been considered, would have made the products unsuitable. Examiners found instances of broker-dealers recommending unsuitable variable products because they had not taken into account the customer's: age; financial or tax status; investment objectives; investment sophistication and ability to understand the complexity of variable products generally, and specifically the ability to monitor the investments in subaccounts; low risk tolerance; need for liquidity; lack of need or desire for life insurance; ineligibility under the terms of the prospectus. Specific examples of the egregious practices found by the examiners included: sales of variable products that required the mortgage of customer's home to finance the purchase or sales that required the customer to borrow from an existing life insurance policy or annuity; sales to non-natural entities that caused a loss of the tax-deferrable status of the annuity (obviously one of the major reasons a customer would want a variable

[1] *See,* Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products (June 2004).

annuity); recommendations of high-risk equity funds in subaccounts for investors with low risk tolerance; sales of variable products to customers who had expressed a desire for liquidity and where the customer would incur surrender charges to obtain their funds; sales of variable products when the customer may not have needed or wanted life insurance.

Examiners found instances of representatives giving false and misleading reasons for switching or replacing variable annuities and cases of clients not being advised of the sales charges associated with the switches or replacements. They also found variable annuities switched or replaced in customer accounts every two or three years.

Not surprisingly, examiners also found that supervisors did not do what was necessary to stop the sales of the variable annuities in situations where their sale made no economic sense. Supervisors were found not to have reviewed the correspondence which made false or misleading justifications for variable annuity switches and replacements. They also found firms that did not require supervisors to review the suitability of recommendations or sales and that they lacked any sort of compliance systems to accomplish that goal.

B. Supervision

After setting out the authority mandating that broker-dealers must supervise employees in a way that is reasonably designed to achieve compliance with securities laws and rules, and the authority that sets forth the penalties for not doing so, the report notes many examples of broker-dealers' failure to supervise the sales of variable annuities. Among the supervisory failures noted were the following: no requirement to ascertain customer objectives; no requirement to determine whether the product is suitable; no requirement to review allocation of premium payments to the underlying fund; no procedures for remedial measures for problem registered representatives. The report also notes that the procedures that were in place did not address the firm's variable annuity business or did not adequately address the firm's variable annuity business because of its growth. Supervisors had also failed to review and approve transactions and to investigate red flags. Among the red flags identified were patterns of excessive switching or replacement of variable annuities. Firms also failed to put registered representatives on heightened supervision after a pattern of abusive sales practices was found.

Examiners found documentation failures in cases where the principal's signature was missing from account forms or other documents requiring a record of supervisory approval. The firms also did not document customers' net income and net worth or investment objectives and other information which could have been used by the broker-dealer to make suitability determinations.

C. Disclosure

The report notes that the NASD has already provided guidance to broker-dealers regarding disclosures that broker-dealers should make to customers investing in variable insurance products, namely NASD NTMs 96-86, 99-35 and 00-44. The guidance states that to the extent practical, registered representatives should provide a current prospective to customers when recommending a variable life insurance policy or variable annuity contract. Furthermore, registered representatives should discuss with the customer all relevant facts such as: (1) fees and expenses (including mortality and expense charges, administrative charges and investment advisor fees); (2) the lack of liquidity of these products (including issues such as potential surrender charges and the federal tax penalty); (3) any applicable state and local government premium taxes; (4) market risk. The report also states that the NASD suggests:

That the registered representative should make sure that the customer understands the effect of surrender charges on redemptions and that a withdrawal prior to the age of 59 ½ could result in a withdrawal tax penalty, and should also make sure that customers 59 ½ or older are informed when surrender charges are applied to withdrawals. Moreover, the NASD suggests that any communication discussing the tax-deferral benefits of variable life insurance should not mislead investors by obscuring or diminishing the importance of the life insurance features of the product, or by overemphasizing the investment aspects of the policy or potential performance of subaccounts. With regard to sales of annuities in tax-qualified plans, the NASD states that when a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (e.g., 401(K) plan, IRA), the registered representative should disclose to the customer that the tax deferral accrual feature is provided by the tax-qualified retirement plan and that the tax-deferral feature of the variable annuity is unnecessary.

With regard to disclosure, the report states that firms fail to disclose fees, risk, lack of liquidity of variable products, tax implications and the potential consequences of financing a variable product. Examiners noted undisclosed conflicts of interest, such as recommendations of investment advisors or asset allocation services based on the investment advisor's relationship with the broker-dealer rather than on the advisor's performance or ability to assist the investor.

D. BOOKS AND RECORDS

The report notes that a broker-dealer making transactions in variable products must maintain a purchase and sales blotter, order tickets and customer account information. The Securities and Exchange Commission has also recently issued an Interpretive Release which deals with, among other things, the application of the daily blotter requirement to variable product transactions. Examiners found instances of customer information not being collected as required with the result being that the suitability determinations of recommendations to buy variable products could not be made. Documents regarding switching or transferring variable annuities had also not been maintained. Examiners found instances of no documents being maintained regarding the disclosure to customers of fees for variable products. Customer complaints were also not documented and not reported to the NASD as required.

E. TRAINING

The report notes that given the complexity of variable products, it is essential that the persons selling these products and their supervisors receive adequate training regarding what they are selling. The report also notes that both the SEC and the NASD are investigating reports of registered representatives attending sales training seminars whose purpose is teaching aggressive sales tactics for selling variable products to the elderly.

In light of the findings of the examiners, the report states that the NASD has proposed new requirements tailored specifically to transactions in deferred variable annuities and variable insurance products "from new sales practice standards and supervisory requirements to increased disclosure and sales force training" in the form of a proposed new rule. The proposed new rule is intended to codify and make mandatory the best-practice guidelines that the NASD had previously issued. The proposed rule, set forth and explained in NTM 04-45, is in Appendix "A" following this summary.

APPENDIX A
TEXT OF RULE CHANGE

MEMBERS' RESPONSIBILITIES REGARDING DEFERRED VARIABLE ANNUITIES

(A) APPROPRIATENESS/ SUITABILITY

(1) No member or person associated with a member shall recommend to any customer the purchase, sale or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that (A) the customer has been informed of the material features of the deferred variable annuity; (B) the customer has a long-term investment objective: and (C) the deferred variable annuity as a whole and the underlying subaccounts are suitable for the particular customer based on the information set forth in paragraph (a)(2) of this rule. These determinations shall be documented and signed by the associated person recommending the transaction, in addition to being approved by a registered principal, as required by paragraph (c) of this Rule.

(2) Prior to recommending a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, liquidity needs, liquid net worth, marital status, number and age of dependents, occupation, risk tolerance, savings, tax status and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(B) DISCLOSURE AND PROSPECTUS DELIVERY

(1) Prior to effecting any purchase, sale or exchange of a deferred variable annuity, regardless of whether the transaction has been recommended, a member or person associated with a member must provide the customer:
(A) A current prospectus: and
(B) A separate, brief and easy-to-read (written in "plain English") risk disclosure document that highlights the main features of the particular variable annuity transaction, including (i) liquidity issues, such as potential surrender charges and tax penalties; (ii) sales charges; (iii) fees, such as mortality and expense charges, administrative fees, charges for riders or special features, and investment advisory fees; (iv) federal and state tax treatment for variable annuities; and (v) potential market risks. The risk disclosure document also must inform the customer whether a "free look" period applies to the deferred variable annuity contract, during which the customer can terminate the contract without paying any surrender charges and receive a refund of his or her purchase payments. In addition, the risk disclosure document must inform the customer that all applications to purchase or exchange a deferred variable annuity are accepted subject to review and approval by a designated registered principal.

(2) Prior to effecting any exchange or replacement of a deferred variable annuity, a member or person associated with a member must, in addition to the information required by paragraph (b)(1) and regardless of whether the transaction has been recommended, provide the customer with the following information in writing:
(A) A summary of all significant differences, if any, between the existing and proposed deferred variable annuities' contractual provisions, guarantees, death benefits, withdrawal provisions and/or tax treatment;
(B) Surrender charges, including both those that may be assessed on the surrender of the existing contract and those applicable to the proposed contract;
(C) Costs that are associated with purchasing a new contract, including new sales loads and other start-up expenses; and
(D) The possibility, if any, of modifying or adjusting the existing contract to meet the customer's objectives rather than exchanging or replacing the contract.

A member or person

associated with a member may use an existing exchange or replacement form authorized by a state insurance commission or other regulatory agency to satisfy the disclosure requirements of this paragraph to the extent that the regulatory agency's form requires disclosure of the information required by this Rule. If the regulatory agency does not require disclosure of all of the information required by this Rule, a member or person associated with a member may create and use an addendum to the regulatory agency's form.

