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Features And Columns

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From the Editor's Desk

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The deadline for receiving submissions for the Fall, 2005 issue of *PIABA Bar Journal* is October 10, 2005. All submissions should adhere to the following format:

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President's Message

By Rosemary Shockman

Dear Members:

As you know, the directors met in Colorado Springs in mid July for a two-day meeting. I thank them for taking time from their schedules and incurring traveling expense. During that meeting, the Board:

1. Adopted a strategy for attempting to move the NASD to grant challenges for cause more liberally in variable annuity cases. PIABA is concerned with potential industry arbitrators whose firms are engaged in the same misconduct as that charged in the subject lawsuit.

2. Adopted plans for proposing changes in arbitrator definitions at the NYSE.

3. Discussed and adopted plans for efforts to change CRD reporting practices to require reporting of cases in which the broker's conduct is the subject of the arbitration claim, but the broker is not named as a party.

4. Adopted plans for attempting to set an annual meeting aimed at an exchange of ideas and training for non-lawyer assistants to PIABA members.

5. Reviewed final changes to the annual meeting plans.

6. Approved continued efforts directed to arbitrator recruitment through advertising.

As you have seen on the list serve, the Board and other PIABA members have been extremely active in preparing comments for submission to the SEC. These comments have included:

a. The NASD Code Rewrite. (Special thanks are extended to Bob Banks for his work.)
b. Comments on fees in broker/broker dealer cases. Reasoned Awards. Appointment of Arbitrators - Amendment to NYSE Rule 607.

I look forward to seeing you all at the annual meeting.

Rosemary J. Shockman

ProfLipner's "I Love New York Law: Why Arbitration Recovery Statistics Are Meaningless

By: Seth E. Lipner

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Bald statistics are meaningless. Statistics about arbitration recovery rates are even more meaningless. The purpose of this article is to demonstrate why that is so. A second purpose is to suggest one use of arbitration statistics that needs to be incorporated into the arbitration process.

OVERSTATED CLAIMS

The amount demanded in an arbitration Statement of Claim (in many cases) bears only a tenuous relationship to the damage incurred. The reasons are numerous:

=> there is no penalty for overstating damages in the Claim. As the amount sought increases, filing fees go up only marginally, providing little economic disincentive to over-estimating the losses.[1]

=> there is often no need for Claimant's counsel to expend, at an early time in the case, the money necessary for a detailed economic analysis. While some attorneys do their accounting work in advance, many delay the process. Indeed, unlike court, where an early demand for Bill of Particulars as to damages is routine, the arbitration claimant does not have to submit his damage calculation until twenty (20) days before the hearing. In cases such as these, damage demands in the Statement of Claim are likely to be "ballpark" figures.

=> in complex cases, where damages are multi-faceted or hard to compute, the careful attorney must, at the pleading stage, err on the side of over-inclusion. For example, claims for capital losses might not take account of income earned as an offset or long-shot claims for lost profits can be made. In short, at the claim stage, every manner of loss is conceived of and included.

=> in these days of high market volatility, the measure of damages in cases is likely to depend on the period chosen and the securities analyzed. Naturally, at the pleading stage, Claimant's counsel may choose an advantageous period to look at, or Claimant make seek to separate losers from winners. At the hearing, however, that same Claimant may retreat to another, more logical or persuasive position.

[1] An exception might exist for small cases (under $50,000), where inflated demands can affect filing fees in both paper and single-arbitrator cases. An investor with a $50,000 case and wanting a single public arbitrator will not inflate the claim.

=> at the hearing, the claimant may accept some measure of comparative fault, give up some claims to enhance others, or otherwise limit his claims. That is rarely if ever done at the pleading stage.

=> in certain cases, claimants seek damages measured by comparing the account to what a well-managed portfolio would have done during the time period. In some cases, such an award is not justified; in others, such an award is justified, but the "measure" offered in the Claim is different from the one used by the arbitrators in the award.

In contrast to the arbitration Statement of Claim, at the arbitration hearing, the Claimant will put forth (or stipulate to) a detailed accounting of losses. For the reasons just stated, that accounting is likely to be less (in some cases significantly less) than the lump sum claimed in the *ad damnum* clause of the Claim. Perhaps, at the time of filing, Claimant did not have all his statements, or that information was learned after filing that reduced the damages sought which were sought at the hearing. In addition to the reasons listed above, the desire not to look "greedy" may cause counsel to cut out some claims at hearing. The pre-hearing vetting process between counsel may also reveal errors in an early damage calculation, which require downward adjustment.

The NASD and NYSE award forms, unfortunately, do not provide a line for "Amount Sought at Hearing". Instead, the award form calls only for the "Amount Sought in the Claim". While it would be advantageous for all for the SROs to include "Amount Sought at Hearing"in all the awards, they have not done so. Until that happens, any statistics derived from the Amount Sought in the Claim are meaningless.

THE POOL OF CASES GOING TO AWARD

The NASD reports that approximately 50% the cases that are filed settle before award. Thus, the "pool" of cases for which we can see awards has been reduced from what it is originally was at the time of filing. This fact greatly affects the way we must look at award statistics.

The pool of filed cases includes a broad panoply of suitability-type cases.[2] Some involve risk-averse investors, other risk-willing investors, and a wide variety of every type of in-between - in other words, a fairly "normal" distribution.[3]

All other things being held equal, risk-averse people are more likely to settle (even for inadequate amount) than are risk-willing people. As the following (oversimplified) chart shows, the pool of claimants going to arbitration hearing (*i.e.* not settling) is thus rich with risk-willing claimants.

	Risk-averse	Risk-willing
cases filed	100	100
go to hearing	34	66

The chart demonstrates that if 200 people file claims, half being risk-averse and half risk-willing, and we assume that risk-averse claimants settle twice as often as risk-willing investors, the pool of cases going to arbitration hearing contains twice as many risk-willing claimants (66/34) as risk-averse. No matter what percentage settlement rate is chosen, or what the actual distribution of claimants risk tolerance, since risk-averse claimants will always settle more frequently than risk-willing claimants, the pool of non-

[2] For this analysis I am using only suitability-type cases. The analysis may or may not hold (depending on the circumstances) in other sorts of cases. Since, however, the majority of investor cases have a suitability flavor, I focus the analysis there.

[3] Indeed, if the distribution is skewed, it is skewed toward the risk-averse. If skewing exists, it makes the analysis here even stronger.

settling cases will always have a relatively higher percentage of risk-willing individuals in it than did the pool of cases at the time of filing.

Were these cases personal injury cases, that observation would be of no moment, because in such cases, risk tolerance does not affect case quality. But in suitability cases, risk-willing investors generally have ***weaker*** cases than do risk-averse investors. The pool of suitability cases going to award is thus rich with *relatively* weak cases. Studying awards in those cases tells us absolutely nothing about how the "average" suitability case will fare at a hearing; it certainly tells us nothing about how a ***good case*** would fare.

Obviously, the arguments put forth in this section apply only when looking at a broad population of cases.[4] Nothing here is meant to suggest that studying an individual arbitrator's awards is not useful - even though there are usually no reasons given, at least something useful can often be discerned from looking at individual arbitrator's awards, especially those who have decided a fair number of suitability cases. But large-scale statistics about win rates and recovery rates are largely worthless - they should certainly not become the basis for anyone's evaluation of the merits (or likely outcome) of a strong suitability case.

NO REASONS

Arbitrators are not required to offer reasons, and they rarely do so. It is virtually impossible to read an award and discern the logic behind it.[5] It is impossible to tell whether an investor got all he sought on one claim, or part of what was sought on several claims. It is impossible to know whether the result was a product of a failure to mitigate damages, or loss was measured against a market index, or whether income was used as a set-off against capital losses, or if some other form of relative fault was assessed. It is impossible to tell how much of the claim was losses, and how much for "lost profits". As stated previously, the reader of an award does not even know if the amount awarded is the amount actually sought at the hearing.

Statistics about arbitration hearing results are thus truly "bald". They tell us nothing about what happenned, other than that a claim was filed, and it was decided in a certain manner. Trying to discern any more is akin to reading tea leaves.

PRO SE CASES AND INADEQUATE REPRESENTATION

My estimate is that pro se cases account for 10% - 20% of the cases decided.[6] In addition, there is, I believe, a significant population of awards where representation of the Claimant was inadequate. That is not to suggest that a skilled litigator cannot transfer his skills to the peculiarity of the arbitration setting, but sometimes it doesn't. Both these facts keep award statistics down. These situations - lack of representation and lack of adequate representation are more likely to occur on Claimant's side, again skewing statistics to make it seem that recovery by experienced counsel in a good case is likely to be low. The fact is, statistics tell us nothing about what a good case will bring.

[4] In any large population, there will be exceptional cases (e.g. intransigent respondents, personal situations), and the "quality" of cases exists on a continuum, but the analysis holds for the large population, whatever settlement rates one plugs into the chart.

[5] The NASD's announcement that Claimants will, in the future, have the option of requesting a "reasoned awards" will, if adopted and used, improve the amount of knowledge and information that can be gleaned from reading awards.

[6] Following inquiry, I learned that the NASD does not track such statistics.

A MEANINGFUL WAY TO USE ARBITRATOR STATISTICS

Arbitrator statistics (as opposed to arbitration statistics) can be meaningful, however, but only if used correctly. Since we can discern little to nothing about a case from reading the award, it is difficult to make inferences of "fairness" or "bias" simply by reading an individual arbitrator's awards. Yet sometimes when we review awards (if an arbitrator has enough), the trained eye can sense hints of a pattern of bias (lots of zeros) or a pattern of giving very low recoveries (lots of small numbers). But putting intuition aside, a bald review of arbitrator recovery rates is unlikely to "prove" anything.

But statistics can be helpful in proving things when used correctly - i.e. when results are measured against a meaningful standard. Thus, if an arbitrator with a statistically significant sample of awards is far below or above a computed mean, then there is more than a "suspicion" or "sense" of bias - it has become statistically likely.

Despite this fact, the NASD and NYSE appear routinely to reject causal challenges to an arbitrator based upon statistical indicators of bias (even when it is based on a large sample of awards). The NASD and NYSE, which do precious little to insure that arbitrators have no bias (only resumes and reference letters are reviewed, and direct conflicts screened[7]), should compute mean recovery rates and standard deviations for every region, and, where arbitrators fall outside some pre-set limit, the arbitrator's cases (and awards) are automatically flagged and reviewed internally, and an interview conducted to determine if there is a reason for the anomaly or whether bias exists.[8]

While such monitoring may have unintended consequences, there is nothing wrong with setting criteria for those who judge others, and monitoring the results. Universities do it with faculty grading, and even major league baseball does it with umpires - they test the propriety and consistency of an umpire's judgment calling balls and strikes by comparing ball/strike ratios to a mean. Bar Associations and Judicial Nominating Committees, who screen judges for appointment and advancement, always look at "conviction rates", "reversal rates", and other statistics. The NASD and NYSE need to do the same.[9]

CONCLUSION

Any study of arbitration statistics must take account of these anomalies in the pool of cases going to award. Bald statistics are worthless. Arbitration statistics, unfortunately, are among the baldest. Arbitrator statistics, can be useful in a limited way, but, unfortunately, the SROs continue to look the other way at ingrained arbitrator bias.

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[7] The NASD and NYSE conduct no interviews of candidates to be arbitrators, and, upon information and belief, neither organization regularly reviews arbitrators' awards for fairness or indications of bias. Voir dire by parties is of course limited.

[8] The suggestion here is that thus be done routinely as a check on the fairness of the pool - whether the NASD and NYSE want to consider granting challenges based on statistics is a different, though perhaps meritorious, point.

[9] This author is not sufficiently sophisticated in sampling and statistics to discuss the number of awards which might be required to obtain a statistically significant sample for an individual arbitrator, or how the distribution should be measured. Such calculations, however, are not difficult for experts.

From The Lone Star State: Overcoming Statute of Limitation Defenses in Securities Arbitration

By Samuel B. Edwards

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I. **INTRODUCTION**

As the market crash of the early 2000's becomes increasingly distant, attorneys representing Claimants in securities arbitration will be forced to fight more and more arguments for dismissal based on the lapsing of the statute of limitations. As an organization, it is imperative that PIABA develop a unified front of cognizable arguments to help those investors who have waited, for various reasons, until now to file their arbitration claims. This article focuses on helping arbitration attorneys fight limitations arguments by (1) arguing that the NASD six-year eligibility rule is the only applicable statute of limitation for arbitration claims and (2) using Texas state law to toll otherwise applicable statutes of limitation.[1]

II. **THE NASD RULES**

As with any determination in securities arbitration, the first place to look for a defense against brokerage firm tactics is in the NASD Code.

a. Using the Six-Year Eligibility Rule as the Statute of Limitations

The code itself has an eligibility rule that many attorneys ask the arbitrators to apply as the only "statute of limitations" for NASD cases. The NASD "six-year rule," or "eligibility rule" is found in Rule 10304, which states in part that "[n]o dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act, dispute, claim or controversy." *NASD Rule 10304 (2005).* The issue of whether courts or arbitrators should make the determination of whether a claim was barred by the six-year time limitation was the subject of extensive litigation and eventually resolved in 2002 by the United States Supreme Court in *Howsam v. Dean Witter Reynolds, Inc. See* 537 U.S. 79 (2002). In *Howsam*, the Court ruled that since eligibility was a procedural, rather than substantive issue, arbitrators should determine whether or not the six-year rule barred a particular claim, rather than a trial court. *Id*. In January of 2005, the NASD released a Notice to Members which announced the amendment of the eligibility rule to conform with the Supreme Court's decision in *Howsam* as well as to make clear the impact of that decision on future cases. Effective May 1, 2005, arbitrators, and not courts, will

[1] This article focuses on the NASD rules since the majority of customer disputes are filed with the NASD. However, most, if not all, of these same arguments could be made in an NYSE case given that the NYSE Rules are almost identical on these issues.

determine whether a claim is ineligible for arbitration under the rule; make clear that dismissal of a claim on eligibility grounds in arbitration does not preclude a claimant from pursuing the claim in court; provide that, by requesting dismissal of a claim under the rule, the requesting party is agreeing that the claimant may withdraw all related claims without prejudice and may pursue all of the claims in court; and state that the six-year time limit on the submission of claims does not apply to any claim that is directed to arbitration by a court of competent jurisdiction upon request of a member or associated person.