(C) PRINCIPAL REVIEW

(1) No later than one business day following the date of execution of the deferred variable annuity application, a registered principal shall review and approve the transaction, regardless of whether the transaction has been recommended. In reviewing the transaction, the registered principal shall consider whether (A) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specific age (standard established by the member) or with a short-term investment objective; (B) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member); (C) the transaction involves an exchange or replacement of a deferred variable annuity contract; (D) the deferred variable annuity transaction involves a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements; (E) the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; and (F) the purchase of the deferred variable annuity is for a tax-qualified retirement account (e.g.. 401(K) plan, IRA). Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(2) When a member or a person associated with a member has recommended the transaction, a registered principal, taking into account the underlying supporting documentation described in paragraph (a)(2) of this Rule, shall review, approve and sign the appropriateness/suitability determination document required by paragraph (a)(l) of this Rule no later than one business day following the date of execution of the deferred variable annuity application. This principal review and approval requirement is in addition to the requirements of paragraph (c)(l) and, if applicable, paragraph (c)(3) of this Rule.

(3) When the transaction involves an exchange or replacement of a deferred variable annuity, regardless of whether the transaction has been recommended, a registered principal must review, approve and sign the exchange or replacement analysis form or addendum described in paragraph (b)(2) of this Rule no later than one business day following the date of execution of the deferred variable annuity application. This principal review and approval requirement is in addition to the requirements of paragraph (c)(l) and, if applicable, paragraph (c)(2) of this Rule.

(D) SUPERVISORY PROCEDURES

In addition to the general supervisory and record keeping requirements of Rules 3010 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen for and require a registered principal's review of the following:

(1) A deferred variable annuity investment for a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specific age (standard established by the member) or with a short-term investment objective;

(2) A deferred variable annuity investment that exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);

(3) A deferred variable annuity exchange or replacement;

(4) A deferred variable annuity investment for a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements;

(5) A deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements; or

(6) A deferred variable annuity investment for any tax-qualified retirement account (e.g., 401(K) plan, IRA).

Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.

(E) TRAINING

Members shall develop and document specific training policies or programs designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including liquidity issues, sales charges, fees, tax treatment, and market risks.

Expert's Corner: Municipal Bond Market Improprieties and the Potential Brutality of Investing in Bonds

By Jeffery & Michele Schaff

Jeffery and Michele Schaff provide expert consulting services, expert witness and testimonial services and exhibits for cases being litigated or potentially litigated as well as for parties wanting to adopt practices aimed at mitigating the risk of potential litigation. The Schaffs founded Ardor Fiduciary Services to serve the needs of attorneys and fiduciaries. They are two of a small cadre of professionals certified to perform Certified Fiduciary Audits and have earned the Certified Investment Management Consultant accreditation. Jeffery is an Accredited Investment Fiduciary Auditor. His professional history includes extensive brokerage experience as both a registered representative and principal and also experience as an investment advisor. Michele is a CPA with a master's degree in taxation (accounting) and Big-Six experience. The two jointly own Ardor Financial Group, a financial consulting boutique with affiliated entities that include a fee-only registered investment advisory and a CPA practice specializing in financial planning and taxation. The Ardor practices have adopted a stringent ethics code and privacy policy. Northfield, Illinois. Phone: 847.441.3228. E-mail: JSchaff@ArdorFinancial.com and MSchaff@Ardor Financial.com.

Are bonds inherently "safe" investments for the average investor? Not even in a perfect world, say where markets are truly efficient, would that possibility exist. Investing in bonds is complex, with many opportunities to mismanage risks not properly understood by investors.

Bonds as Investments

There are two lines of thought on bonds. The old-school belief, which some still espouse, contends that bonds are inherently safe investments and accordingly supports putting the portion of one's money that must be kept safe in bonds. However, modern financial theory has since proven that line of thinking wrong. In 1959 with his seminal book *Portfolio Selection: Efficient Diversification of Investments*, Harry Markowitz proved that it is neither the specific securities nor the asset classes used in a portfolio that make the portfolio risky or safe per se, but rather the blend of differing security types and/or asset classes that determine the relative risk of a portfolio. Subsequent oft-quoted research has demonstrated that over 90% of a portfolio's behavior, or performance, is attributable to the portfolio's asset allocation. [Source: *Determinants of Portfolio Performance*, published in *Financial Analysts Journal*, July/August 1986, Brinson, Beebower & Hood]

The investment community has grown to embrace Markowitz's Nobel Prize winning portfolio management theory, which has been incorporated under the umbrella title of Modern Portfolio Theory. The legal and legislative communities have expressed their support of Modern Portfolio Theory by making it an integral part of the Uniform Prudent Investor Act, ERISA and other acts governing investment management on behalf of another.

Appropriately, the new-school philosophy recognizes bonds as a necessary component of asset allocation, acknowledging that portfolios need both stocks and bonds. The greater the proportion of bonds to stocks, the relatively more stable a portfolio's returns are; and hence, the less risky the portfolio will be.

No matter how one looks at it, old-school or new-school, he has to agree that bonds are important for preserving the security of a portfolio. This wisdom was clearly borne out over the period of 2000 through 2002. As the share prices of America's best known companies fell, so did interest rates, which gave bondholders a boost in the prices of their bonds that translated into significant returns. Investors who were fully invested in the S&P 500 lost 37.61% total return over this period, while investors whose portfolios were fully invested in the LB Aggregate

Bond Index gained a total return of 33.46%. Balanced investors were rewarded for their prudence: a 60/40 blend of S&P 500 to LB Aggregate Bond Index lost only 14.03%. [Source: Ibbotson Associates]

Investing in Bonds

As if bonds are not complicated enough, consider what one must go through to maintain a bond portfolio. Regardless of the appropriateness or relative risk associated with any particular bond or class of bonds, the process of actually investing in a bond poses additional risks entirely separate from those associated with the actual investment –trading risk. As with any investment, there is a cost for every transaction. However, unlike equity trades, the costs of bond trades are not necessarily disclosed, and when a bond is thinly traded, the undisclosed and difficult to obtain data can be hazardous to the financial health of the investor. This topic is covered in more detail in the section below titled Bond Sales Practices.

Hypothetical Example

Mr. and Mrs. Smith, a couple in their seventies, have retired to a resort community in Florida. They own their home and have no debt. They invested $1,000,000 in a municipal bond portfolio, which comprises essentially all of their assets outside their residence. They rely on the interest generated by their bonds to fund their living expenses and have accordingly declared income as their sole investment objective. As investors, they are risk averse, and they possess average investment experience. One day they walk into your office, angry over losses in their bond portfolio. They explain that their $1,000,000 municipal bond portfolio has fallen to under $625,000 over the past three years. During your meeting, you learn that (1) their portfolio was consistently comprised of ten municipal bonds; (2) all of the bonds had maturities of about fifteen years, with an average coupon of 6.5% and current yield of 4%; (3) none of the bonds were exchange traded; (4) the clients generally like their stockbroker and feel that he watched over their account like a hawk, as he switched bonds at the first sign of trouble; (5) on average, one bond was switched per quarter; (6) interest rates rose by 1% during the three-year period; and (7) the couple asked their broker to liquidate the entire portfolio at the end of the period.

Is this a case of sour grapes or ***bond brutality***?

The Respondent's argument for sour grapes would undoubtedly be centered on the fact that interest rates rose, in this hypothetical example, by 1% over the period. Since rising interest rates cause bond prices to fall, one should indeed expect a bond portfolio's value to fall during such a period of rising rates. Still, an expert in this case might conclude that a 1% rise in interest rates would only account for depreciation of approximately $94,000 in this hypothetical portfolio, leaving over $275,000 in unaccounted losses**.** While the Smiths' losses are unfortunate, their case might not seem particularly compelling, given that the portfolio was invested in municipal bonds, not internet stocks, and the annual turnover rate was only 40%.

But what if something far more nefarious was afoot? For the sake of this example, assume that (1) the bonds were thinly traded; (2) the effective spread between the bid and ask prices for the bonds at the time the stockbroker bought or sold the bonds averaged 10%; and (3) the brokerage firm handling the Smiths portfolio made a market in all of the bonds in question. In such a situation, the broker and/or brokerage firm could retain the 10% spread between the bid and ask as undisclosed compensation on the trades by trading the bonds within the firm's own client base. [Note: The firm could accomplish the same outcome if they bought the bonds from another dealer at 90% of the price that the client paid for them.] Since the only brokerage compensation that a firm is required to disclose on bond trade confirmations is the commission charged above the offer for purchases or below the bid on sales, the Smiths would never have seen that form of slippage. Regulations require neither markups nor markdowns be disclosed on confirmations for bond trades.

All other factors aside, the spread between the bid and ask price of a bond creates a source of loss that lies in wait, veiled until a sale generates its recognition. If the bond is held to maturity, the hidden loss does not surface because the bondholder receives the full face value of the bond at maturity. If, however, the bond is sold prior to its maturity, the loss is triggered. This hidden amount may seem fairly innocuous when the spread between the bid and ask is small and appears to reasonably reflect transaction costs, and it may be if an investor seldomly executes a trade. On the other hand, this spread, which can be markedly exacerbated by a broker who does not seek to obtain the best prices for the investor, can meaningfully damage a more actively traded bond portfolio. The consequential losses can be iniquitous. In the hypothetical example, the Smith's portfolio was effectively worth only $900,000 immediately after their $1,000,000 initial investment solely because of the effective 10% spread between the bid and ask prices of the bonds, as that was what the Smiths would have received if they had asked their broker to liquidate their bonds.

Now, if one considers the effect of liquidating one bond from this portfolio every quarter, the 10% quarterly haircut added a total of $118,000 in losses in the example. Another $88,200 of losses were generated when the broker liquidated the bonds remaining in the portfolio at the end of the three-year period. All tolled, the broker's effective spread between the bid and ask prices shaved a whopping $206,200 off the Smith's "safe" municipal bond portfolio. The 1% rise in interest rates could have accounted for roughly $94,000 in further losses. Then toss in a $50,000 decline from the near default of just one of the 22 bonds held over the period, and $356,200 of the decline in the Smith's portfolio have been attributed. With only ten bonds in the portfolio, the specific risk to the assets was quite high, so it would not be surprising if even greater losses were suffered as a result of the concentration, or lack of diversification. Finally, assuming that the stockbroker also charged a 1% commission on each of the trades, buys and sells, add another $39,178 to the losses. [Note: In the example, for ease of computations, commissions were paid by the Smiths and did not come from the portfolio itself.] The above figures account for possible losses of approximately $389,378 sustained by the Smiths in the hypothetical example. Considering that the total stated commissions and undisclosed markups collectively amounted to over $245,000, this hypothetical reflects more than merely bad luck. It reveals **bond brutality.**

Bond Sales Practices

The above hypothetical may strike the reader as implausible, as 10% spreads may seem unrealistically high. In reality, however, actual investors are exposed to situations much worse than the one described in the preceding hypothetical illustration.

In the municipal bond market, for example, some investors are exposed to spreads much greater than 10%. One resource that tracks the spreads between municipal bond trades is www.MunicipalBonds.com. They publish the year's top 100 largest spreads on municipal bonds that traded at least twice in one day. In 2003, the worst spread of bids occurred on 03 June, when investors executed four trades in which they sold New Jersey Building Authority bonds for between $110.00 to $1,155.70 per bond, and the worst spread of offers was on 02 June, when five trades were executed between $112.50 to $1,201.08 per bond. MunicipalBonds.com also measures two-trade spreads, in which a group of bonds were both bought and sold by investors on the same day. Their top 100 largest two-trade spreads for 2003 ranged from 10.5% to 91%! The most egregious case involved 200 Snohomish County bonds that were sold by one investor for a total of $20,728 and bought by another investor for $202,728. The second worse case of 2003 involved 200 Palmer Massachusetts bonds that one investor sold for a total of $200,000 and another bought for $366,332. It is fair to say that both buyers and sellers of municipal bonds are susceptible to being exploited by unfair pricing. [See Figure 1.]

Notable Spreads of Municipal Bond Trades

Bond	Date	Volume (000)	Type	Spread	Lowest Price	Highest Price
New Jersey Building Authority, 5.25%, 12/15/06	03 June 2003	100	Bid	104.570	11.000	115.570
California State, 5.25%, 06/01/18	02 June 2003	1,200	Bid	95.691	10.941	106.632
Florida State Municipal Power, 10/01/30	19 May 2004	625	Bid	99.000	1.000	100.000
Long Island Power Authority, 12/01/29	21 June 2004	1,000	Bid	99.000	1.000	100.000
New Jersey State Turnpike, 6.50%, 01/01/16	02 June 2003	65	Offer	108.858	11.250	120.108
Wisconsin, 5.75%, 12/15/27	29 May 2003	105	Offer	104.520	11.000	115.520
New York State Tollway, 5.00%, 03/15/08	18 June 2004	1,600	Offer	103.767	3.050	106.817
New Mexico Fin Authority, 5.25%, 06/15/16	30 April 2004	6,930	Offer	103.511	4.779	108.290
Washington State, 5.375%, 10/01/08	30 May 2003	200	Bid/Offer	104.609	11.532	116.141
Holyoke Massachusetts, 5.25%, 08/01/06	02 June 2003	250	Bid/Offer	100.013	11.009	111.022
South Carolina State Cap Appreciation, 06/01/09	08 April 2004	~	Bid/Offer	183.500	1.500	185.000
Baltimore Maryland, 07/01/32	18 May 2004	150	Bid/Offer	100.000	100.000	200.000
Snohomish County Washington, 4.75%, 12/01/03	05 June 2003	200	2 Trade	91.000	10.364	101.364
Palmer Massachusetts, 4.00%, 10/01/10	14 August 2003	200	2 Trade	83.166	100.000	183.166
California State Economic Rec, 01/01/10	09 June 2004	10	2 Trade	80.000	112.000	192.000
Phoenix Arizona Indl Development, 12/01/14	01 June 2004	45	2 Trade	31.960	60.944	92.904

Figure 1

NASD Recognizes Problems with Bond Investing

The NASD recently addressed improprieties found in municipal bond trading. On 29 June 2004, the NASD announced that it had fined eight brokerage firms for not getting the best prices for customers selling bonds. Instead, these firms sold their customers' bonds at prices less than the NASD determined to be their fair market values. [See Figure 2.]

NASD Municpal Bond Fines of Brokerage Firms

Firm	Fine $	Restitution $	Number of Trades Cited	% Under FMV Lowest Cited	% Under FMV Highest Cited
Charles Schwab	30,000	30,869	6	6.57	38.57
Edward Jones	15,000	10,181	8	9.04	36.00
First Trust Portfolios	60,000	58,680	8	13.32	122.47
Merrill Lynch	55,000	54,527	12	11.39	115.50
Morgan Stanley	20,000	18,312	4	6.85	35.30
Prudential	10,000	7,306	3	16.28	57.63
UBS	100,000	100,666	7	14.57	91.78
Wachovia	20,000	19,486	8	10.94	63.45

Figure 2

The NASD also addressed fixed income investments in its April 2004 Notice to Members, *NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds*. The Notice primarily served as a reminder to the brokerage community of its obligation with respect to the suitability of bond recommendations and the proper disclosure of risks. It further provided a general reminder of the risks of fixed income investments and of a firm's sales practice obligations in connection with bonds and bond funds.

The April 2004 Notice to Members also referenced a study that quantified investors' ignorance on the subject of investments. The study, *NASD Investor Literacy Research*, published in 2003 by Applied Research & Consulting LLC, contained ten multiple choice questions about basic investment terms. Of the investors polled, only

- 40% understood the relationship between bond prices and interest rates;
- 71% understood the fundamental concept of a bond;
- 84% identified U.S. Treasury Bonds as the safest bonds; and
- 51% knew the definition of a junk bond.

The study was an insightful reference in the NASD's April Notice. By including it, the NASD gently reminded its members that the average investor is simply not very savvy financially. Interestingly, the survey also questioned investors' financial literacy beyond the topic of bonds and found that only

- 21% correctly identified the definition of a no-load mutual fund;
- 79% understood the concept of a stock; and
- 72% knew that riskier investments produce higher returns over time than less risky investments.

Fixed income investments have become a hot topic at another of the NASD's divisions – the Dispute Resolution Unit. Brokers and brokerage firms are experiencing an increasing numbers of complaints involving bonds, despite the fact that bonds have been the bright spot in most investors' portfolios over the past three years. In fact, claims filed with the NASD involving corporate bonds increased 150% in the years 2000 through 2003 while the Lehman Brothers Aggregate Bond index rose a total of 39%. In the same period, claims involving common stocks increased a comparatively modest 89% while the S&P 500 fell 20%. [See Figure 3.]