NASD Notice to Members 05-10 (May 1, 2005).

While the six-year eligibility rule has often been viewed as a statute of repose which cannot be tolled, at least one court has cited *Howsam* as authority to hold that arbitrators have the power to toll the six-year eligibility rule. *See Gregory J. Swartz & Co., Inc. v. Fagan*, 2003 WL 1891879, at *2 (Mich. App. Jan. 31, 2003).

Given the long time period to file a claim under the eligibility rule, whether it can be tolled or not, it is clearly understandable why claimants ask to use it as the statute of limitation. The basic argument is that arbitration is a creature of contract that is not governed by traditional rules of procedure. Rather, the parties have agreed that the NASD rules, not the rules of any particular state, will apply to the hearing. Effectively, the six-year eligibility rule operates as a modification to the general statutes of limitation. There is nothing unusual or inappropriate in parties agreeing to change a statute of limitation, as many states allow the parties to litigation to make such agreements. For example, under Texas law, parties can legally change the statute of limitations through contract, including their arbitration agreement. *See EZ Pawn Corp. v. Mancias*, 934 S.W.2d 87, 89, 40 Tex.Sup.Ct.J. 104 (Tex. 1996) and *In Re Luna*, 2004 Tex. App. Lexis 8241, 21 I.E.R. Ca. (BNA) 1353 (Tex. App. – Hous.[14th Dist.], September 9, 2004.

Moreover, it makes perfect sense that the statute of limitations for a securities arbitration is six years. The primary reason for statutes of limitation is the fear that evidence will become stale or destroyed if too much time is allowed to pass. *See Pearson v. Exxon Corp*., 2000 U.S. App. Lexis 25473 (6th Cir., 10/4/2000, filed). As there are no national standards for keeping documents, it is reasonable that statutes of limitation be only a few years, allowing potential defendants to legally throw away evidence in the normal course of business without fear of a spoliation claim. However, there are very particular standards on the type of documents brokerage firms must keep and rules requiring the records be kept for a reasonably long time. *See* NASD Conduct Rules 2110 and 3110. Coincidentally, that time period is generally 6 years. *See* SEC Rules 17a-3 and 17a-4. As a result, a modification of the general statute of limitations that correlates with the time period documents must be preserved is certainly a reasonable interpretation of the six-year eligibility rule.

Additionally, since the remedies and causes of action available in arbitration are different than those available in court, it stands to reason that arbitration needs its own statute of limitation to apply to those claims. The most obvious example is a claim based on a violation of SRO rules. Brokerage firms often include boilerplate language in answers stating the typical defense that violations of SRO do not form the basis of a cause of action. However, the NASD has made it clear, through the statements of Linda Feinberg and others, that violations of SRO rules are actionable in NASD cases.[2]

[2] At the First NASAA Arbitration Forum, held 7/20/04 at the National Press Club in Washington, D.C., Linda Fienberg represented that one of the benefits of arbitration is that “in NASD SRO arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law. It can be cognizable under NASD rules.”

Accordingly, since there is the ability to recover damages in arbitration that might be otherwise unavailable, at a minimum, the six-year rule should work as the statute of limitation for those claims.

b. Countering The Argument that the Six-year Rule Does not Extend the Statute of Limitations

The brokerage firm's defense to the six-year eligibility rule being the appropriate statute of limitation for NASD claims is almost universally the language contained in the Code which states "[t]his Rule shall not extend applicable statutes of limitations …." NASD Rule 10304(c). The two basic defenses to this argument are (1) a reading of 10304(c) from a statutory constructionist standpoint clearly demonstrates the language is not meant to apply to the six-year rule[3] and (2) normal statutes of limitation to not apply to arbitration and therefore the language is irrelevant.

1. The (c) applies to (b), not (a) argument

Rule 10304 has three sections discussing eligibility and statutes of limitation in NASD arbitration. *See* NASD Rule 10304. It is important to read these sections together to determine how they interact. Specifically, section (a) discusses the eligibility rule and defines the time period for bringing an NASD complaint. Section (b) discusses the movement of a case from arbitration to court. Section (c) then follows to discuss the opposite situation, moving a case from court to arbitration. It is no accident that the phrase "shall not extend applicable statutes of limitation" is contained in section (c), just after a discussion of removing a case to court. Clearly, the NASD was seeking to clarify that when a case has been removed to court, the six-year rule no longer applies.

Since this can be a confusing argument, it is imperative that you carefully explain it to the panel. The best way to convey the point to a panel is to put the rule in front of them and ask the panelists to look at it. On its face, the argument logically and visually makes sense by the simple organization of the rule. Then, the point can be brought to the panel by asking: If the part of the rule stating it "shall not extend applicable statutes of limitations" applied to Section (a), why is it included in section (c)? Presumably, the drafters of the NASD Code could have easily included this term as a part of section (a). However, because the NASD's intent was clearly to speak only about the ramifications of the rule when the case is removed to court, they placed it as far from section (a) as possible.

2. Applicability of general stautes of limitation in arbitration

The second contention to make to the panel is the often-used argument that statutes of limitation do not apply to arbitrations. The issue of whether statutes of limitation should even apply to arbitration hearings has been the subject of endless debate. Arbitration is considered to be an equitable forum in which a panel has great latitude to ignore harsh legal strictures in order to achieve justice and fairness. As a result, applying absolute deadlines to filing claims is seemingly inconsistent with arbitration itself.

As discussed above, the NASD Code states that the rule does not extend the "*applicable* statutes of limitations." NASD Rule 10304(c) (2005) (*emphasis added*). Brokerage firms have a habit of leaving out the term "applicable" in their arguments as it begs the question of whether any statutes of limitation apply to NASD arbitrations. As has been discussed in numerous previous PIABA articles, many states' definition of how to bring a claim supports the contention that the state's statutes of limitation are not applicable to an arbitration claim, rendering that language in 10304(c) meaningless.

[3] This argument was largely developed by Kurt Arbuckle and borrowed for this article.

In Texas, the fact that state statutes of limitation do not apply to arbitration proceedings is demonstrated in the use of the word "suit." For example, the statute providing for the four-year limitations period reads, "[a] person must ***bring suit*** on the following actions not later than four years after the day the cause of action accrues…" TEX. CIV. PRAC. & REM. CODE ANN. § 16.004 (Vernon 2005) (emphasis added). Under Texas law, bringing suit and initiating arbitration have been viewed as separate and distinct concepts for 150 years. In 1855, the Texas Supreme Court stated, "[t]he words *court* and *suit* have a distinct meaning, and suggest a very different idea from arbitrators and arbitration. These words have been understood and construed in the connection in which they are used to mean either the District Court or that of a justice of the peace, as the case may be." *Yarborough v. Leggett*, 1855 WL 4956 (Tex. 1855). Indeed, it is commonly accepted black-letter law that "suit" connotes "any proceeding by a party or parties against another *in a court of law*." Black's Law Dictionary (8th ed. 2004)(emphasis added). Arbitration does not take place within the state's established judicial system, and traditional rules of civil procedure do not apply to arbitration proceedings. As a result, Texas statutes of limitation should not bar arbitration claims because they only serve to bar *suits* which are filed in courts of law after the given time period.

While this may seem too legalistic an interpretation of the statute, it is consistent with interpretation of statutory law in other jurisdictions. In California, for example, the statute of limitations reads differently, providing that "[t]he periods prescribed for the commencement of *actions* … are as follows." Cal. C.C.P. § 335 (West 2005) (emphasis added). "Actions," as defined under the California C.C.P. are "an ordinary proceeding *in a court of justice*…" Cal. C.C.P. § 22 (West 2005) (emphasis added). Clearly, California statute of limitation periods only govern the administration of justice by the courts, and are, by their own terms, inapplicable to arbitration.[4] As in Texas, statutory limitations periods should not bar claims in arbitration in California.

The NASD Code additionally refers to limitations in court by stating, "the time limitations which would otherwise run or accrue for the institution of legal proceedings shall be tolled [when an arbitration claim is filed]." NASD Rule 10307(a) (2005). The NASD Code, therefore, provides for a distinction between any "applicable" time limitations which may apply to claims filed in arbitration versus applicable time limitations for initiating court proceedings (while also distinguishing "legal proceedings" from "arbitration proceedings").

It is important to note to the arbitration panel that such an interpretation of the eligibility rule serves the customers and brokerage-dealers in securities arbitration evenly. Investment firms and broker-dealers bring claims in arbitration, just as customers do, and may benefit from not having their potential claims time-barred by statutes of limitation.

Ultimately, under Texas law, and that of many other jurisdictions, the panels should be easily swayed that the statute of limitations for action in that particular state are not applicable to NASD proceedings. As a result, the only "statute of limitation" is the six-year rule.

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[4] Several states have statutes of limitation provisions similar to California's, which provide limits on "actions." For a comprehensive list of cases in which courts have ruled that arbitration proceedings did not constitute "actions," and thus statutes of limitation were not applicable, see *Statute of Limitations as a Bar to Arbitration Under Agreement*, 94 A.L.R.3d 533 (2004).

III. TEXAS CAUSES OF ACTION AND THEIR LIMITATION PERIOD

The following list provides the most common causes of action which may be pled in connection with typical securities disputes in NASD arbitration.[5] Also presented are the controlling limitation periods. The subsequent sections will discuss the various techniques claimants may use to overcome a statute of limitations defense.

- Breach of Contract: Four years "after the day the cause of action accrues."[6]
- Breach of Duty of Good Faith and Fair Dealing: Two years "after the day the cause of action accrues."[7]
- Breach of Fiduciary Duty: Four years "after the day the cause of action accrues."[8]
- Fraud: Four years "after the day the cause of action accrues."[9]
- Negligence: Two years "after the day the cause of action accrues."[10]
- Negligent Misrepresentation. Two years after the day the cause of action accrues.[11]
- Texas Deceptive Trade Practices Act: Two years "after the date on which the false, misleading, or deceptive act or practice occurred or within two years after the consumer discovered or in the exercise of reasonable diligence should have discovered the occurrence of the false, misleading, or deceptive act or practice."[12] This may be "extended for a period of 180 days if the plaintiff proves that failure timely to commence the action was caused by the defendant's knowingly engaging in conduct solely calculated to induce the plaintiff to refrain from or postpone the commencement of the action."[13]
- Texas Securities Act §33: Three years "after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence; or… five years after the sale."[14]

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[5] This list was developed largely from Nelson S. Ebauh & Grace D. O'Malley, *Picking Your Battles: A Guide to Selecting Causes of Action Under Texas Law to Recover for Suitability Violations*, Vol. 12, No.1 PIABA Spring (2005).

[6] Tex. Civ. Prac. & Rem. Code Ann. § 16.004 (Vernon 2005).

[7] Id. § 16.003(a). *See* Robert R. Johnson, *Limitations on a First-Party Breach of Good Faith and Fair Dealing Action Accrues at Denial Of Claim*, 33 S. Tex. L. Rev. 329, 338-39 (1992) ("Section 16.003 is the general tort statute and 'embodies a legislative determination of what a 'reasonable time' is for bringing ... an action for injuries not resulting in death....' [Moreno v. Sterling Drug, Inc., 787 S.W.2d 348, 351 (Tex.1990).] …Courts have reasoned that an "action for breach of the duty of good faith and fair dealing sounds in tort," and thus subject to the two-year statute of limitations. [*Izaguirre v. Texas Employers' Ins. Ass'n*, 749 S.W.2d 550, 555-56 (Tex. App.--Corpus Christi 1988, writ denied) (*citing Chitsey v. National Lloyds Ins. Co.,* 738 S.W.2d 641, 642 (Tex.1987) and *Arnold v. National County Mut. Fire Ins. Co*., 725 S.W.2d 165, 168 (Tex.1987)]").

[8] *Id*. § 16.004(a)(5).

[9] TEX. CIV. PRAC. & REM. CODE ANN. § 16.004(a)(4) (Vernon 2005).

[10] *Id*.

[11] *See HECI Exploration Co. v. Neel*, 982 S.W.2d 881, 885 (Tex.1998).

[12] TEX. BUS. & COM. CODE § 17.565 (Vernon 2005).

[13] *Id*.

- Rule 10b-5: "[T]he earlier of two years after the discovery of the facts constituting the violation or five years after such violation.[15]
- Actions that do not have an express limitations period: Four years "after the day the cause of action accrues."[16]

IV. TOLLING STATUTES OF LIMITATIONS THROUGH DISCOVERY OF THE WRONGFUL ACT

If the Panel rejects the arguments above, the next step is to argue that the statute of limitations should be tolled under the law.

a. The Discovery Rule

The first step in overcoming a limitations defense may be to invoke the discovery rule, which is an exception to what Texas law recognizes as the "legal injury rule." The legal injury rule states that a "cause of action accrues when a wrongful act causes some legal injury, even if the fact of the injury is not discovered until later, and even if all resulting damages have not yet occurred." *S.V. v. R.V.,* 933 S.W.2d 1, 4 (Tex. 1996). "When applicable, the discovery rule tolls the running of the statute of limitations until the plaintiff discovers, or through the exercise of reasonable care and diligence should discover, the nature of his injury." *Booker v. Real Homes, Inc*., 103 S.W.3d 487, 491-92 (Tex. App.– San Antonio, 2003). Be careful when asking for the use of this defense as the party seeking to invoke the discovery rule must plead the rule in anticipation of an assertion of a limitations defense, or must amend or supplement the complaint to preserve the defense.[17] *See Wright v. Greenberg,* 2 S.W.3d 666, 677 (Tex. App.—Houston [14th Dist.]1999, pet. denied). When a case moves forward to arbitration "with a fact question as to when the [claimant] discovered, it is the [claimant] who benefits by the discovery rule who must ensure that such an issue is submitted." *In re Estate of Matejek*, 928 S.W.2d 742, 745 (Tex. App.—Corpus Christi 1996), *writ denied*, 960 S.W.2d 650 (Tex. 1997).

b. Unsuitability Claims and the Discovery Rule

Suitability claims are among those that can benefit from the discovery rule given that claimants rarely can be held to have "discovered" the unsuitability of their securities because of their lack of sophistication. Moreover, if the broker is continuing to maintain that the customer should "hold the course" and this is a "good stock", it appears that the unsuitability claim can be tolled until the customer learns that these representations are false.