Dispute Filings

Description	2000	2001	2002	2003
Claims Involving Corporate Bonds	141	161	253	353
LB Aggregate Bond Index Return	11.63%	8.47%	10.27%	4.11%
Claims Involving Common Stocks	2,018	2,911	3,080	3,812
S&P 500 Index Return	-9.11%	-11.88%	-22.11%	28.70%

Figure 3 Sources: NASD and Ibbotson Associates

General Risks of Fixed Income Investments

Since relatively few fixed income cases will be as brutal as the aforementioned hypothetical, it is important to be empowered with some fundamental knowledge about bonds and managing a fixed income portfolio. Otherwise it could be difficult to assess the merit of a potential client's case. To better understand why and when things go awry and investors suffer losses, it is important to understand the general risks of investing in fixed income securities. As with equity investments, the most prominent risks of investing in fixed income **securities are specific risk and market risk.**

Credit Risk

Specific risk, as applied to bonds, is primarily comprised of credit risk, which at its extreme is default risk, the possibility that the issuer's financial condition would weaken and threaten the repayment of the debt instrument.

Credit rating companies evaluate the creditworthiness of companies, or issuers, as well as the debt instruments that they issue and then assign ratings that they believe reflect the financial health of the entity and its bonds. Changing conditions in a company's financial capabilities or outlook may prompt the rating companies to change their respective ratings. When the credit rating of an issuer or an issue is lowered, the bond's price typically falls commensurately.

The two most prominent bond credit rating agencies are Moody's Investors Services ("Moody's") and Standard and Poor's Corporation ("S&P"). There are two general categories, Investment Grade and Below Investment Grade, with each having several subcategory rankings within them. [See Figure 4.]

Bond Credit Ratings

Description of Grade	Moody's	S&P
Investment Grade		
Highest Grade	Aaa	AAA
High Grade	Aa1, Aa2, Aa3	AA+, AA, AA-
Upper Medium Grade	A1, A2, A3	A+, A, A-
Medium Grade	Baa1, Baa2, Baa3	BBB+, BBB, BBB-
Below Investment Grade		
Speculative Grades	Ba1, Ba2, Ba3	BB+, BB, BB-
	B1, B2, B3	B+, B, B-
Highly Speculative Grades	Caa1, Caa2, Caa3	CCC+, CCC, CCC-
	Ca	CC
	C	C
Default	~	D

Figure 4

As the above chart depicts, it is not sufficient to judge an issue on its general categorization of Investment Grade or Below Investment Grade. The broad range of investment grade ratings allows for a significant difference in quality between the Highest Grade and Medium Grade. Even the highest grade within Speculative Grades is meaningfully different than the lowest. All speculation is not the same. It is important to know an issue's actual rating and what it means.

Bonds that are collateralized are more secure than bonds that are subordinated, not backed by assets. Large, successful issuers are generally better credit risks than smaller, less proven issuers, although large issuers have been known to declare bankruptcy and leave their subordinated bondholders empty-handed. Additionally, as a bond moves closer to maturity, less opportunity exists for a credit rating downgrade or default, so there is less risk for either of these to occur in bonds closer to maturity than those with relatively longer maturities.

At its extreme, credit risk encompasses the possibility that an issuer could default on its bonds, a situation for which S&P reserves a credit rating of D. However, given that credit rating agencies typically lower their ratings as a company's financial situation worsens, the public is usually alerted to the likelihood of default as an issuer's bond rating tumbles from one grade down to another, and not surprised by an announcement of default. In fact, most bonds actually default from a junk rating. In 2001 and 2002, the default rate of high yield bonds averaged just under 10%, the highest rate since 1991. The absolute dollars lost to defaults during this period were the largest ever recorded. Investors should not ignore their bond holdings traditionally thought to be safer, whether by reputation or because of a better credit rating, as even municipal bonds default. According to The Bond Market Association, 1 of every 200 municipal bonds issued between the years 1940-1994 defaulted.

Interest Rate Risk

The other prominent investment risk is market risk. Applied to bonds, market risk is primarily the risk that rising interest rates will cause bond prices to fall. It is most commonly known as interest rate risk.

Interest rates are cyclical, as are economies and investment markets. When interest rates are historically high, as they were in the early 1980s, one should reasonably expect them to fall to a more average level; and when rates are historically low, as they are today, one should expect them to similarly rise. When cyclical things such as interest rates deviate from their mean, they eventually trend back to their mean or long-term averages. Although it is not possible to know exactly where interest rates will be at any future date, planning for their impending changes is not only possible, but necessary. Fortunately, interest rates are slow moving and therefore do not catch one entirely off guard with dramatic movements.

The present trend of interest rates is upward. Alan Greenspan has repeatedly testified that the Federal Reserve is in the process of raising interest rates in an effort to stave off inflation. He has further stated that the current rates were only lowered to their historic levels in an effort to orchestrate a soft landing from our previously robust economy. Incorporating information about current economic affairs, such as that described in the immediately preceding sentences, is an important aspect of managing a bond portfolio.

When interest rates rise, as they have already started to do, bond prices fall. The degree to which the price of a bond or bond fund is susceptible to falling as a result of rising rates is expressed by its duration. Duration, which is a figure resulting from a complicated calculation determined by the yield and maturity of a bond or group of bonds, numerically demonstrates the volatility of interest rate changes thereon. Bonds with shorter durations are less susceptible to falling interest rates than those with longer durations. The shorter the duration, the smaller the decrease in a bond's value for a given interest rate increase; and the greater the duration, the larger the decrease in a bond's value. Hence, lowering the duration of a bond portfolio is an effective strategy for managing interest rate risk in a rising interest rate climate. Fixed income portfolios with short average durations (i.e. under 2 years) are better postured to handle a climate of rising interest rates than are those with intermediate average durations (i.e. 5 to 8 years). The duration of bond mutual funds is typically available to investors through mutual fund research sources such as Morningstar or through internet portals like Yahoo!.

Another investment strategy for protecting a fixed income portfolio from rising interest rates is laddering. Laddering a bond portfolio involves investing in a sequence of the same type of bonds, each with a maturity that is progressively greater than the preceding one by a fixed interval. For example, an investor buys 10 investment grade corporate bonds, with one maturing every six months. Every time a bond matures, he reinvests in another bond at the prevailing interest rate, with a maturity date six months after that of the last maturing bond. In this scenario, the portfolio would turn over every five years. The number, interval and frequency of the maturities can be tailored to the prevailing interest rate climate and an investor's needs and tolerances.

By holding each bond to maturity, the investor receives the full face value of each bond, thereby insulating himself from the impact of rising interest rates. Remember, one does not realize a loss on the decrease in the bond's value caused by interest rate increases unless he sells the bond. So, holding to maturity nullifies interest rate risk.

Diversification

What is the best protection against specific risk, or the risk of defaulting bond investments? Diversification. Similar to equities, the fewer the number of issues in a bond portfolio, the greater the impact on the portfolio of any single negative event involving one of the holdings. A portfolio on the whole is more susceptible to losses when it is concentrated in a small number of holdings because an investor is at risk that a lowered credit rating or default of any single holding would seriously damage the overall value of his portfolio. A portfolio's viability should not hinge on the success of every holding. Although a minimal 10 issues may be a decent effort at diversifying some of this risk, it more reasonably takes 20 to 40 issues to significantly diversify away the specific risk of the underlying bond holdings.

Why would this sort of diversification be unusual in an investor's account? Money. Most bonds have a par value of $1,000 and trade in lots of five or ten bonds. Ten issues of ten bonds purchased at par value would require $100,000 of an investor's portfolio. Moreover, that $100,000 would only allow for minimal diversification of a single asset class (e.g. intermediate term corporate bonds). To further diversify his bond portfolio, an investor would need to invest in multiple classes of bonds, which are divided into many categories: short-term, intermediate-term, long-term, corporate, United States government, municipal, convertible, high yield, foreign, etcetera. And diversification would be necessary for each of the bond classes comprising the portfolio.

If an investor chose three bond asset classes and decided to hold 20 issues for each class, which would only be on the low end of reasonable diversification, he would need to invest $600,000. In order to have a more fully diversified portfolio of individual bonds, an investor could easily need $1,000,000, and that is just for the fixed income portion of his portfolio.

The most popular way to achieve diversification is also the least capital intensive:

investment pools such as open and close ended mutual funds, exchange traded funds and unit investment trusts. With an open end mutual fund, for instance, an investor can own a share of a diversified bond portfolio for as little as $1,000, the face value of a single corporate bond.

Diversification can also be used to manage interest rate risk, or the threat of rising interest rates. If one cannot comfortably determine where in the interest rate cycle rates are, he can simply diversify each of his asset classes as described above, but additionally for maturities or duration. For instance, instead of simply owning one fund per asset class, say one investment grade corporate bond fund, an investor could own two, one with a short duration (e.g. two years) and one with an intermediate duration (e.g. five years).

Additional Concerns

Whether investing in individual bonds or bond mutual funds, investors should be aware of a few additional noteworthy issues. Since most bonds are traded over-the-counter, the bond market can seem reminiscent of the Wild West. Pricing information is difficult for investors to obtain on their own and scarcely reliable. Even custodial statements can misstate the true value of bond holdings. The lack of publicly referenced benchmarks further compounds this information deficit, leaving investors ill-equipped to understand the actual fair value of their fixed income holdings.

As demonstrated in the above section titled Bond Sales Practices, both buyers and sellers of bonds are susceptible to unfair pricing. Trading information on most bonds is simply not readily available. Nonetheless, some bonds do have published prices. These listed bonds trade on an exchange, most prominently the NYSE, and their prices are published in investment journals. They are the minority, though. For instance, the $1.3 trillion municipal bond market is comprised of over 50,000 municipal bond issuers and over 175,000 total issues that are not traded on an exchange. Investors cannot see their municipal bonds quoted in their newspaper, nor are they available on Yahoo!. Fortunately there have been some improvements in the municipal bond market. Internet savvy investors can the find prices of their bonds at www.MunicipalBonds.com, a website that purports to be the only third party source where investors can find municipal bond quotes for free.

Poor pricing availability also plagues custodians, which are challenged to properly value non-exchange traded bonds on their clients' statements. As a result, many investors' statements do not accurately reflect the value of their bonds, and they therefore are entirely unaware of the real value of their portfolio until they sell one of their holdings. Even if the custodian carried accurate prices for the bonds, the valuations listed on the client statements may still differ greatly from the actual prices that a client would receive upon selling those bonds should their broker fail to get the market's best price.

Exacerbating investor ignorance of the issues surrounding their bonds is the lack of commonly available proxy information by which investors can evaluate their own bond portfolios. The media regularly reference such equity benchmarks as the Dow Jones Industrial Average, S&P 500 and the NASDAQ Composite, yet generally fail to include any for bond investments, such as the Lehman Brothers Aggregate Bond index (total return). This omission by the media is a significant but scarcely considered source of ignorance with respect to fixed income investments. Investors are left to monitor changes in the Prime Rate or in the prices of U.S. Treasury Bonds as indicators for changes in prevailing interest rates. Unfortunately, neither are effective proxies for monitoring and evaluating the fixed income portion of a portfolio.

Looking Forward

The number of claims

involving bonds will likely rise at an increasing rate over the next few years. The trend has already begun. Despite a favorable bond market over the last four years, the claims have already been on the rise. The NASD seems to be placing greater emphasis on bonds. Although the media have not yet meaningfully picked up this cause, they do typically follow complaint and regulatory trends and ought to therefore increase their coverage in the not so distant future. If they do, the effect will likely be a lengthening and strengthening of the complaint cycle.

The bear market for stocks, from 2000 through 2002, chased investors away from their heavy weightings in equities. Seeking a respite from the risky world of falling stock prices, investors withdrew to bonds and bond funds, and did so as interest rates were dropping to historic lows. A large number of investors who own bonds, many of them with little knowledge on the subject, will suffer surprising losses when interest rates turn direction, causing their bond prices to fall. Translation: there is a large supply of investors who may want to file complaints, particularly after a significant rise in interest rates.

It is a known certainty that interest rates are cyclical. And although interest rates have hovered around historic lows over the most recent years, the trend is now upward. A rise in rates is not merely imminent – it is already in progress. They will continue to rise and bond prices will accordingly fall. As Mr. Greenspan and the Federal Reserve combat inflation by raising interest rates, investors will see the value of the fixed income portion of their portfolios erode. None will be pleased. Most, 60% according to the NASD sanctioned study, will be shocked to see the erosion because they did not understand the risks inherent in fixed income investments.

The Dreaded Mediation Impasse: Possible Ways of Avoiding It

By Joan Stearns Johnsen

Joan Stearns Johnsen is a mediator and arbitrator located in Boston, Massachusetts. She is a member of the NASD and NYSE panels. Telephone: 617-558-9443; Facsimile: 617-558-9447; Address: 201 Fuller Street, West Newton, MA 02465; e-mail: JSJMediate@aol.com

Mediation serves a valuable purpose regardless of the outcome. Everyone learns more about the case. Even though mediation is not an opportunity for free discovery side, through the process of risk analysis directed by the mediator, everyone invariably gains insights into their own and their adversary's case. Clients unfamiliar with the formality and emotional strain of litigation learn first hand about the rigors and intensity of the process. Actually living through mediation is a much better introduction to litigation than any description in the lawyer's office. Thus, even when mediation results in impasse there has been value added from the process.

However, mediations are intended to settle cases. Lawyers and parties spend valuable time and money because they expect a result. Everyone works towards that result and in most cases settlement is reached. In spite of the benefits achieved when settlement is not reached, no one hires a mediator indifferent to whether the day concludes with an impasse rather than a settlement. Impasse is something everyone wants to avoid when choosing to mediate. Mediation is an art not a science and there are as many ways to avoid impasse, as there are personalities and fact patterns. Here are some ideas of how to get across the finish line and get what you paid for.

I believe, first of all, that the best way to avoid impasse is to anticipate it. This of course will not work in all instances, but if you prepare thoroughly, you may be able to figure out where the problems are likely to arise. One impediment to settlement that can be anticipated is what Suzanne Mann Duvall of Dallas, Texas refers to as "phantom parties." A phantom party is someone who although not actually present at the mediation will torpedo your mediation just as your client is about to sign on the dotted line. Your client understands why he or she is settling and intellectually can appreciate why the deal is one that should not be passed up. Just prior to forever releasing all claims the party seeks validation from a trusted ally and wham, you have an impasse. Or perhaps your client doesn't speak to the phantom party; in fact he or she fears speaking to the phantom party and being "second guessed." The Phantom Party can be any of a number of people. Most frequently it is a family member. It can be an advisor of any sort.

Just being aware that such individuals are out there is helpful. Probe when you interview your client. Determine whether your client honestly will be able to make a decision independently. If you have concerns, it may be a good idea for the phantom party to participate in the mediation. I say it may be a good idea, because you don't want the phantom party derailing your mediation either. But in most cases there is a distinct advantage to having the wife, mother, son, or whoever present. Let that person participate in the process and also understand why the deal may actually make sense. Allow the advisor to ask questions and learn so the advice when given is informed. Yes the phantom party may be someone you would prefer not to deal with, but he or she is there whether you like it or not. Their influence must be managed, not ignored. You will never have full settlement authority until they give their blessing.

To avoid a premature end to your mediation, send your client into the mediation well prepared. This includes explaining that the mediation will be emotional. Let them know that they may hear things that make them angry. Sorry. Litigation tends to be uncomfortable and unpleasant. You may also mention that mediation is unlikely to be anywhere near as intense or infuriating as the hearing. Tell your client that mediation is a process. There will be both an exchange of information and of offers and demands. Sometimes attorneys fail to empathize with their clients' possible unfamiliarity with the mechanics of negotiation. The first number is presented and a party will respond with supreme disappointment. They begin to pack up since the number offer is unacceptable. Those of us who engage in this process regularly take for granted the fact that the question of acceptability applies to the best and final number, not to the first number.

In addition, parties should be prepared by their attorneys to have realistic explanations as to what is a possible result. There is no benefit to either the process or to the client by setting unrealistic expectations. Realistic expectations should directly relate to what a likely outcome will be at arbitration. Your adversary will be similarly evaluating the case. A rational settlement is necessarily where the two evaluations intersect. Setting unrealistically high or low expectations doesn't get you a better result. Realistic expectations don't prevent you from aiming higher. The risk of sending your client into a mediation with unrealistic expectations is that at some point it may be necessary to either adjust the expectations of your client or pass up a potentially rational settlement and succumb to impasse.

I think this approach makes sense both from the standpoint of good mediation advocacy and from that of solid business practice. Setting realistic expectations does not prevent a party from attempting to achieve better than expected results. However, it does enable the party to understand when the lawyer has achieved a superb result. It would make the party appreciate a truly exceptional result if the expectations are realistic. It is better to exceed expectations than to have to adjust them at a later time.