The best example of using the discovery rule for a suitability complaint was outlined in *Hanley v. First Investors Corp. See*, 793 F.Supp. 719 (Tex. App.—Beaumont 1992). In *Hanley*, nineteen investors purchased shares in various mutual funds through an investment firm. *See id.* Some of the funds recommended by the firm were "high yield" or "junk" bonds. *See id.* at 720. The plaintiffs in the case claimed that their broker represented these funds as guaranteed and safe, and that the investments would earn a high rate of return. After investing in the funds, however, the plaintiffs' saw a dramatic devaluation in their funds.

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[14] TEX. REV. CIV. STAT. ANN. ART. 581-33(H)(2)(a)-(b) (Vernon 2005).

[15] Pub. L. No. 107-204, 116 Stat. 745, Title VIII, § 804(a) (2002) (Sarbanes-Oxley Act of 2002)

[16] TEX. CIV. PRAC. & REM. CODE ANN. § 16.051 (Vernon 2005).

[17] The easiest way to get around this is to simply include language in your statement of claim that says "the claimant did not discover that she had a claim until ____."

For reasons not stated in the case, the plaintiffs waited some time before pursuing legal action against the investment firm. On motion for summary judgment, the defendant sought to have plaintiffs' claims barred by the statute of limitations. In applying the discovery rule to the plaintiffs' claims, the court made several noteworthy observations:

- An investor who reads a prospectus is on notice of fraud for limitations purposes when there is a contradiction between the contents of the prospectus and any oral representations made by the broker. However, there must be a showing that the investor *read* the prospectus.
- Although plaintiffs signed receipts indicating that they had received delivery of prospectuses, such receipts were not sufficient as matter of law to impute knowledge of contents of prospectuses.
- Plaintiffs could not be imputed with knowledge of the fluctuations in value of their investments from information gleaned from monthly statements.
- Plaintiffs could not be imputed with knowledge of fluctuations in values of their investments from monthly listings of prices per share of mutual funds published in local newspapers

See id. at 722.

These observations reinforce the trend in courts to refuse to impute knowledge of trade papers, public records, and registration statements on innocent investors. *See id.* Moreover, the Court correctly recognized the fact that even investment-grade securities may experience a vast degree of price fluctuation, so knowledge of unsuitable investments should not be imputed simply because an investment loses value. As a result, under *Hanley,* the discovery rule tolls the statute of limitations until the plaintiff has inquiry notice of the fraudulent misrepresentation of the risks associated with the unsuitable investments, not the fluctuation in value of the unsuitable investments. *See id.*

c. Misrepresentation Claims and the Discovery Rule

The discovery rule can also be easily applied in cases of fraud and fraudulent concealment, as long as the misstatement is not easily verifiable. *See Computer Assocs. Int'l v. Altai, Inc.,* 918 S.W.2d 453, 456 (Tex. 1996). Generally, such claims are brought under federal securities laws or, in Texas, the Texas Securities Act.

For actions arising under federal securities laws, such as Rule 10b-5, the statute of limitations is two years after "discovery of the facts constituting the violation." Pub. L. No. 107-204, 116 Stat. 745, Title VIII, § 804(a) (2002) (Sarbanes-Oxley Act of 2002). Exactly when "discovery of the facts" occurs such that the claimant's duty to investigate in a reasonable manner varies among the circuit courts. Several circuits have held expressly that the date on which the claimant should have discovered the alleged fraud by exercising due diligence is the date of discovery, and the date on which the limitations period will begin. *See*, Michael A. Collora & David M. Osborne, *Statute of Limitation and Eligibility Issues in Securities Arbitration*, 1382 PLI/Corp 259, 264 (August 2003)(*citing Young v. Lepone*, 305 F.3d 1, 9-10 (1st Cir. 2002); *Fuqua v. Ernst & Young LLP*, 33 Fed. Appx. 569 (2nd Cir. 2002); *Law v. Medco Research*, 113 F.3d 781, 785 (7th Cir. 1997)). The Fifth Circuit, in 1988, held that inquiry notice applied to fraud claims such as those arising under Rule 10b-5, indicating that the claimant is deemed to have discovered the injury when he has been presented with evidence suggesting the possibility of fraud. *See Jensen v. Snellings*, 841 F.2d 600, 606 (5th Cir. 1988).

Texas courts have further explained the inquiry notice requirement for the discovery rule. In *Pace v. McEwen*, the Court of Civil Appeals of Texas, El Paso stated:

> [k]nowledge of facts that would have excited inquiry in the mind of a reasonable

> prudent person which, if pursued by him with reasonable diligence, would lead to the discovery of fraud, is equivalent to knowledge of the fraud as a matter of law. **However, the mere fact that one had the opportunity or power to investigate the fraud is not sufficient in law to charge him with knowledge. The defrauded party must be cognizant or aware of facts as would have caused the ordinarily intelligent and prudent person to investigate.**

Pace v. McEwen, 574 S.W.2d 792, 797 (Tex. App.—El Paso 1978), reh'g denied (Nov. 29, 1978) (emphasis added).

Under the language in the Texas Securities Act, claims are barred "three years after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence …." TEX. REV. CIV. ANN. ART. 581-33(H)(1). The determination of whether a customer should have discovered the fraud through "the exercise of reasonable diligence" is generally a jury question since it is necessarily fact intensive. *See Enterprise-Laredo Associates v. Hachar's, Inc*., 839 S.W.2d 822 (Tex. App. – San Antonio 1992), writ denied per curiam, 843 S.W.2d 476 (Tex. 1992). Moreover, the courts vary widely in how they apply this rule. As a result, a statute of limitation defense based on an argument that the fraud should have been discovered should never be the basis for a pre-hearing dismissal.

Under either Federal or Texas claims for fraud, the discovery rule is particularly applicable. Although such statutes often require some diligence on the part of a customer, such diligence appears in most cases to be minimal.

d. Churning Claims and the Discovery Rule

Claims based on churning may pose problems in determining a definitive date on which to commence the limitations period. Brokerage firms often argue that customers had to be aware of the trading, especially if the case involves an enormous amount of trades, as opposed to just a few, large trades. As a result, according to the brokerage firms, customers are on notice early with churning offenses. However, this argument does not work in Texas. As the Fifth Circuit noted in *Miley v. Oppenheimer*,

> [c]hurning is a unified offense: there is no single transaction, or limited, identifiable group of trades, which can be said to constitute churning. …[A] finding of churning…can only be based on a hindsight analysis of the entire history of a broker's management of an account and of his pattern of trading in that portfolio, in comparison to the needs and desires of an investor.

637 F.2d 318 (5th Cir. 1981).

The Fifth Circuit further noted that "in applying the limitations period to a churning cause of action, one must consider the entirety of the transactions in question and the degree of investor sophistication." *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 528 (5th Cir. 1987). Under both *Miley* and *Romano* it is clear that vague or incomplete monthly statements, lack of sophistication of the investor, and the broker's control of the account mitigate against imputing discovery or knowledge of the broker's churning to the investor.

V. OTHER DEFENSES AGAINT LIMITATIONS ARGUMENTS

Even if the discovery rule does not extend the statute of limitation far enough, Texas law provides for several other alternatives.

a. Fraudulent Concealment

Fraudulent concealment is an equitable doctrine that provides an equitable defense to statute of limitations. *See Chandler v. Chandler*, 991 S.W.2d 367, 394 (Tex. App.--

El Paso 1999), reh'g overruled, (June 9, 1999) and review denied, (Sept. 23, 1999). Claimants may plead this defense to an arbitration panel as an arbitrable procedural matter. *See Smith Barney Shearson, Inc. v. Boone*, 838 F.Supp. 1156, 1160 (N.D. Texas 1993). However, fraudulent concealment is not an independent cause of action. *See Id*. While the discovery rule and the doctrine of fraudulent concealment both serve the claimant by providing an exception to the statute of limitations, they are two distinct concepts. As the Court of Appeals in Dallas noted, "the doctrine of fraudulent concealment concerns whether, and for how long, the statute of limitations is tolled; on the other hand, the discovery rule determines when a cause of action accrues." *Gibson v. Ellis*, 58 S.W.3d 818, 824 (Tex. App.—Dallas, 2001).

Fraudulent concealment provides a temporary estoppel effect which precludes the culpable party from avoiding "liability for his actions by deceitfully concealing wrongdoing until limitations has run." *Bankruptcy Estate of Harrison v. Bell*, 99 S.W.3d 163, 168 (Tex. App. Corpus Christi, 2002), appeal dismissed as moot, 2003 WL 194999 (Tex. App. Corpus Christi, 2003). The estoppel effect is not permanent, ending when the claimant has inquiry notice of the wrongdoing, or when the fraud is actually discovered. *See Booker v. Real Homes, Inc.,* 103 S.W.3d 487, 493 (Tex. App. – San Antonio, 2003, as clarified on denial of reh'g, Feb. 26, 2003) and Rule 53.7(f) motion filed, (Mar. 31, 2003). A finding that an agent has fraudulently concealed wrongdoing will prevent the running of the statute of limitations against the principal. *See Bonner v. McCreary*, 35 S.W. 197 (Tex. Civ. App. 1895), writ refused. "Under Texas law, to show that a plaintiff is entitled to the estoppel effect of fraudulent concealment, the plaintiff must show that (1) the defendant had actual knowledge of the wrong, (2) a duty to disclose the wrong, and (3) a fixed purpose to conceal the wrong." *Id*. at 493.

An attorney malpractice case is illustrative of the fraudulent concealment doctrine. In *Gibson v. Ellis*, the plaintiff, Gibson, sued his former attorney for malpractice after he discovered that the attorney had wrongfully paid an expert witness out of Gibson's share of the settlement. *See Gibson v. Ellis*, 58 S.W.3d 818 (Tex. App.—Dallas, 2001). At the time Gibson authorized his attorney to make the payment, the attorney had made misleading claims about the standard practice of paying expert fees. Gibson claimed that the attorney took affirmative steps to conceal or misrepresent the reasons for the payment of the expert witness fees. Gibson discovered the insidious nature of his attorney's misconduct only after conducting independent legal research, undertaken after the applicable statute of limitations for legal malpractice had run. In finding that the statute of limitations did not bar Gibson's claim, the Court held that the limitations period was tolled until the time at which the attorney's fraud was discovered through reasonable diligence, and did not start running at the time at which Gibson knew of the payment.

Like attorneys, brokers may owe a fiduciary relationship to their investors. In such a situation, a broker that engages in misconduct which injures the investor has a duty to disclose such misconduct. Fraudulent concealment of the wrongdoing will toll the statute of limitations until the investor has inquiry notice of the broker's fraud. This appears to include misrepresentations such as "this is just the way the market works" or "everyone is losing money and there is nothing you can do about it" as such statements would tend to mislead a customer into believing the losses were not the result of any wrongdoing. Since virtually every case filed based on losses from the 2000 market crash will undoubtedly include such a claim from the customer, fraudulent concealment may become the best argument for claimants against a statute of limitation defense

b. Duress

Duress may also form a basis for tolling the statute of limitations. Similar to fraudulent concealment, duress estops the defendant from asserting the limitations defense. *See Wheatley v. National Bank of Commerce*, 555 S.W.2d 500, 506 (Tex. Civ. App. – Dallas, 1977). Both duress and fraudulent concealment prevent "the limitations from running until some future date of either discovery of the true facts or termination of the duress; neither prevents the cause of action from actually accruing until that future date, such as is true with the discovery rule." *Id*. In other words, the cause of action will accrue when the wrongful act occurs, and a claim of duress may be asserted to toll the statute of limitations.

Duress is a fact intensive issue, and the extent to which the claimant was influenced by duress must be determined from all the surrounding facts and circumstances. *See Pierce v. Haverlah's Estate*, 428 S.W.2d 422, 426 (Tex. Civ.—App. Tyler 1968, writ refused n.r.e., Oct. 2, 1968). The party claiming duress "has the burden to show that the duress would have, in reasonable probability, prevented a person of ordinary prudence from exercising his or her own free will and judgment in filing suit prior to [the end of the limitations period]." *Id*. at 428.

Brokers are in a unique position to exercise undue influence over their investing clients. For example, in *Pace v. McEwen*, the defendant broker, McEwen, executed many trades over several years when the client was ninety years old, was in weak physical condition and there was some question as to her mental capacity. It was then that the defendant convinced the aged and frail woman to, without the aid of independent advice, transfer to him the vast majority of her stock. The stock transfers left the client in an impoverished condition. The trial court found, and the appellate court affirmed, that the defendant's actions constituted undue influence over the client. The court noted that "undue influence is a form of legal fraud. It may exist without resort to false representations, but by a more subtle form of deceit or cunning, particularly where there has been an unconscionable advantage taken of a confidential relationship." *Id*. at 800. The court found that duress and the discovery rule formed a basis for tolling the statute of limitations so that the customer's claim would not be barred.

A broker's actions may rise to the level of duress if the investor reasonably feels precluded from taking any action to prevent the broker from pursuing an unlawful course of conduct. If, as in the *Pace* case, the investor is elderly and of questionable mental capacity, the likelihood that the broker may take advantage of the fiduciary relationship is much higher. Whether the broker has benefited from excessive commissions, or from fraudulently induced gifts, an investor under the undue influence of a broker should not be barred by the limitations period from pursuing a legal claim. The limitations period should be tolled until the duress is lifted and the investor is able to take appropriate action.

c. Equitable Tolling

Equitable tolling may provide a claimant with another method of overcoming the limitations defense. Texas law recognizes the doctrine in a limited number of scenarios, such as when a claimant has been induced or tricked by his adversary's misconduct into allowing the limitations period to pass, or when the claimant made diligent, but unsuccessful, efforts to pursue his judicial remedies. *See Smith v. J-Hite, Inc*., 127 S.W.3d 837 (Tex. App.—Eastland 2003). Equitable tolling is usually only available under extraordinary circumstances, which requires a showing of the following factors: "(1) lack of actual notice of filing requirement; (2) lack of constructive knowledge of filing requirement; (3) diligence in pursuing one's rights; (4) absence of prejudice to the defendant; and (5) a plaintiff's reasonableness in remaining ignorant of the notice requirement." *Hand v. Stevens Transport, Inc. Employee Benefit Plan*, 83 S.W.3d 286 (Tex. App. Dallas 2002).