Another way to avoid an impasse at the mediation is avoid "overlawyering" prior to the mediation. It is wise to mediate early in the process before excessive expenses that may prove an impediment to resolving the case have been incurred. Mediating early means that both sides know their case even though they may not be ready to go into the arbitration. The lawyer does have to know what the case is really about and what realistically will and will not be likely to be provable at hearing. Every bit of evidence does not have to be ready to go. Separate in your own mind argument and theory from what can be proven. Do not spend so much on preparation that any recovery has to include thousands of dollars spent on trial preparation. The value of the case will be based on trading losses and damage analyses relating to your client's securities account. It is unlikely that your adversary will be willing to compensate your client for expenses too. Overlawyering is a potential cause of an impasse. Avoid creating a situation where a settlement offer that is fair based on the various damage analyses is insufficient due to the expenses already expended.

Be prepared to mediate. This is different from being prepared to litigate. The fact that it is mediation does not mean that you can give the case a cursory glance. Do not postpone preparation until the actual hearing unless you really do want to have a hearing. Think about your opening statement. Prepare what you will say to your adversary so you make the most of a valuable opportunity. Focus on the strengths and weaknesses of your case. Anticipate impediments to settlement. Spend time with your client preparing them for what to expect. Give some serious thought to an appropriate damage analysis and negotiation strategy for mediation as well as for the hearing. Unfamiliarity with your case will lead to insecurity about the offers and demands. You must know with certainty what the net out of pocket losses are. Damages may or may not be the same number. Knowing the actual losses and formulating your damage theory are critical to effectively negotiating a settlement as well as to knowing a good deal when it is presented to you. Failure to prepare is a way to sideline a mediation.

Do not confuse litigation advocacy with mediation advocacy. It is appropriate to slant facts, be argumentative and to demonstrate total confidence in your position at the hearing. Painting an unreasonably rosy picture of the likely outcome is not the best way to conduct private sessions of a mediation. Unless you have an evaluative mediator or an early neutral evaluator, there is no point in unrealistically raising the expectations of your client. In mediation, your objective should not be to persuade the mediator. Your objective should be to settle your case. That requires an honest view of your case and the ability to negotiate effectively. Posturing too vigorously in private sessions for the benefit of the mediator may have the undesired effect of persuading your client. The client may not be willing to accept a reasonable settlement if you have succeeded in convincing him of how successful your arguments will be at a hearing.

Be flexible. There is more than one way to negotiate. Remember that you can only control your own style of negotiation. You cannot control the conduct of your adversary. You hurt your own chances for reaching a settlement when you respond to the style of negotiation of your adversary. It is entirely possible to reach a resolution with someone you don't like, don't respect, and don't agree with. Don't lose the war over hurt feelings regarding style. Just because the other side does not respond to your demand the way you want them to is no justification for ending the negotiation. Rather than attempting to change the way they negotiate, attempt to understand it so you can respond appropriately. The negotiation portion of the mediation is a way of communicating with the other side in numbers as well as words. Figure where you think they are going and why you think they are going there. Look past the style to the substance. Listen for messages delivered with the number. Learn to read between the lines. It is in your interest and ultimately in the interest of your client to work with your adversary.

There are several negotiating techniques to fall back on when all else fails, but only when all else fails. I don't advise parties to take the easy way out initially because I believe an advantage of mediation is the ability to retain control of the result.

One impasse breaking technique is the Mediator's Solution. This is a great method to use when all else fails, but should not be the method of choice in all situations. With the mediator's solution, the parties allow the mediator to pick the point at which the case should settle. The mediator allows the parties to either accept or reject the number. It can be used to break a deadlock or to speed up the negotiation. It should not be used too early in the process even though it saves the parties a lot of stomach churning. Even though the parties give up control of the final number, it is still better than the award of an arbitrator, because it can be rejected. But it is not the same as retaining control over the negotiation and possibly obtaining a better result through hard work. Nevertheless, there are those situations when the Mediator's Solution is definitely called for.

When parties are somewhat unsure of an appropriate settlement range, it is possible to explore ranges rather than numbers. By establishing an appropriate range, the parties can see that a resolution is in fact likely. A range can also narrow the possibilities. Without actually putting a specific number on the table the parties can explore with one another where there is a possible overlap of ranges. This may be very helpful to explore the value of the case. Without a realistic view of the value it is impossible to reach a resolution.

Another technique when parties are very far apart is the conditional offer and demand. When parties refuse to move in anything other than minute steps, the conditional offer allows two steps to be accomplished in a single round. The first party places a number on the table. However, there is a second number disclosed only to the mediator. The second party will only receive the second number if he is willing to make the requested move. Sometimes the mediator refuses even to disclose the second number unless the second party makes the requested move. This can sometimes be dangerous if the secret number does not reflect a substantial enough move.

There are many other creative techniques such as baseball mediation where the parties each select a number and the mediator chooses one of those two possibilities as the final recommendation. This can give one party a serious reality check if he has not realized up until this point how unrealistic he may be in his negotiation. In regular baseball, each side knows the other side's number. In night baseball, only the mediator knows both numbers. Besides the fact that the parties are relinquishing control to the mediator, another drawback with this technique is that at the end of the negotiation when this technique is usually used, the parties may have a sense as to how the mediator views the case. It may be clear as to which number is likely to be selected.

Negotiation like litigation is hard work. Sometimes the best way to avoid impasse is just to keep working. Parties come to mediation because they are willing to settle. The issue is always for what. Don't be quick to give up until you find the right place for your settlement. Both parties have the same case and there should be an appropriate place to meet if you are willing to engage in some hard work. You don't fail until you actually give up, so don't give up. Revisit, reconsider, back up and try again. Try something you have never tried before. Just because you have always negotiated a certain way doesn't mean you can't try a different way.

Rationally it should be possible in every case to reach a settlement because it is in everyone's best interest to do so. If everyone views their case as objectively as possible the two cases will be one when viewed by an objective third party such as an arbitrator. By making reference to the only other alternative to settlement, the arbitration, it is absolutely possible to find an appropriate range for a settlement and then keep working towards resolution. Sometimes this process is more painful and protracted than this simplified description sounds. Sometimes a client needs education; sometimes a lawyer needs education; sometimes everyone needs some education. Just as with everything in life, there are no deep dark secrets to achieving success. You can usually reach your objective with hard work, patience and perseverance. Good luck.

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.

Lester W. Becker et al. v. Financial Network Investment Corporation
NASD Case No. 01-05481

Claimants asserted the following causes of action: violation of New York Consumer Protection Act, NY General Business Law, violations of federal securities laws, fraud in offer or sale of securities, breach of contract, common law fraud, constructive fraud through breach of fiduciary duty, negligence and gross-negligence in connection with the solicitation of investments in ETS Payphones. Claimants requested compensatory damages, interest, costs and attorneys fees.

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

1. The panel found Respondent liable to Claimants for a total of $556,982.34 in compensatory damages plus interest at the rate of 9 percent from August 15, 2003 until the date of payment of the award.

2. Respondent was ordered to pay Claimants attorneys fees of $150,000 pursuant to *Coutee v. Barington Capital Group, LP*, 336 F.3d 1128 (9th Cir. 2003) and New York Consumer Protection Act, NY General Business Section 349.

3. Respondent was ordered to pay costs of $21,782 and $300 for Claimants' filing fee.

4. The panel made the following findings of fact:
   a. Investment of Claimants in ETS Payphones as recommended was inappropriate and fraudulent;
   b. Claimants did have a business relationship with Respondent's representatives that related directly to Investment Services;
   c. That Alan Justin, Jr., was, at all times pertinent, a supervision managerial agent of Respondent and acting as the FNIC agent in supervising activities;
   d. That Alan Justin, Jr. Respondent's Office of Supervisory Jurisdiction ("OSJ"), and Respondent's other representatives, Jay Gianni, Patrick Justin, David Sada and Eric Justin, were all active participants in the fraudulent sale of inappropriate and fraudulent ETS Payphones investments; and
   e. That Respondent did not reasonably nor adequately supervise its OSJ and its representatives.

5. The panel assessed $11,250 in forum fees against Respondent.

The award is significant for at

least two reasons. First, because it is a make whole award including an award of attorneys fees, interest and costs. Second, the findings of fact made against FNIC regarding ETS Payphones. The panel found that ETS was a fraud, that the brokerage firm did not reasonable supervise the activities of its brokers.

Claimants' Counsel -
Joel Goodman, Esq. of Goodman & Nekvasil
Respondent's Counsel –
Luigi Spadafora, Esq. of Winget, Spadfora & Schwartzberg, LLP
Claimant's Expert - None
Respondent's Expert –
John Pinto
Hearing Situs –
Buffalo, New York
Arbitrators -
Howard B. Cohen, Esq., Public/Chairman
Eugene M. Setel, JD, Public
Richard A. Scalfani, Industry

Anna Cialino et al. v. Wall Street Financial Group, Inc. and Bruce Whitman
NASD Case No. 02-05346

Claimants asserted the following causes of action: negligence, breach of contract, breach of fiduciary duty, unsuitability, control liability, respondeat superior and failure to supervise involving the sale of a Mid-America charitable gift annuity (ultimately a Ponzi scheme). 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 and costs.

1. The panel found Respondents jointly and severally liable to Claimants for $328,000 in compensatory damages and $600 for Claimants' filing fee.

2. The panel assessed Respondents $14,400 in expert witness fees.

The award is significant for a few reasons: 1) the award is against an independent contractor registered representative as well his firm, 2) the firm denied all liability of their independent contractor, supervision, and NASD jurisdiction, 3) while most CGAs are exempted investments, these were securities since they paid commission and the underlying firm failed to follow up on the exemptions. The award followed case law showing that a client of a broker becomes a client of the firm. There is presently an appeal pending.

Claimants' Counsel -
Richard D. DeVita, Esq. of DeVita & Associates
Respondents' Counsel -
Michael S. Schwartzberg, Esq. of Winget, Spadafora & Schwartzberg, LLP
Claimants' Expert –
Nancy Jones
Respondents' Expert –
Kord Lagerman, who did not testify
Hearing Situs –
New York, New York
Arbitrators -
Sherri L. Hughers, Esq., Public/Chairman
Alvin Green, Esq., Public
Harry D. Frisch, Esq., Industry

The Joyce S. Douglas 1998 Revocable Trust v. Morgan Stanley DW, Inc.
NYSE Case No. 2003-011292

Claimant asserted the following causes of action: over-concentration in telecommunications stocks, unsuitable investments and use of margin, lack of supervision, fraud, breach of fiduciary duty, negligent misrepresentations, violations of NYSE and NASD Rules and securities laws and violations of the California Elder Abuse statute. Claimant requested compensatory damages, interest, costs and attorneys fees.

Respondents 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 Respondent liable to Claimant for $750,000 in compensatory damages.

2. The NYSE forum fees of $9,000 were assessed against Respondent.

The award is significant and believed to be one of the larger NYSE arbitration awards this year.

Claimant's Counsel -
Erwin Shustak, Esq. of Shustak Jalil & Heller
Respondent's Counsel –
Clifford Hyatt, Esq. of Gray Cary Ware & Freidenrich, LLP
Claimant's Expert –
Bob Grosnoff
Respondent's Expert - None
Hearing Situs –
San Diego, California
Arbitrators -
Susan Dettmer Metsch
James Knotter
William Richardson

Patricia Greulich et al. v. Prudential Securities, Inc. and Robert C. Goe
NASD Case No. 02-00679

Claimants asserted the following causes of action: breach of contract, negligence, breach of fiduciary duty, failure to supervise and violations of state and federal securities laws relating to unsuitable investments, options trading, short selling and concentration in the technology sector. Claimants alleged that the broker exercised written and de facto discretion over the various accounts. Claimants requested compensatory damages, interest, costs and attorneys fees.

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

1. The panel found Respondents jointly and severally liable to Claimants for $128,000 in compensatory damages.

2. The panel found Respondents jointly and severally liable to Claimants for $30,000 in attorneys fees pursuant to *First Interregional Equity Corp. v. Haughton*, 842 F.Supp. 105, 112 (S.D.N.Y. 1994).

3. The panel found Respondents jointly and severally liable to Claimants for $11,056 in expert witness fees.

The award is significant for the grant of attorneys fees pursuant to the *First Interregional* case and the argument made by Claimants' counsel that arbitrators have the authority to award attorney fees unless the parties specifically exclude an award of attorneys fees from the scope of the arbitration agreement.

Claimants' Counsel -
William K. Flynn, Esq. of Strauss & Troy
Respondents' Counsel –
Michael Weisman, Esq. of Katen Muchin Zavis Rosenman and Martin Hunger, Esq. of Prudential Securities, Inc.
Claimants' Expert –
Ross P. Tulman
Respondents' Expert - None
Hearing Situs –
Cincinnati, Ohio
Arbitrators -
Bill Swinford, Jr., Esq., Public/Chairman
K Steve Kimball, CFA, Public
Robert Economou, Industry

Norman Huff et al. v. Prudential Securities, Inc. and Michael G. Dobbins
NYSE Case No. 2003-011725

Claimants asserted the following causes of action: breach of contract, negligence, failure to supervise, breach of fiduciary duty, misrepresentations and omissions involving the theft from a brokerage firm account. 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 and costs.

1. The panel found Respondents Prudential and Michael Dobbins jointly and severally liable for failure to supervise, breach of fiduciary duty and fraud. The Claimants were awarded trade recission, that is, all of the securities in their accounts shall be transferred to the ownership of Respondents and Respondents are ordered to pay to Claimants the total amount of funds originally invested, together with any

deposits made in to the accounts.

2. The panel found Respondents Prudential and Michael Dobbins jointly and severally liable for Claimants' attorneys fees of $74,000.

The award is significant and holds the brokerage firm and broker liable for a one size fits all strategy that was recommend to virtually all of the broker's clients.

Claimants' Counsel -
Jacob Zamansky, Esq. of Zamansky & Associates
Respondents' Counsel –
Loren Schechter, Esq. of Kirkpatrick & Lockhart
Claimants' Expert - None
Respondents' Expert - None
Hearing Situs –
Cleveland, Ohio
Arbitrators -
Robert Drake
Dean Guerin
Michael King

Robert and Denise Kadar v. Banc of America Sercurities, LLC
NYSE Case No. 2002-011054

Claimants asserted the following causes of action: common law fraud, negligent supervision, breach of fiduciary duty, breach of contract, violation of federal securities laws, negligence, breach of express and implied duties and failure to provide suitable advice with respect to investments in Doubleclick stock. Claimants requested compensatory damages, interest at the rate of 9 percent, costs and attorneys fees.

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

1. The panel found Respondent liable to Claimants for $625,000 in compensatory damages plus interest at the rate of 9 percent from October 12, 2000 until the date of payment of the award.

The award is significant because the brokerage firm earned little or no fees during the life of the account. The award was made on the basis of the original solicitation of the clients and the failure of the firm in living up to the promises made regarding the diversification and management of Claimants' concentrated position in Doubleclick they received as a result of their employee stock options.

Claimants' Counsel -
Stuart Meissner, Esq.
Respondent's Counsel –
Peter Boutin, Esq. and Ben Suter, Esq. of Keesal, Young & Logan
Claimants' Expert –
Jim French and Howard Berg
Respondent's Expert –
Paul Yanofsky
Hearing Situs –
New York, New York
Arbitrators -
Charles Aitcheson
Harold Gelb
Robert Allen

Rau L. King et al. v. IFG Network Securities, Inc.
NASD Case No. 02-05285

Claimants asserted the following causes of action: violation of federal securities laws, violations of Florida Securities and Investor Protection Act, breach of contract, common law fraud, breach of fiduciary duty, negligence and gross negligence relating to the investment in an Evergreen Securities, Ltd. fund. Claimants 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 Claimants' claims.

1. The panel found Respondent liable to Claimants for compensatory damages plus pre-judgment interest in the amount of $59,227.05.

2. The panel found that Respondent sold an unregistered security in violation of Section 517.07 of the Florida Statutes of the Florida Securities and Investor Protection Act.

3. The panel required Claimant to tender all interest in the Evergreen fund back to Respondent.

4. The panel determined that the issue of attorneys' fees is to be decided by a court of competent jurisdiction.

5. The panel assessed $7,500 in forum fees against Respondent.

The award is significant because the arbitrators granted rescission of the Claimants' Evergreen investment.

Claimants' Counsel -
Joel Goodman, Esq. of Goodman & Nekvasil
Respondent's Counsel –
Burton W. Wiand, Esq., Elaine M. Rice, Esq. and Michale S. Lamont, Esq. of Fowler White Boggs Banker, P.A.
Claimants' Expert - None
Respondent's Expert - None
Hearing Situs –
Tampa, Florida
Arbitrators -
Richard W. Thornburg, JD, Public/Chairman
Richard K. Wilson, Esq., Public
Lewis W. Slaughter, Industry

Marilyn McCarthy et al. v. Asset Management Securities Corp.
NASD Case No. 03-00460

Claimants asserted the following causes of action: breach of fiduciary duty, negligence, negligent supervision, violation of the Florida Securities and Investor Protection act relating to the purchase of aggressive growth mutual funds in Claimants' account. Claimants requested compensatory damages, interest, costs and attorneys fees.