Other jurisdictions have held that equitable tolling will not apply when the delay in pursuing judicial remedies is caused by the claimant's lack of legal knowledge,[18] the claimant's excusable neglect,[19] or the sloth of the claimant's attorney.[20]

In cases where the defendant's course of conduct induces the plaintiff to refrain from filing suit within the limitations period, and the plaintiff exercises reasonable diligence, equitable estoppel may prevent the defendant from invoking the limitations defense. In *Leonard v. Eskew*, investors in oil and gas properties agreed to pay the defendant one-eighth the cost of drilling a test well in exchange for interests in defendants oil and gas properties. 731 S.W.2d 124 (Tex.App.—Austin 1987). The investors paid the defendant for the cost of the test well, but the defendant never conveyed the percentage interest in the oil and gas properties to the investors. Upon the investors' requests, the defendant occasionally met with the investors to discuss their concerns, each time assuring them that the conveyance was imminent. The defendant's assurances that the problem would be resolved caused the investors to withhold legal action until the limitations period had run. *Id*. at 126-27.

At trial, the court found that the defendant's words and conduct induced the investors to delay filing their claims beyond the limitations period; and therefore, the defendant was estopped from interposing the limitations bar. *Id*. at 133. On appeal, the court found that the test for equitable estoppel used by the trial court was valid under Texas law and that investors who could present sufficient evidence to indicate that a seller of securities had induced them into delaying the filing of their claims past the limitations period had a valid defense. *Id*.[21]

In situations similar to the *Leonard* case, investors may find themselves victimized by a broker who has made unsuitable investments with the investors' money. After a confrontation about the appropriateness of the investment, the broker or his supervisor may assure the investor that prudence may dictate to wait out the storm or that taking action may put the investments at further risk. By his words and conduct, a broker or his supervisor may induce even a reasonably diligent investor to refrain from filing a legal claim until the limitations period has passed.

The best example of this is a customer who has been diligently writing letters to a firm and its management. Invariably, the firm continues to write back letters asking the customer to further explain the situation or to provide documentation. This letter writing scenario could go on for months, or even years, misleading the customer into believing the firm intends to fairly resolve the matter while the statutes of limitation lapse. Equitable estoppel prevents the manipulative broker and his firm from interposing the statute of limitations defense.

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[18] *Nearhood v. Tops Markets, Inc*., 76 F.Supp. 2d 304, 307 (W.D.N.Y. 1999).

[19] *Ott v. Johnson*, 192 F.3d 510, 513-14 (5th Cir. 1999), reh'g denied, (Dec. 3, 1999) and cert. denied 120 S. Ct. 1834 (U.S. 2000).

[20] *Plowden v. Romine*, 78 F. Supp. 2d 115, 118 (E.D.N.Y. 1999).

[21] The court, however, went on to rule against the investors in this case because of insufficient evidence presented at trial.

VI. **CONCLUSION**

There are several arguments to deliver to a panel that the NASD six-year rule is the only "statute of limitation" applicable to NASD arbitrations. However, even if a Panel rejects this idea, the discovery rule, fraudulent concealment, equitable tolling, and other such devices may be employed in arbitration to overcome the limitations defense. The application of general tolling arguments, as well as other equitable arguments, should allow investors an extended period of time to file additional claims. As Collora & Osborne conclude, "[a]ttorneys representing claimants with older claims…may have to be imaginative in drafting their statements of claim – including listing all reasons why the claimant could not reasonably have uncovered the fraud in a timely manner – in order to avoid motions to dismiss within the arbitration process itself." *Id*. at 278. As investor representatives, we must become more imaginative in our pleadings and well versed in the law of limitations to better serve our clients in cases going forward.

Lessons learned in the labyrinth of loss causation – Finding your way in InfoSpace

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Like the story in Greek mythology, respondents have devised what they think is the perfect labyrinth to ensnare claimants from any hope of escape – loss causation. But there is hope! Like the Greek myth, the labyrinth is only a puzzle with a disguised solution.

There are numerous paths through the labyrinth, but which one will lead to the promised land – liability and damages? Courts have issued decisions in the last few months and years reformulating and reinterpreting prior decisions regarding loss causation, but the standard remains ambiguous.[1]

With multiple, apparently conflicting, standards in the Second Circuit alone, the labyrinth looks daunting. Respondents argue that claimants cannot prove loss causation, because their recommendations do not cause the prices of stocks to fall.

This defense seems as ridiculous on its face as a conflicted research analyst's recommendation to buy. But there's just enough *dicta* in these decisions to give this defense a veneer of respectability.

This article discusses the various twists and turns of the loss causation labyrinth. Don't let the Panel get confused. Loss causation does not bar recovery on an InfoSpace claim by a Merrill Lynch customer who relied on fraudulent research. The labyrinth can be successfully navigated.

The Starting Line: What is Loss Causation?

Loss causation is "a causal connection between the material misrepresentation and the loss."[2] "If that relationship is sufficiently direct, loss causation is established."[3]

"While loss causation is easily defined, its application to particular facts has often been challenging."[4] Courts have rendered "somewhat inconsistent precedents," which have "required numerous clarifications."[5] "Part of the problem lies in the continued expansion of the definition of 'securities fraud.'"[6] "Loss causation is a fact-based inquiry and the

1 *In re Initial Public Offering Sec. Litig. ("In re I.P.O.")*, 2005 WL 1529659 (S.D.N.Y. June 28, 2005).

2 *Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt., LLC*, 2005 WL 1560506 (S.D.N.Y.), *quoting Dura Pharmaceuticals v. Broudo*, 126 S.Ct. 1627, 1631 (2005).

3 *Lentell v. Merrill Lynch*, 396 F.3d 161, 174 (2d Cir. 2005), *citing Suez Equity*, 250 F.3d at 96-98.

4 *Castellano v. Young & Rubicam*, 257 F.3d 171, 187 (2d Cir. 2001).

degree of difficulty in pleading will be affected by circumstances. . . ."[7]

Respondents have latched onto two recent decisions to erroneously claim that they are now immune from liability – *Lentell v. Merrill Lynch* and *Dura Pharmaceuticals v. Broudo*. As explained below, these cases have not announced new loss causation standards.

The *Dura Pharmaceuticals* Standard: Losses Caused by Justifiable Reliance

Courts have likened loss causation "to the tort concept of proximate cause, meaning that in order for the plaintiff to recover it must prove the damages it suffered were a foreseeable consequence of the misrepresentation."[8] While an imperfect analogy,[9] recent decisions, including the *Dura Pharmaceuticals* decision by the Supreme Court, show a trend toward discussing loss causation in terms of common law torts, rather than statutory intent.

In *Dura Pharmaceuticals*, the United States Supreme Court cited the Restatement (Second) of Torts (1977) with approval as the judicial consensus for proving loss causation:

> "One who fraudulently makes a representation of fact, opinion, intention or law for the purpose of inducing another to act . . . in reliance upon it, is subject to liability . . . **for pecuniary loss caused . . . by his justifiable reliance upon the misrepresentation."**[10]

This standard is nothing new. In a claim for a Rule 10b-5 securities fraud, it is well established that a defrauded investor must plead that the defendant "(1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) **that plaintiffs' reliance was the proximate cause of their injury.**"[11]

Take the example of Merrill Lynch customers suing Merrill Lynch for sales of InfoSpace made in reliance on fraudulent Merrill Lynch research.

Merrill Lynch consented to NASD findings that Respondent "issued research reports on GoTo.com and InfoSpace that were materially misleading because they were contrary to Merrill Lynch research analysts' privately expressed negative views."[12]

Merrill Lynch told its customers "BUY," while omitting that it privately believed "SELL." Merrill Lynch's fraudulent BUY

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5 *In re I.P.O.*, 2005 WL 1529659, *3, *citing Suez Equity*, 250 F.3d at 98 n.1.

6 *Id.*

7 *Lentell*, 396 F.3d at 174.

8 *Suez Equity Investors v. Toronto-Dominion Bank*, 250 F.3d 87, 96 (2d Cir. 2001).

9 *AUSA Life Ins. Co. v. Enrst & Young*, 206 F.3d 202, 233-35 (2d Cir. 2000)(Winter, J., dissenting).

10 Restatement (Second) of Torts §525 (1977); *cited in Dura Pharmaceuticals v. Broudo*, 125 S.Ct. at 1632.

11 *In re IBM Sec. Litig.*, 163 F.3d 102, 106 (2d Cir. 1998)(emphasis added).

12 NASD Letter of Acceptance, Waiver & Consent, No. CAF030028, p. 24 (Apr. 24, 2003).

recommendation induced their customers to purchase InfoSpace in reliance upon Merrill Lynch's representation that the BUY rating was the product of Merrill Lynch's "world-class securities research team."[13]

When the price of InfoSpace fell, Merrill Lynch reiterated its BUY recommendation, causing its customers' losses by "overcoming [Claimants'] misgivings prompted by the market behavior of the securities."[14]

Customers' reliance on Merrill Lynch's allegedly independent and honest BUY recommendation, that InfoSpace was not overvalued, caused their injury. This detrimental reliance on Respondent's fraudulent BUY recommendation explains why ". . . the misstatements were the reason the transaction turned out to be a losing one."[15]

Merrill Lynch's Alleged Fraud is Directly Related to the Value of InfoSpace

The Second Circuit has established that loss causation is proven when the misrepresentation or omission relates to the value of the stock.[16] Merrill Lynch, like Salomon Smith Barney and other firms, was "in the business of speaking to the public about stock values. [It] spoke forcefully and frequently about the value of [InfoSpace]."[17] "Having spoken, [Respondent] may be liable for any material omissions in those statements."[18]

Research analysts review and analyze a company's essential economic indicators. "All of the information in a research report is distilled into a single recommendation, or 'rank.'"[19] "Critical to the value of these reports . . . [is that they were] held . . . out to be based on accurate information and to contain independent and unbiased recommendations **on which the investing public could rely.**"[20]

Merrill Lynch customers trusted Merrill Lynch's BUY recommendation – that InfoSpace was not overvalued. Their trust in their broker was entirely reasonable. They maintained positions in InfoSpace as the

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13 Merrill Lynch represented that customers should purchase its Unlimited Advantage trading platform to have "open access" to research from its "world-class securities research team," because "even the most sophisticated investor can find it difficult to sort through the wealth of available information and make the right choices." Merrill Lynch Unlimited Advantage Brochure, pp. 2, 4, 1.

14 *Marbury Management v. Kohn*, 629 F.2d 705, 708 (2d Cir. 1980); *Suez Equities v. Toronto-Dominion Bank*, 250 F.3d 87, 97 (2d Cir. 2001); *AUSA Life Ins. v. Young & Rubicam*, 206 F.3d 202, 227 (2d Cir. 2000)(Jacobs, J., concurring).

15 *Lentell*, 396 F.3d at 173, *citing First National Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994).

16 *Suez Equities*, 250 F.3d at 97.

17 *In re WorldCom Sec. Litig.*, 294 F.Supp.2d 392, 428 (S.D.N.Y. 2003)(Cote, J., discussing Salomon Smith Barney and Jack Grubman's research on WorldCom).

18 *Id.*

19 *Fogarazzo v. Lehman Brothers*, 341 F.Supp.2d 274, 278 (S.D.N.Y. 2004).

20 *Id.*

stock fell believing that the stock would bounce back, as recommended by Merrill Lynch. **Since the fraudulent BUY recommendation "induced the purchase (transaction causation) and related to the stock's value (loss causation), it was causally related to the loss.**"[21] Thus, customers' reliance on Merrill Lynch's BUY recommendation caused their losses.

The *Lentell* Holding: Materialization of a Concealed Risk

"[O]ver time, the Second Circuit has advanced several different standards for pleading loss causation, including 'direct causation,' 'materialization of risk,' and 'corrective disclosure,' all of which are referenced in *Lentell*. . . ."[22] "However, the common thread is that, in each situation, **"the loss be foreseeable and [ ] the loss be caused by the materialization of the concealed risk."**[23]

Merrill Lynch concealed the risk that InfoSpace was overvalued by recommending it as a BUY rated stock:

1. On March 1, 2000, Respondent's research analyst privately admitted that she could not justify the price of "dinky" InfoSpace with a mere $100 million in estimated revenues for the year 2000.

2. In another exchange of emails in early April 2000, a research analyst told Henry Blodget that he had better hope the CEO of Merrill Lynch was out of InfoSpace.

3. In June 2000, a research analyst admitted: "...I would sell," when referring to InfoSpace and insider sales.

4. In July 2000, Blodget admitted that InfoSpace was a "powder keg," and, in October 2000 that InfoSpace was a "piece of junk."

The concealed risk that InfoSpace was wildly overvalued materialized as the market learned the truth. Within the month of March 2000, the stock price had lost almost half of its value. Merrill Lynch alleges, without evidence, that the market caused its customers' losses, but the NASDAQ Index had lost only 6.9% of its value in March 2000.[24]

The loss was clearly foreseeable. Foreseeability requires only that "the loss might reasonably be expected to result from the reliance."[25] Merrill Lynch knew that its customers would receive and rely upon its fraudulent BUY recommendation of InfoSpace. Merrill Lynch knew that the price of InfoSpace would fall to correct the

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[21] *Suez Equity*, 250 F.3d at 97; *see Castellano v. Young & Rubicam*, 257 F.3d 171, 187 (2d Cir. 2001); *see also Lentell*, 396 F.3d at 174 ("We follow the holdings of *Emergent Capital*, *Castellano*, and *Suez Equity*").

[22] *In re Initial Public Offering Sec. Litig.*, 2005 WL 1529659, *3 (S.D.N.Y.), *citing Lentell*, 396 F.3d at 174.

[23] *Id., citing Lentell,* 396 F.3d at 173 (holding that "[t]his Court's cases – post-*Suez* and pre-*Suez* – require both that the loss be foreseeable *and* that the loss be caused by the materialization of the concealed risk")(emphasis in original).

[24] On March 3, 2000, the NASDAQ index was 4,914.79. On March 31, 2000, it had fallen to 4,572.83, or 6.9%. Over the same period, InfoSpace fell from $273 to $145.44, or 46.8%.

[25] Restatement (Second) of Torts §548A, *cited in Dura Pharmaceuticals*, 125 S.Ct. at 1633.

overvaluation. Thus, it was foreseeable that Merrill Lynch's customers would incur losses by relying on Merrill Lynch's fraudulent BUY recommendation.

Merrill Lynch's Interpretations of *Lentell* and *Dura Pharmaceuticals* are Flawed

Merrill Lynch has argued that the *Lentell* and *Dura Pharmaceuticals* Courts hold that fraudulent buy recommendations are immune from liability because investors cannot prove loss causation. This argument is fatally flawed.

First, the *Lentell* Court specifically rejected this myopic interpretation:

> **"We do not suggest . . . that 'systematically overly optimistic' ratings of the type published by the Internet Group are categorically beyond the reach of the securities laws."**[26]

Merrill Lynch's BUY recommendation of InfoSpace was not merely "overly optimistic," but was, as the NASD found, fraudulent. Merrill Lynch customers' reliance on the fraudulent BUY recommendation caused their losses.

Unlike Merrill Lynch customers, the *Lentell* plaintiffs presented no facts supporting a finding that Merrill Lynch did not actually believe in its recommendations of 24/7 Media and Interliant. *In re Merrill Lynch*, 273 F.Supp.2d 351, 374-5 (S.D.N.Y. 2003)("Without the . . . emails concerning securities other than Interliant, the Interliant plaintiffs have no e-mails or other contemporaneous facts concerning Interliant to attempt to explain why any rating on Interliant was not actually and reasonably believed at the time it was issued").

Regarding InfoSpace, Merrill Lynch did not actually believe in its recommendation to purchase InfoSpace. Merrill Lynch issued research reports on InfoSpace that were materially misleading because they were contrary to Merrill Lynch research analysts' privately expressed negative views.

Second, Merrill Lynch incorrectly assumes that, since the New York Attorney General publicly revealed Merrill Lynch's fraud in April 2002, its customers cannot prove loss causation for any prior damages.[27] Respondent's argument is erroneous and conflicts with Second Circuit precedent.

The *Lentell* Court stated that "to establish loss causation, a plaintiff must allege. . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered, *i.e.*, that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."[28]

The "something" Merrill Lynch allegedly concealed was the fact that **InfoSpace was overvalued**. The market began discovering

[26] *Lentell*, 396 F.3d at 177.

[27] Judge Winter called Respondent's argument "counterproductive – indeed ranging from perverse to bizarre. . . ." *AUSA Life*, 206 F.3d at 238 (Winter, J., dissenting). Rather than promote full disclosure, it would encourage firms "to continue the fraud and make riskier gambles in the hope of salvation." *Id.* at 239. *See also Demarco v. Lehman Bros.*, 309 F.Supp.2d at 636 (loss causation proven when the market discovers the facts concealed by a research analyst, not when the analyst's fraud becomes public); *In re Initial Public Offering Sec. Litig.*, 297 F.Supp.2d at 673; *Fogarazzo*, 341 F.Supp.2d at 291-92.

[28] *Lentell*, 396 F.3d at 175 (emphasis added; internal citations omitted), *citing Suez Equity*, 250 F.3d at 95. *See Demarco v. Lehman Bros.*, 309 F.Supp.2d 631, 636-37 (S.D.N.Y. 2004).

this concealed risk in March 2000, driving down the price of InfoSpace. As was the case in *Demarco v. Lehman Bros.* and *In re Parmalat Sec. Litig.*, 2005 WL 1527674 (S.D.N.Y.), what matters here are the facts Merrill Lynch was allegedly concealing – not merely the fact that Merrill Lynch was allegedly lying.[29]

Third, respondents' affirmative defense that an intervening factor, such as a general market decline, caused their customers' losses requires evidence. Merely alleging that the market decline caused the customers' losses is nothing more than speculation.

As long as the customer relied on the fraudulent research recommendation, the chain of causation is unbroken. As the price of InfoSpace declined, Merrill Lynch continued to publish its allegedly fraudulent recommendation to buy, overcoming customers misgivings and preventing its customers from discovering the fraud.[30]

The Second Circuit has consistently held that, where a party alleges "an intervening event, like a general fall in the price of Internet stocks, the chain of causation . . . is a matter of proof at trial. . . ."[31] Moreover, as mentioned above, while the NASDAQ fell only 6.9% in March 2000, the price of InfoSpace lost almost half of its value.

Fourth, Merrill Lynch has erroneously argued that its customers cannot assert that the allegedly false statements or omissions *themselves* caused them damage. This argument misstates the Court's test for proving loss causation. The United States Supreme Court made it clear that the test is whether "**reliance was the proximate cause of their injury.**"[32]

Merrill Lynch's argument applies only to pure fraud-on-the-market cases, such as *Lentell v. Merrill Lynch*. It does not apply to face-to-face transactions.[33] In *Lentell*, plaintiffs did not allege they were Merrill Lynch customers, that they bought securities through Merrill Lynch or that they relied on the allegedly fraudulent research. *Lentell* was a class action, not an individual arbitration claim.

As Judge Kaplan pointed out on June 28, 2005, the *Lentell* Court "concluded that plaintiffs had failed to plead loss causation because they did 'not allege that the subject

[29] *Demarco v. Lehman Bros.*, 309 F.Supp.2d at 636-37 ("[T]he Complaint adequately alleges that in or around October, 2000 the market was finally apprised of the negative information concerning RealNetworks that had earlier led Stanek to take a secretly negative view of the stock and that, as the result of those revelations, the stock declined, causing the losses on which plaintiff here sues. . . . This suffices for loss causation under any standard"); *In re Parmalat*, 2005 WL 1527674, *17 ("The concealed risk materialized when Parmalat suffered a liquidity crisis on December 8, 2003 and was unable to pay bonds as they came due. . . . That the true extent [of] the fraud was not revealed to the public until February – after Parmalat shares were worthless . . . is immaterial where, as here, the risk allegedly concealed by defendants materialized during that time. . .").

[30] *Fogarazzo*, 341 F.Supp.2d at 290 (discussing Lehman Brothers' research).

[31] *Lentell*, 396 F.3d at 174.

[32] *In re IBM Sec. Litig.*, 163 F.3d at 106.

[33] *In re Merrill Lynch*, 273 F.Supp.2d at 366 (Pollack, J.) (distinguishing *Suez Equity* and *Marbury Management* as transactions involving face-to-face transactions, as opposed to fraud on the market cases).

of those false recommendations (that investors should buy or accumulate 24/7 Media and Interliant stock), or any corrective disclosure regarding the falsity of those recommendations, is the cause of the *decline* in stock value that plaintiffs claim as their loss.' **The use of the word 'or' indicates that a corrective disclosure is not necessary where, as here, plaintiffs allege that the subject of the misrepresentations and omissions caused their loss.**"[34]

When claimants can allege that the subject of the fraudulent statements caused their losses, corrective disclosure is not required.

Conclusion

The path through the labyrinth may be found by proving that the customer's reliance on the allegedly fraudulent research caused the customer's losses. Investors are not required to prove that the misrepresentation caused their losses. They only have to prove that their reliance did.

[34] *In re Parmalat Sec. Litig.*, 2005 WL 1527674, *17 (S.D.N.Y.), *quoting* Lentell, 396 F.3d at 175 (bold-face added by Claimant; italics by Kaplan, J.).

Private Investment Accounts: Fact From Fiction

By Joanne A. Schultz

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When George Bush won his second term as President of the United States in November of 2004, he claimed that the American people had given him a mandate to fix some pressing issues facing the country. His administration chose to focus on Social Security, with little mention of the health care crisis or the burgeoning budget deficit. President Bush claims "The system will be in the red in 13 years, and in 2042 the system will be broke." While the details of the White House plan have not yet been finalized, the broad outline includes: (1) the diversion of Social Security payroll taxes to the creation of private investment accounts; (2) government borrowing to sustain current benefit payments (which would otherwise by paid for by the payroll taxes); and (3) sharp cuts in benefit payments for future retirees (with the claim that income from their private accounts will make up for it).[1]

Of course, the fundamental question of whether the Social Security program was ever intended to be an investment program has largely been ignored. Today's Social Security system provides basic insurance for every worker – a minimal retirement income (the average monthly benefit is less than $850), and support for survivors, disabled workers, and their families. As the basic source of income protection for the nation's families, Social Security does not have much margin for error. It provides more than half of the income for 60% of households headed by retirees. For an additional 17 million spouses and children who today are dependents of disabled workers or survivors of deceased workers or retirees, Social Security benefits provide essential support.[2]

In order to sell this plan without adequately addressing these issues, the administration is taking a two-pronged approach. First, they are waging a scare campaign about the prospective collapse or bankruptcy of the system, and second, they are pushing private accounts as a panacea that will give everybody an opportunity to become participants in the American dream. They assert that these accounts will inevitably provide better returns, allowing people to build a sizeable nest egg which they can leave to their children.

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[1] Martin, Patrick, "Facts and myths about Bush's plan for Social Security privatization," http://www.wsws.org/articles/2005/feb2005/socs-f03.shtml.

[2] Anrig, Greg and Waso, Bernard, "What Would Really Happen Under Social Security Privatization?" *The Century Foundation*.

"By making every citizen an agent of his or her own destiny, we will give our fellow Americans greater freedom from want and fear and make our society more prosperous and just and equal," Bush said in his second inaugural address.[3]

The President immediately embarked on a 60-day, 60-city road show. Spending millions of taxpayer dollars under the guise of town hall meetings, Bush appeared on stage with a group of hand selected people who help bolster his plan.[4]

There is no specific White House plan, but basic themes have emerged. These have been met with considerable opposition from Democrats, along with other large organizations such as the AARP and the AFL-CIO, who are united in their opposition of private investment accounts. Given the importance of the issues at stake, an analysis of the claims being made in support of private accounts is warranted.

How the Accounts Would be Established

Over the last few years, there have been a number of proposed bills introduced in Congress to overhaul Social Security with such titles as 'The Saving Social Security Act of 2005,' 'The Bipartisan Retirement Security Act of 2004,' and the latest attempt to pass some form of private investment account, 'The Growing Real Ownership for Workers Act of 2005.' This latest bill was introduced by representative Jim McCrery (R-LA) and is a scaled back version of the private investment accounts proposed by the President. The bill calls for an amount equal to 2 percent of a participants payroll tax to be placed in a private account, which, amusingly, is to be funded by the annual surplus in the Social Security Trust Fund.[5] The majority of these bills call for the creation of private investment accounts, with differing amounts to be diverted from the payroll tax to fund accounts with misleading acronyms such as **SAFE** (Social Security Savings Accounts For Employees) accounts, or **GROW** (Growing Real Ownership For Workers) accounts. But the Social Security Modernization Act, introduced by Senator Linsday Graham (R-SC) in 2003, was reportedly developed with the help of White House staff, and is based on the main plan designed by President Bush's Social Security Commission.

This bill would allow workers who have reached the age of 25 to choose one of three options for program participation. The default option calls for the establishment of a personal investment account. Current retirees and workers aged 55 or older as of the beginning of 2004 would remain in the current-law program and would not participate in the personal account program.

The default option of the bill would allow workers beginning in 2006 to redirect 4 percentage points of their payroll contributions, up to $1,300 annually (in 2006, with this limit being wage-indexed in future years), to personal accounts. The personal accounts would be invested in pooled funds similar to those of the Federal Thrift Savings Plan (TSP), with a default portfolio set at 60% stocks and 40% long-term government bonds.

Once the account balance reaches $10,000, workers could then choose to invest in specific private-market, centrally-managed, SEC-approved retirement funds.

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[3] Welch, William, "Social Security accounts would limit control" *USA Today* Jan 26, 2005.

[4] Kumar, Anita, "Social Security blitz may have been a bust," *St. Petersburg Times*, April 30, 2005.

[5] Summary of the Growing Real Ownership for Workers Act of 2005 (June 28, 2005) http://waysandmeans.house.gov/Links.asp?section=46.

In exchange for the personal account contributions, benefits would be offset by a hypothetical annuity based on the worker's account contributions compounded at an interest rate of 0.3% below the realized or expected market yield on long-term Treasury bonds. The default option also calls for reductions in the defined benefits formula and the purchase of an annuity which would provide individuals with 120% of the poverty level in benefits.[6]

Would such an account give individuals greater control, increased yields and the ability to leave any unused assets to their families?

Individual Control

According to Vice President Cheney, private accounts would allow people to have "retirement funds they control themselves and can call their own." However, this statement is inaccurate. Initially, the government would allow individuals to choose from only a few approved investment options, purportedly to be modeled after the options available to employees who participate in the thrift program.

Then, upon retirement perhaps the most overlooked and poorly explained aspect of these proposed private accounts, is the mandate that all account holders will be forced to purchase an annuity. Of course annuities, once purchased, can't be passed on to heirs. So the administration's claims that its proposal would give workers access to an asset that they can leave to their children, practically speaking, will not be true for most workers.

While the current Social Security system provides inflation-adjusted benefits to workers and their spouses for life at no cost, annuities on the private market don't come cheap. Currently, annuities available in the U.S. charge expenses that reduce the total value of an account by 15 to 20%. In Britain, where workers with individual accounts are required to purchase annuities by age 75, annuities reduce the value of accounts by 10%.[7]

Higher Rates of Returns

In his State of the Union address, the President explained, "Here's why the personal accounts are a better deal: Your money will grow, over time, at a greater rate than anything the current system can deliver – and your account will provide money for retirement over and above the check you will receive from Social Security." Do these claims withstand scrutiny?

There have been a number of studies published with respect to projected market returns on private accounts with differing results based on the data used and the interpretation of that data. In a paper published in the *Federal Reserve Bank of St. Louis Review,* the authors compare Social Security benefits relative to those paid from private investments. Three different retirement ages and four possible earnings levels are considered for two private investments – 6 month CDs or the S&P 500. The average monthly Standard and Poor's 500 Composite Index used by the authors is 8.5% annually, and the rate of return on 6-month CDs is 6.9% annually. Given these variables, the authors conclude that, on average, less than 5% of current retirees would receive a higher monthly benefit with Social Security.[8]

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[6] Social Security Administration Memorandum Dated November 18, 2003. Estimated OASDI Financial Effects of "Social Security Solvency and Modernization Act of 2003" http://www.ssa.gov/OACT/solvency/LGraham_20031118.html.

[7] Idemoto, Steve, Bush's Individual Account Proposal: Rhetoric Versus Reality Economic Opportunity Institute *http://www.econop.org/Social*Security/SS-BushRhetoric.htm.