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

1. The panel found Respondent liable to Claimants for breach of fiduciary duty, negligence and negligent supervision and awarded $310,000 in compensatory damages plus interest at the legal rate from February 12, 2004 until the date of payment of the award.

2. The panel found Respondent liable for $5,000 in costs.

3. The panel found Respondent liable for Claimants' attorneys fees in an amount to be determined by a court of competent jurisdiction pursuant to Chapter 517 of the Florida Statutes.

The award is a make whole award based on the conduct of a broker who selected unsuitable equity mutual funds in a discretionary account. The award is significant since the panel award damages based on a well managed portfolio theory which was nearly three times the net out of pocket loss.

Claimants' Counsel -
Jeffrey R. Sonn, Esq. and Jeffrey Erez, Esq. of Sonn & Erez
Respondent's Counsel –
Leonard Bloom, Esq. of Broad & Cassel
Claimants' Expert –
Ralph Feith
Respondent's Expert –
Harold Evensky
Hearing Situs –
Boca Raton, Florida
Arbitrators -
John A. Brekka, Jr., Esq., Public/Chairman
Oscar Schneider, Esq., Public
Morton D. Siegel, Industry

Bruce Merino et al. v. Hotovec, Pomeranz & Co., LLC, et al.
NASD Case No. 02-03897

Claimants asserted the following causes of action: breach of contract, negligence, failure to supervise, breach of fiduciary duty, misrepresentations and omissions involving the theft from a brokerage firm account. 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 and costs.

1. The panel found Respondents Hotovec, Pomeranz & Co., LLC and Steven D. Hotovec jointly and severally liable to Claimants

for $798,297 in compensatory damages.

2. The panel found Respondents Hotovec, Pomeranz & Co., LLC and Steven D. Hotovec jointly and severally liable to Claimants for $1,596,594 in punitive damages.

3. Respondents Hotovec, Pomeranz & Co., LLC and Steven D. Hotovec were assessed $10,800 in forum fees.

The award is significant and holds the brokerage firm and its principal liable for both compensatory and punitive damages for employee theft.

Claimants' Counsel –
  Theodore A. Griffinger, Jr., Esq. and Ellen A. Cirangle, Esq. of Stein & Lubin, LLP
Respondents' Counsel –
  David E. Reynolds, Esq. of Lewis Brisbois Bisgaard & Smith LLP
Claimants' Expert –
  Fergus Henehan
Respondents' Expert - None
Hearing Situs –
  Las Vegas, Nevada
Arbitrators -
  Neil J. Beller, Esq., Public/Chairman
  Michael B. Laikin, Esq., Public
  Steven A. Budin, Industry

Brian P. Olsen et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.
NASD Case No. 03-02870

Claimants asserted the following causes of action: breach of fiduciary duty, misrepresentations, violation of the Washing State Securities Act (RCW 21.20.020 *et seq*.) and violation of the Washington Consumer Protection Act (RCW 19.86.010 *et seq*.) relating to the recommendation to purchase InfoSpace, Inc. stock at inflated prices. Claimants 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 Claimants' claims, attorneys fees and costs.

1. The panel found as follows:

> "The Panel is convinced by a preponderance of the evidence that the Respondent violated RCW 21.20.020 and RCW 19.86.010 and that Claimants are entitled to recover based upon a common law claim of negligent misrepresentation. The panel also finds that the Claimants justifiably relied on ratings given to InfoSpace, Inc. stock of "Buy-Buy" when Respondent believed InfoSpace, Inc. stock should be rated lower. The Panel finds that the proof showed that Respondent did not believe its ratings of InfoSpace, Inc. during the latter half of the year 2000. During this period, the Claimants purchased InfoSpace stock for $117,549 on November 27, 2000."

2. The panel found Respondent Merrill Lynch liable for $83,867 in compensatory damages.

3. The panel found Respondent Merrill Lynch liable for $86,500 in attorneys fees pursuant to *Travis v. Washington Horse Breeders*, 111 Wn 2d 396, 759 P2d 418 (1988).

4. The panel found Respondent Merrill Lynch liable for $16,906 in arbitration costs.

The award is a significant win for an investor making a pure analyst claim for Henry Blodget's research coverage of InfoSpace stock. Virginia Syer, a member of the Henry Blodget research team was called by Merrill Lynch to testify in this matter. The panel rejected Merrill Lynch's claim that the client was at fault for the losses.

Claimants' Counsel –
  Benjamin A. Schwartzman, Esq. of Lovell Stewart Halebian & Barth, LLP
Respondent's Counsel –
  Matthew C. Applebaum, Esq. of Bingham McCutchen, LLP
Claimants' Expert –
  Edward Horwitz
Respondent's Expert –

Bates Private Capital
(damages only)
Hearing Situs –
Seattle, Washington
Arbitrators -
Keith M. Callow, Public/Chairman
G. E. Craig Doupe, Esq., Public
Jan Aalbregise Slinn, J.D., Industry

W. Stewart Swain et al. v. Citigroup Global Markets, Inc. and Robinson-Humphrey Co., Inc.
NASD Case No. 01-03375

Claimants asserted the following causes of action: violation of federal Investment Advisors Act of 1940, breach of fiduciary duty, violation of NASD and NYSE Rules, negligent misrepresentation, breach of contract and fraudulent misrepresentation in connection with the failure of Respondents to execute a collar on Claimants' concentrated stock holdings in Integrated Health Services. Claimants requested compensatory damages, interest, costs, attorneys fees and disgorgement.

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

1. The panel found Respondents Citigroup and Robinson-Humphrey Co. jointly and severally liable to Claimants for $4,265,485 in compensatory damages plus $936,065 in disgorgement.

2. The panel found Respondents liable for making negligent misrepresentations.

The award is significant in size and also because it took more than three years to complete the case.

Claimants' Counsel -
Daniel MacIntyre, Esq. and Robert Sommers, Esq. of Shapiro Fussell, LLP
Respondents' Counsel –
Paul Stivers, Esq., Tony Powers, Esq. and Daniel LaFrance, Esq. of Rogers & Hardin
Claimants' Expert –
William J. Hicks
Respondents' Expert –
Brian Lane and John Compton
Hearing Situs –
Atlanta, Georgia
Arbitrators -
Lisa V. Gianneschi, Esq., Public/Chairman
Sonia Fishkin, Esq., Public
M. Bruce Adelberg, Industry

Stanley P. Witte et al. v. Burgess & Associates et al.
AAA Case No. 03-195-00363-03

Claimants asserted the following causes of action: violations of the federal securities laws, violations of Missouri Securities Act, Violation of Georgia Securities Act, control person liability, common law fraud, negligent misrepresentation and breach of fiduciary duty in connection with the sale of viatical securities. Claimants requested compensatory damages, interest, costs and attorneys fees.

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

1. The arbitrator found Respondents liable and instructed Respondents to pay Claimants $216,318.07 in principal and $102,455.81 in interest in return for tendering the viatical investments.

2. The arbitrator found Respondents liable for $14,945 in arbitrator expenses.

The award is significant because the arbitrator awarded recission of the viatical investments against the unlicenced insurance agents. The rescissionary damages were made pursuant to the Missouri Securities Act.

Claimants' Counsel -
Daniel MacIntyre, Esq. and Robert Sommers, Esq. of Shapiro Fussell, LLP
Respondents' Counsel –
Robert Freeman, Esq.
Claimants' Expert - None
Respondents' Expert - None
Hearing Situs –
Atlanta, Georgia
Arbitrators -
Elwood F. Oakley, III J.D., Chairman

Announcements From The PIABA Office

Office Staff:

Robin S. Ringo, Exec. Director
rsringo@piaba.org

Josh Edge, IT Assistant
joshedge@piaba.org

Karrie Ferguson, Office Assistant
kferguson@piaba.org

April Taylor, Office Assistant
ataylor@piaba.org

2415 A Wilcox Drive
Norman, OK 73069
Toll Free: 1.888.621.7484
Office: 1.405.360.8776
Fax: 1.405.360.2063
E-Mail: piaba@piaba.org
Website: www.PIABA.org

Upcoming Events:

6th Annual Securities Law Seminar, October 20, 2004. Hyatt @ Coconut Point. Bonita Springs, Florida.

PIABA 13th Annual Meeting, October 21 - 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.

California Mid-Year Meeting, February 19, 2005. Location to be announced.

PIABA Board of Directors Meeting, March 5-6, 2005. Location to be announced.

PIABA Board of Directors Meeting, July 16-17, 2005. Location to be announced.

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