But, for this conclusion to be accurate the market returns would have to remain constant. It is not a known fact that the market rates of return in the twenty-first century can duplicate the rates of return in the twentieth century. In fact, the Social Security Trustees themselves forecast a considerable slowdown in GDP growth in the 21st century compared to the experience of the 20th century.

Recently, the *Wall Street Journal* surveyed ten leading financial economists and investment bank economists. Their projections of stock market returns over the next 44 years ranged from 4.0 to 6.5% above inflation, with a median forecast of 4.6%.[9]

The impact of the difference in rates of return and the uncertainty in the market yields was the subject of a study conducted by Robert Schiller, Professor at Yale University and author of *Irrational Exuberance.* In this study, Schiller argues that proponents of private accounts use arguments that generally involve the assumption of a high likelihood of good returns on the accounts. To prove his point, he uses simulations to estimate the probability distribution of returns in the accounts based on long-term historical experience. U.S stock market, bond market and money market data from 1871-2004 were used for the analysis. Assuming that future returns behave like historical data, the study found that a baseline personal account portfolio after offset will be negative 32% of the time on the retirement date, with a median internal rate of return of 3.4%, just above the amount necessary for holders of the account to break even. These results get worse when the simulation is undertaken using international historical rates of returns, which the author argues may be more appropriate given the uncertainty of the US markets' future performance. When those measures are used, the baseline personal accounts are found to be negative 71% of the time on the date of retirement, and the median internal rate of return is 2.6%.

For their projections, the Social Security Trustees have assumed that future real returns for stocks will be 6.5% annually and 3% annually for government bonds, leading to an expected portfolio yield of 4.8 percent for an average portfolio comprised of sixty percent equities and 40 percent treasuries. This yield is net of administrative expenses.[10]

Transition Costs

In order to divert 4% of the payroll tax out of the pay-as-you-go system, the government will have to subsidize it. To do that, the government will be borrowing those funds, reportedly from Wall Street.[11] To pay for this debt, the plan specifies that upon retirement, there will be an "offset" value to an individual's account equal to the terminal value of the Social Security contributions cumulated at a 3% real interest rate, which will be annuitized and subtracted from the traditional Social Security benefit. In addition to this reduced traditional benefit due to the offset, the worker will get the lump sum value of the personal account, whenever there is

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[8] Garrett, Thomas and Rhine, Russell, Social Security versus Private Retirement Accounts: "A Historical Analysis," *Federal Reserve Bank of St. Louis Review,* March/April 2005, 87(2, Part 1).

[9] Furman, Jason, Would Private Accounts Provide A Higher Rate of Return Than Social Security? *Center on Budget and Policy Priorities*, June 2, 2005.

[10] Social Security Administration Memorandum Dated November 18, 2003, "Estimated OASDI Financial Effects of 'Social Security Solvency and Modernization Act of 2003,'" http://www.ssa.gov/OACT/solvency/LGraham_20031118.html.

[11] Liesman, Steve, "Social Security Problem Solving," The *Wall Street Journal,* January 14, 2005.

enough in the personal account to make that possible because he or she would be required to annuitize at least enough of it so that the combined traditional benefit and personal account would be above the poverty line.

In effect, the new personal accounts encourage people to buy on margin with the federal government as the lender, offering a 3% real interest rate on the loan.[12]

Administrative Costs

The Bush administration has used an average of 0.4% of assets annually as their assumption of average administrative costs in their analysis. The costs of administering individual accounts, however, would likely exceed this level. Even the conservative and vehemently pro-privatization Cato Institute assumes that administrative costs on individual accounts would average in the range of 1.17% to 1.83% of assets per year.[13] To provide a consistent basis to compare the costs of various systems, the Congressional Budget Office estimated how those costs would affect balances in a benchmark private account that received contributions of 2% of earnings (similar to the percentages called for in many proposals). The systems that CBO reviewed have administrative costs that, if charged to account holders, would reduce account balances at retirement by as little as 2% or as much as 30%, depending largely on the level of service provided. The CBO used the average annual costs for mutual funds of 1.09% of assets, and estimates that there would be a 23% reduction in assets at retirement.[14] This estimate would probably be more accurate, especially if account holders are allowed to manage their own funds as proposed in the Social Security Modernization Act.

Given the considerable uncertainty surrounding private accounts and the concession from the White House that private accounts would not resolve the trust fund solvency concerns, why is the administration pushing so hard to implement these accounts? Private accounts could be a boon for some firms – and their impact on stock trading will pump up the entire industry. The estimated $54 billion that could pour into the markets is roughly a quarter of stock and bond mutual funds' annual take now.[15]

As these accounts are funded, the Bush administration tilts toward letting owners put their money, 401(k)-style, into actively managed funds. Under that scenario, fee income could balloon. If the funds charged 0.8% of assets – close to the average for big equity funds – Wall Street could rake in $940 billion in investment fees over 75 years and every sector of the financial services industry will be looking for a piece of the action, including banks, who will lobby hard to get their investments in the mix.

While shifting money into the stock market through private accounts might drive up stock prices somewhat (since more money would be competing to buy the same volume of stocks), it would drive down future returns. since workers will be buying into the stock market at an elevated level. If this occurred,

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[12] Shiller, Robert, "The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation" *Cowles Foundation Discussion Paper* No. 1504 April 2005.

[13] *Idemoto, Steve, "Bush's Individual Account Proposal: Rhetoric Versus Reality" Economic Opportunity Institute http://www.econop.org/Social*Security/SS-BushRhetoric.htm.

[14] "Administrative Costs of Private Accounts in Social Security," *A CBO Study,* March 2004 http://www.cbo.gov/showdoc.cfm?index=5277&sequence=0.

[15] Borrus, Amy, "Windfall on Wall Street?" *BusinessWeek Online,* January 24, 2005.

private accounts would likely lead to windfall gains for affluent Americans who already own stocks, which would be offset by lower returns for younger, generally less affluent workers who invested in stocks through their private accounts.[16]

Regulation

Finally, one aspect of these proposals which has received very little debate is regulation. How would these accounts be regulated and, what if any, private rights would account holders have? In reviewing a number of proposed bills, it appears that much of the regulatory jurisdiction would be given to existing regulatory agencies or the bills call for the establishment of new Boards to be headed by existing department heads. A bill introduced by Senator Chuck Hagel (R-N) in March of 2005, calls for personal accounts to be administered by a board within the Social Security Administration titled the Social Security Investment Board, which would be composed of the Secretary of Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Securities and Exchange Commission, and two Senate-confirmed appointments nominated by the President, one of whom will serve as Chairman of the Board.[17] The Social Security Modernization Act of 2003 calls for a Personal Retirement Account Board that, in consultation with the Securities and Exchange Commission, would be charged with certifying institutions engaged in the business of maintaining accounts for individuals for purposes of investment.[18] Because this bill allows individual account holders to move their account there is a section addressing a private right of action providing for the filing of an action in federal district court with a provision for the award of attorneys' fees to a prevailing party.[19] However, this bill has not been reintroduced in the Senate to date. Given the ineffectiveness of the current regulatory system in protecting investors, this issue deserves far greater debate.

The so-called fix being pushed by the administration will effectively dismantle the Social Security system, a program which provides the sole source of income for a number of retirees and the disabled. With the current slowdown in the economy, in which the primary jobs being created are low-paying service sector jobs; the increase in the number of corporations defaulting on their pension obligations; and the possibility of continued low stock market returns, the fundamental changes to the system being proposed deserve honest and extensive debate. Otherwise, the results could be far worse than the problems the system faces today.

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[16] Furman, Jason, "Would Private Accounts Provide A Higher Rate of Return Than Social Security?" *Center on Budget and Policy Priorities*, June 2, 2005.

[17] Sen. Hagel Introduces Bill to Extend Social Security Retirement to 68: First Social Security Bill of this Congress also supports private investment accounts, March 7, 2005, www.seniorjournal.com/NEWS/SocialSecurity/5-03-07HagelBill.htm.

[18] Social Security Modernization Act of 2003 *http://thomas.loc.gov/cgi-bin.*

[19] *Ibid.*

The Great CMO Heist

By Dale Ledbetter

The first mortgage-backed security ("MBS")[1] was brought to the market under the banner of the Government National Mortgage Association ("GNMA") in 1970. The so-called Government Sponsored Enterprises ("GSE") soon followed with the Federal Home Loan Mortgage Corporation ("FHLMC") bringing its MBS product out in 1971 and the Federal National Mortgage Association ("FNMA") joining the party in 1981.

Initially, the creation of these pass-through products benefited virtually everyone. The mortgage markets become more liquid. Areas of low housing demand and with excess cash deposits provided housing support for areas with greater demand and less cash availability. The products were fairly simple. If you owned 1% of a pool of loans, you got 1% of the principal and interest payments which were "passed-through" from the underlying mortgages. Even some of the initial innovations were positive, designed to meet the desires of insurance companies to own products with long-term maturities and the needs of financial institutions to meet short and intermediate-term investment needs.

But then Wall Street fixed-income specialists saw an opportunity to make more money than could ever have been imagined in the relatively sterile days of treasuries, corporates and municipal bonds.

Under the guise of "serving the needs of diverse investors" the Collateralized Mortgage Obligation ("CMO") was born. The first CMO was created in 1983 with the structural architects hailed much the same in the fixed-income world as the God-like "tech" analysts were in the world of equities and IPOs.

The same underlying mortgages would be diced, sliced, carved up, down, and sideways with the underwriters taking their piece at ever turn. These were no longer simply "pass-through" securities but each deal was divided into multiple classes (or tranches). The initial deals would have 3 to 5 classes but by the early 1990's there would be 30 or more classes in each deal. The Wall Street creativity machine was in high gear and the big profits were just beginning. The evolution was rapid and, in hindsight, stupefying. The early three-class deals were based on sequential payments. The first class would have a lower coupon and an earlier maturity. Interest and *all* principal payments would go to the first class

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CMO's

[1] Refers to securities backed by mortgages which include pass-through securities, mortgage-backed bonds, mortgage pay-through securities and collateralized mortgage obligations ("CMOs").

until it was paid off. The subsequent classes would get interest only – no principal – until the first class was fully paid off. Thus, the first class would have a short life span, with the second, third and subsequent classes having intermediate to long term lives. The initial structures were fairly tame and, as Exhibit 1[2] shows below, offered a steady cash flow – clean and predictable.

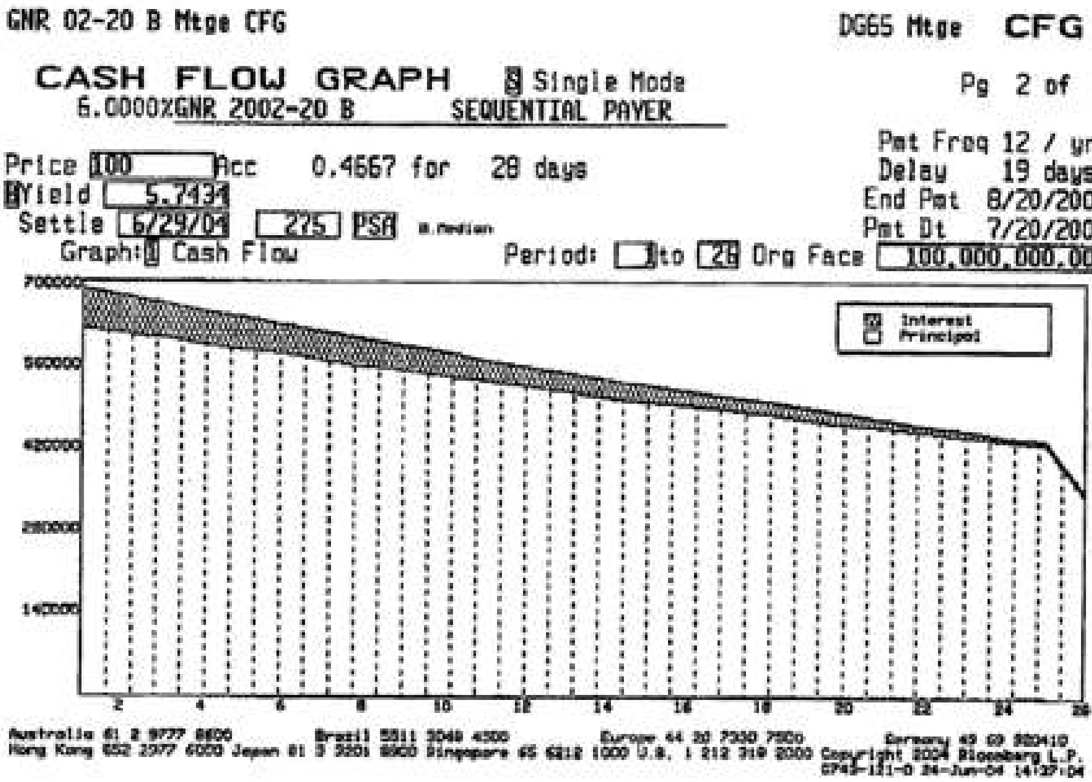

EXHIBIT 1

Let's look at a few of the early, and still *relatively* benign innovations. The goal was to enhance predictability. This led to the creation of Planned Amortization Classes or "PAC's". These "PAC's" would have a band of prepayment speeds.[3]

Early marketers knew little about the real risks of the products they were selling. Those secrets were closely guarded by the upper management and trading gurus who doled out the assumptions they wanted salespeople to use. Amid great fanfare, the pace of creation and distribution of this

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[2] All illustrations are from the Bloomberg website and are reprinted with the permission of Bloomberg, LP.

[3] Prepayment assumptions were and are based on the Public Securities Association ("PSA") and Constant Prepayment Rate ("CPR") prepayment models. CPR was the initial measurement and PSA was created to account for slower prepayments in the early life of most mortgages. PSA assumes 0.2 of the pool prepays in the first month and increases by 0.2 in each month until the 30th month when the prepayment rate levels out at 6% CPR. The CPR is a percentage prepayment rate which relates the percentage of the outstanding balance prepaid on an annual basis. For comparative purposes, 0.2 CPR in the first month would be equal to 100% PSA. After month 30, 6% CPR is assumed to equal 100 PSA. Thus, a 12% CPR would equal 200 PSA.

product took on a frenzied pace. Many early investors, mostly banks, thrifts and credit unions learned the hard way about the perils of extension risk. This led a few bankers, to refer to “CMO” as meaning “Count Me Out.” The damage heaped on many smaller institutions was substantial. Few sought help or redress, not wanting to be embarrassed in their local community. This passive reaction encouraged the best and brightest on Wall Street to intensify the charge.

The damage touched individuals as well as institutional investors. Small financial institutions would purchase a class being told it had a 4 year “maturity.” A change in market conditions would bring prepayments to a screeching halt and, virtually overnight, change the product into one with a 15 year life. The institution would have to recognize a substantial loss since they were, in some instances, required to “mark-to market” even if they did not sell the instrument. The impact on individuals was, and is, often times even more devastating. An individual would be sold a “tricky” class as an alternative to CD’s or near-cash instruments only to find when they wanted to liquidate that the CMO they had been sold was worth far less than what they had paid for it. Exhibits 2, 3, 4 and 5 are examples of the consequences of extension risk[4] gone awry.

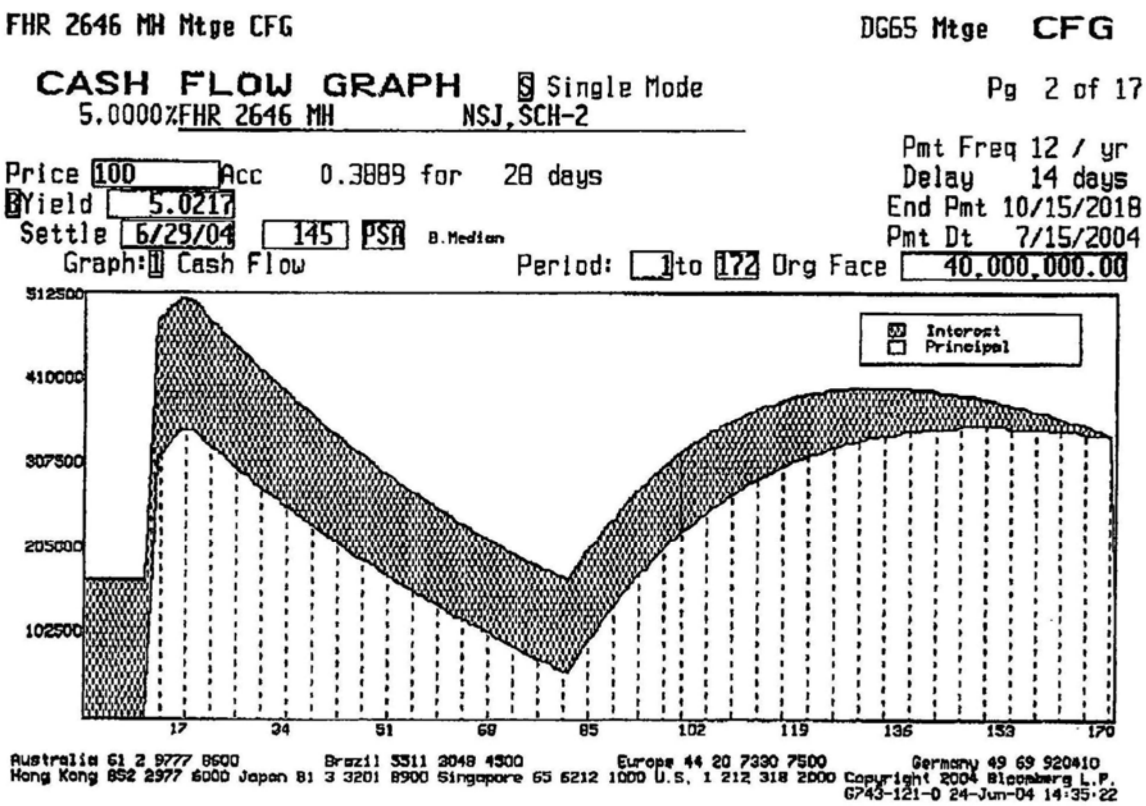


EXHIBIT 2

[4] “Extension risk” occurs when the average life of the security becomes longer. When interest rates rise fewer mortgage holders prepay their mortgages which increases the life of the security.

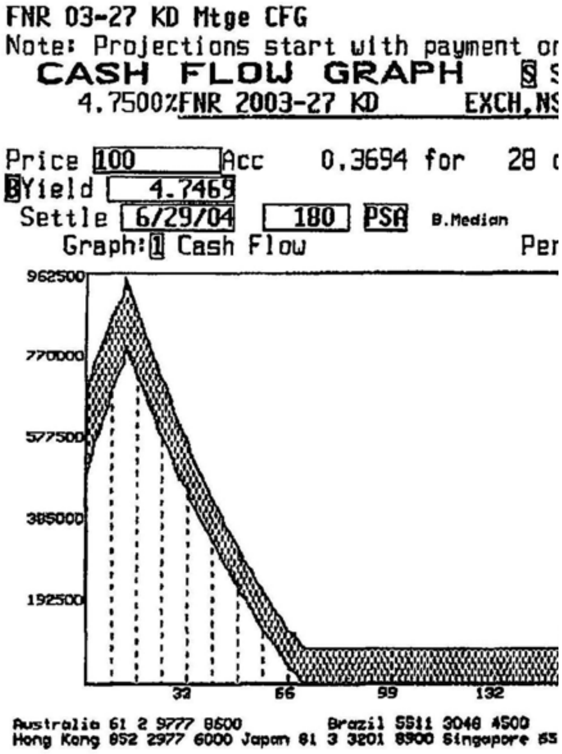
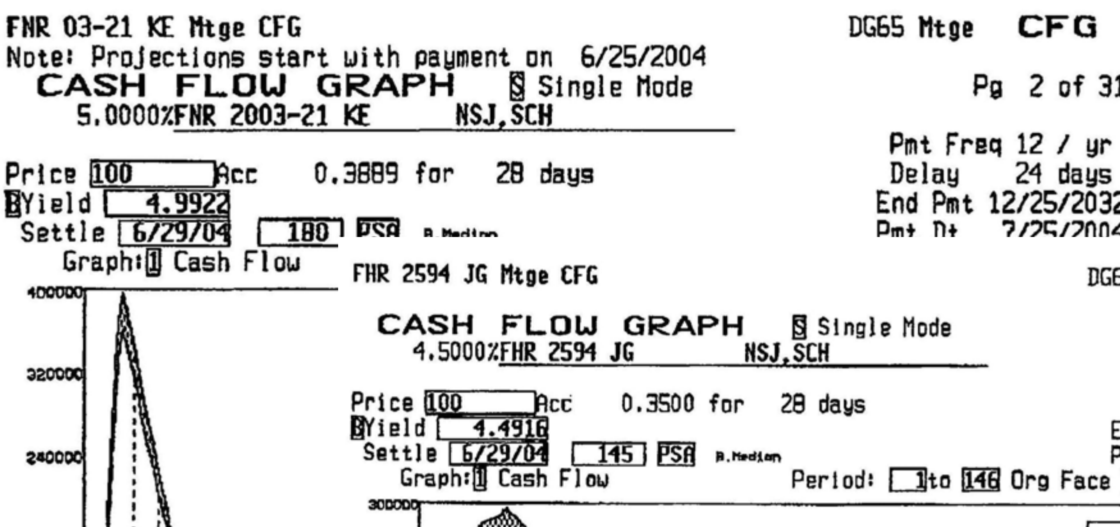


EXHIBIT 3



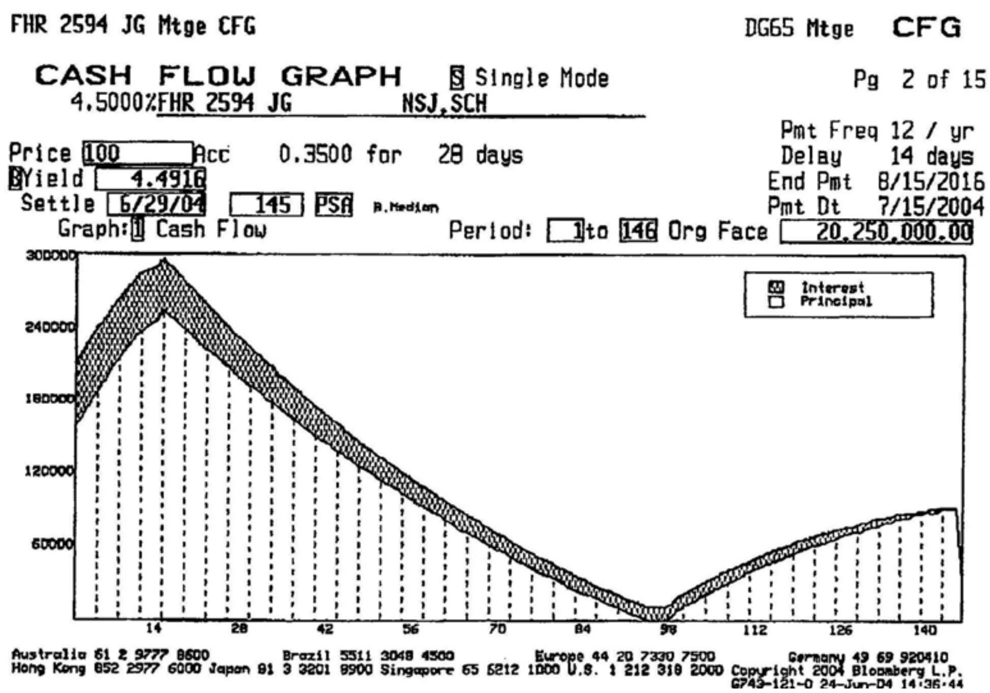
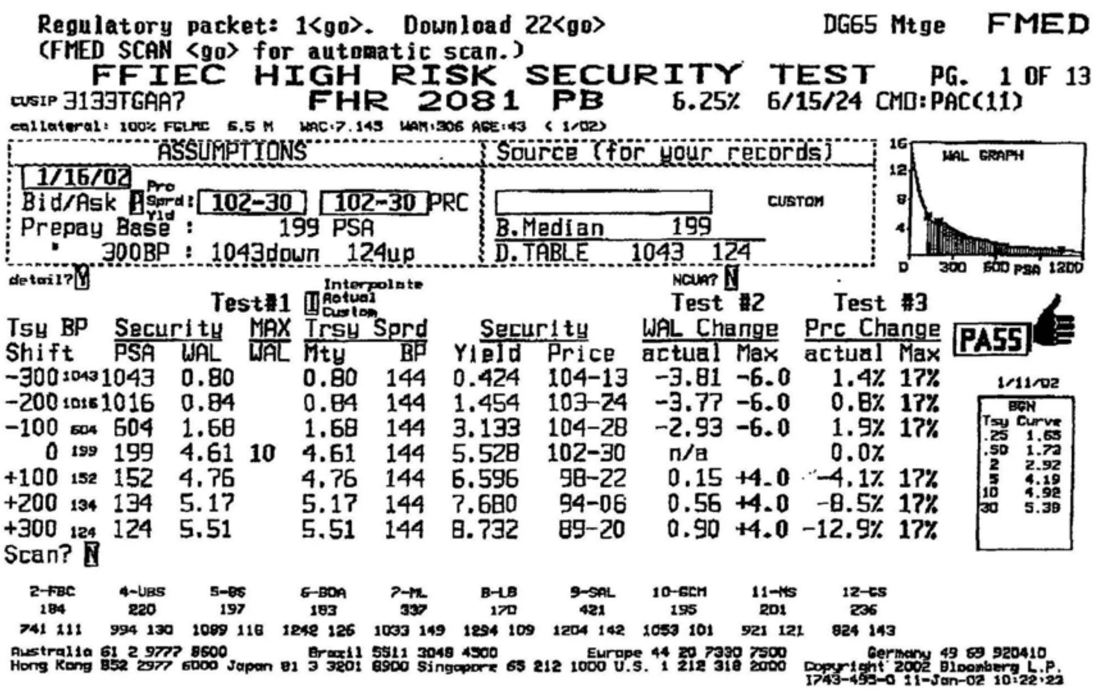


EXHIBIT 4

EXHIBIT 5

Compared to the steady predictability of the instrument in Exhibit 1, these CMO classes represent roller coaster rides that were seldom appropriate for any investor, especially the uninformed investor and the term “uninformed” included all but the very most sophisticated investors.

Regulators became alarmed and took action. The FIFIEC test was developed. Exhibit 6: As you can see, there were three FIFIEC



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(FMED SCAN <go> for automatic scan.)
FFIEC HIGH RISK SECURITY TEST PG. 1 OF 13
CUSIP 3133TGAA7 FHR 2081 PB 6.25% 6/15/24 CMO:PAC(11)
collateral: 100% FGLMC 6.5 M WAC:7.143 WAM:306 AGE:43 (1/02)

ASSUMPTIONS
1/16/02
Bid/Ask P Pro Sprd Yld: 102-30 102-30 PRC
Prepay Base : 199 PSA
" 300BP : 1043down 124up

Source (for your records)
CUSTOM
B.Median 199
D.TABLE 1043 124

WAL GRAPH
16 12 8 4 0 300 600 PSA 1200

detail? Y NCUA? N

Test#1 I Interpolate Actual Custom Test #2 Test #3

Tsy BP Shift		Security PSA	Security WAL	MAX WAL	Trsy Sprd Mty	Trsy Sprd BP	Security Yield	Security Price	WAL Change actual	WAL Change Max	Prc Change actual	Prc Change Max
-300	1043	1043	0.80		0.80	144	0.424	104-13	-3.81	-6.0	1.4%	17%
-200	1016	1016	0.84		0.84	144	1.454	103-24	-3.77	-6.0	0.8%	17%
-100	604	604	1.68		1.68	144	3.133	104-28	-2.93	-6.0	1.9%	17%
0	199	199	4.61	10	4.61	144	5.528	102-30	n/a		0.0%	
+100	152	152	4.76		4.76	144	6.596	98-22	0.15	+4.0	-4.1%	17%
+200	134	134	5.17		5.17	144	7.680	94-06	0.56	+4.0	-8.5%	17%
+300	124	124	5.51		5.51	144	8.732	89-20	0.90	+4.0	-12.9%	17%

Scan? N

PASS

1/11/02

BGN Tsy	Curve
.25	1.65
.50	1.72
2	2.92
5	4.19
10	4.92
30	5.38

2-FBC	4-UBS	5-BS	6-BOA	7-ML	8-LB	9-SAL	10-GCM	11-MS	12-CS
184	220	197	183	337	170	421	195	201	236
741 111	994 130	1089 118	1242 126	1033 149	1294 109	1204 142	1053 101	921 121	824 143

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Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 212 1000 U.S. 1 212 318 2000 Copyright 2002 Bloomberg L.P.
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EXHIBIT 6

tests which had to be passed for a security to be purchased by a financial institution. The specific security could not, at purchase, have a weighted average life[5] of more than 10 years.

Secondly, the weighted average life cannot shorten more than 6 years or lengthen more than 4 years given a 100/200/300 basis point shift in interest rates.

The third test involved price volatility stating that the price could not change more than 17%. These FIFIEC tests became the gospel for regulated, institutional investors. It was obvious that most buyers did not know what they were doing in this area and the horror stories became commonplace. To protect these "sophisticated" investors, which Wall Street picked on like so many fish in a barrel, regulators took action and made FIFIEC test compliance a regular part of every financial institution examination. Individual investors were left to protect themselves and rarely would a broker discuss the FIFIEC test with an individual investor. If an examiner found a security had been purchased which flunked the test, the bank could be forced to sell the security. There is no longer an automatic liquidation requirement but the purchasing institution has the burden of describing what they bought and why they bought it. If they can't meet that requirement to the satisfaction of the examination team, the institution will still, at the least, face a regulatory "write-up".

Wall Street did not view the FIFIEC test as a deterrent for long, but instead, took it as a challenge. Major firms began to structure product to be "on the edge." Given the base test, the security would, at the time of purchase, pass the test but, within a few short months, fall off the edge leaving the frustrated banker as yet another victim of extension risk. It was clear – in hindsight – that investors needed to run prepayment scenarios at slower or faster speeds than those required to meet or pass the base test at the time of purchase. Exhibit 7 reflects a security which passed the test at the time of purchase but would fail just four months later.

[5] This is the standard measure of risk in MBS product as opposed to most other types of securities which use maturity. Generally, securities with a longer maturity or "average life" will be more volatile and have greater price variance than those with shorter maturities. Most mortgage-backed securities have 30 year stated maturities (there are also 15 year and a few other final maturity products in the marketplace but they represent a distinct minority of the total market), but given the monthly principal payments, defaults and refinancings, most of the cash flow will be received much earlier. The final, stated maturity date will not change, <u>but</u> the prepayment rates do change leading to a variance of the weighted average life.

EXHIBIT 7

Exhibit 8 presents an even more interesting case. In this case, even with heavy cash flow initially, there was more than "extension risk," there was "extension certainty" even if interest rates never changed. The sellers of this security knew the facts, did not disclose, and, clearly, deceived the buyer who ends up with a big loss. Worse yet, a family planning to use funds for a college education or a retiree looking for some hard-earned leisure found themselves frustrated and fuming. Exhibit 9 presents a similar scenario.

EXHIBIT 9

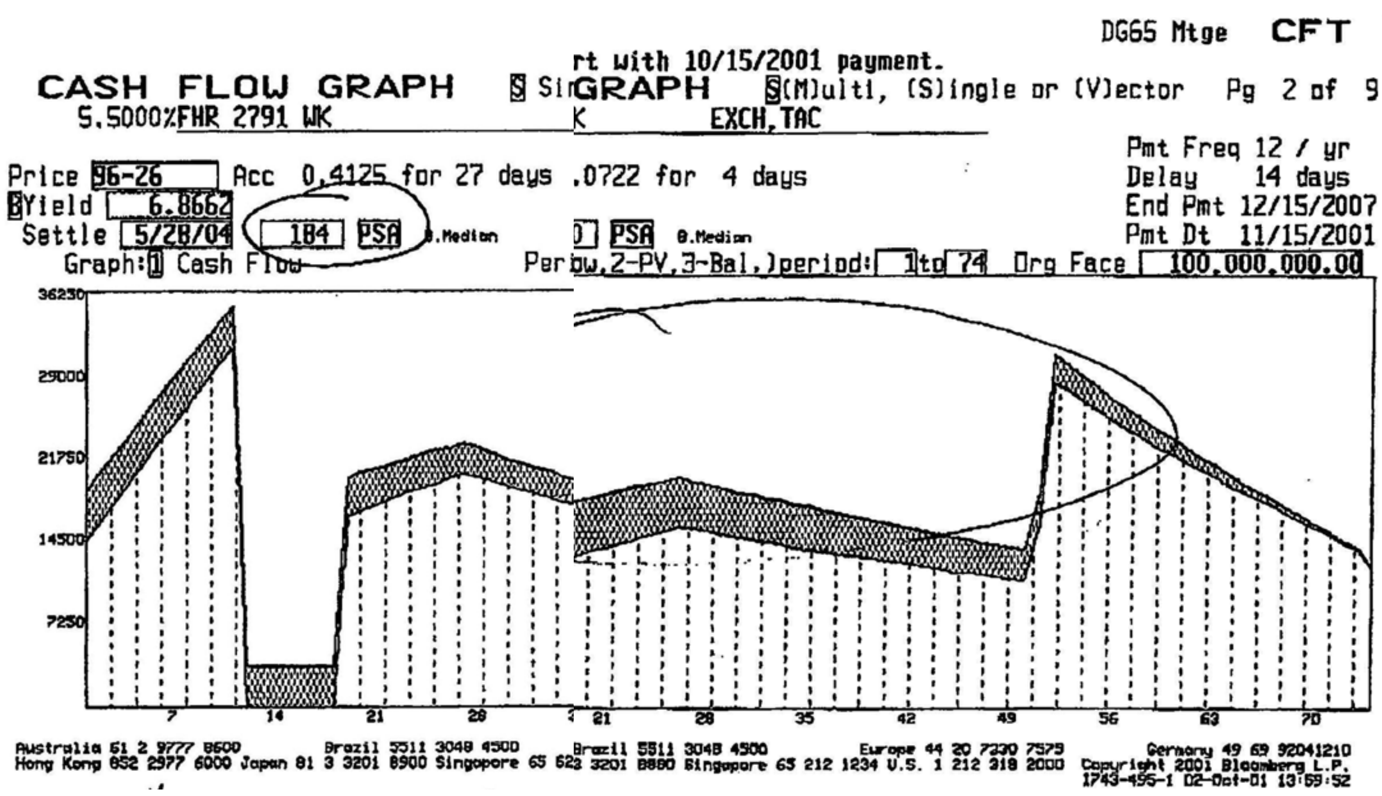
EXHIBIT 9 This instrument shown on Exhibit 9 is structured to have heavy cash flows on the front end and thus have a shorter average life at issue date. Then – BAM – prepayments hit the wall. There are virtually *NO* cash flows for a period of time, and there is substantial extension *even if* rates do not rise.

This security was sold several weeks *BEFORE* issuance when the seller doesn't even know the specific class (or tranche) being purchased. (The investor should be shown alternative cash flow scenarios but in many cases this is not done.) This usually won't be known until about 2 weeks before issuance. But, the buyer is committed, can't get out of the transaction, and is then stuck with a substantial loss.

Let's trace another specific example from beginning to tragic end. A small financial institution purchased FHR 2785 UM. The instrument had a 5% coupon with a Weighted Average Collateral ("WAC") of 5.43% and a Weighted Average Maturity ("WAM") on the underlying collateral of 350 months. The original projections on the security showed a PAC (Planned Amortization Class) Bond of 147 to 202 PSA. The zero (0) base used for this security which is based on the consensus of primary dealers was 186 PSA. This indicated a bond equivalent yield of 6.013%, a dollar price of 98 3/32 and an average life of two years. On those PSA assumptions, this would produce a principal window of 5/04 - 11/09 on 30 year collateral.

A regional dealer wanting to be conservative, rather than accept the Wall Street rhetoric without question ran the security at 125 PSA which was 61 PSA below the consensus median. This produced a

EXHIBIT 8



principal window of 5/04 - 2/13 which produced an average life of 2.9 years. The rate shock analysis run using the FIFIEC test showed that a 300 basis point rate increase would produce a bond equivalent yield of 5.475% with a 5.18 year average life. Rates down 300 basis points would produce an 8.23% bond equivalent yield and an average life of .57 years.

The banker purchased this security based on all the projections created by the originating primary dealer and passed on in good faith by

CLASS CMO

Bloomberg CMO — CMO CL

1)	AD	Accretion Dir.	21)	INV
2)	AFC	Available Funds	22)	IO
3)	ARB	Ascending Rate	23)	LIQ
4)	AS	Accel Security	24)	MEZ
5)	CALL	Call Option	25)	MR
6)	CAM	Controlled Am.	26)	NAS
7)	CMPLX	Complex	27)	NPR
8)	CPT	Component	28)	NSJ
9)	CSTR	Coll. Strip Rate	29)	NTL
10)	DCALL	Date Callable	30)	PAC
11)	DLY	Non-Zero Delay	31)	PEC
12)	DRB	Descending Rate	32)	PO
13)	EDC	Extended Delay	33)	PT
14)	EXCH	Exchangeable	34)	PUT
15)	EXE	Excess P&I	35)	PZ
16)	FLT	Floater	36)	R
17)	FTV	Fix to Variable	37)	RSTP
18)	HAZ	Hazard Bond	38)	RTL
19)	HB	Hard Bullet	39)	SB
20)	IAN	Index Amort	40)	..

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EXHIBIT 10

the broker with the small, regional dealer. Two weeks after agreeing to the purchase, the banker got a shock when he checked on his purchase and found it listed not as a "PAC" bond but as a "non-sticky jump" ("NSJ"). The original average life purchase went from 2.00 years on the purchase date to 16.5 years on settlement date! The buyer was informed that he had a loss in the security of approximately 18 points, or almost $180,000 on an initial purchase of $1 million.

The number and types of classes would be comical if they did not represent such a costly smokescreen for investors. Exhibit 10 is the current Bloomberg listing of CMO class types:

Few brokers can adequately explain to investors the subtleties and nuances of these numerous classes. Most don't even try. They rely on the assumptions provided to them by traders and managers and set sail to convince investors to "trust" their assumptions and conclusions.

Freddie Mac (FHLMC) FHR 2594 lists *228* classes in a single deal – with all 228 classes taking their cash flow off the same instruments. Who, among investors, could hope to accurately analyze such a structure?

Investors – institutional and individuals alike – need to be protected from the Great CMO Heist. Literally millions of dollars have been lifted from investors and transferred to the overstuffed pockets of Wall Street. There are small firms and individual advisers and consultants who know how to properly analyze these instruments and to pierce the foggy veil of confusion and uncertainty. Investors must, at a minimum see the Bloomberg analysis on an individual security and then seek unbiased advice on the appropriateness of that security for their particular situation. Anything less poses inordinate risk and many sales, whether to individuals or institutions, are blatantly unsuitable.

A letter I received recently from a frustrated broker sums up the problem:

> I have been in the institutional fixed income business for years but have become so frustrated with the shenanigans of Wall Street in the structuring of CMO's that I have decided to hang up my license. The CMO product has become a vehicle for primary dealers to reward their best accounts and to foist the trash off on small dealers, financial institutions and individuals.

We have an obligation to alert investors that they have recourse. The kind of expertise is available to analyze what was done and to hold the culprits accountable. When properly educated and sufficiently armed, investors will rally to recover their losses. As an organization and as individual Piabians we have a responsibility to understand these products and to render aid to those in need – both institutions and individuals.

Recovery From The Florida Securities Guaranty Fund

By Nicholas J. Taldone

In addition to representing investors in securities arbitrations, Nicholas Taldone is a certified Court mediator and NASD and AAA arbitrator. He has offices in Clearwater, Florida. He is admitted to practice in the states of New York, New Jersey, California and Florida. He can be reached at 727-712-1400 or via email at taldonelaw@msn.com.

Florida investors that have prevailed in arbitration with a finding that the Florida Investor Protection Act ("SIPA") has been violated sometimes find that the respondent broker is judgment proof and/or that the respondent broker-dealer is out of business. In these and other situations where the aggrieved investor is unable to collect fully or partially on the award, resort to the Florida Securities Guaranty Fund established under SIPA[1] should be considered.

The Fund is funded by assessments against broker-dealers, investment advisers, and associated persons as part of their registration process with Florida. The Florida Department of Financial Services administers the Fund.

LIMITS OF COMPENSATION FROM THE FUND

An investor who qualifies may receive monetary compensation from the Fund for the unsatisfied portion of a judgment against the person or entity who advised or sold the failing investment to the investor. Compensation from the Fund to an individual investor is currently capped at $10,000 and is limited to actual or compensatory damages, excluding costs and attorney's fees.[2] The total aggregate limit against any one dealer, investment adviser or associated person is $100,000 regardless of the number of claimants involved.[3] Where there are multiple claimants, the Department of Financial

Services prorates the payment to the claimant based upon the ratio that the person's claim bears to the total claims filed.[4]

ELIGIBILITY FOR RECOVERY AGAINST THE FUND

To qualify for compensation from the Fund, the respondent against whom the claimant has the award must have been registered with the state of Florida as a broker-dealer, associated person or investment advisor at the time of the unlawful acts alleged in the statement of claim.[5]

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[1] *Fla. Stat.* § 517.131.

[2] *Fla. Stat.* § 517.141(1).

[3] Id.

[4] Fla.Stat. 517.14(2).

Next, an investor must show that he or she has received a final judgment in an action where the cause was based on a violation of F.S. 517.07 (sale of unregistered securities) or F.S. 517.301(fraudulent conduct in connection with the offer, sale or purchase of unregistered securities)[6]. An award must have a specific finding of a violation of sections 517.07 or 517.301 to be eligible for application to the Fund. General reference in an award to a violation of "Chapter 517, Florida Statutes" is insufficient.

The next condition for eligibility to bring a claim against the Fund is that the investor has made a reasonable search to determine whether the judgment debtor has any assets from which to satisfy the judgment.[7] In the case of a judgment against an individual associated person or investment adviser, the staff of the Florida Department of Financial Services ("DFS") is generally satisfied with counsel's affidavit that a reasonable search has been made and that the judgment debtor has no assets or that the assets are exempt from execution, garnishment or levy or that the assets are insufficient to pay the judgment for some reason. Judgment debtors who are not individuals may require more collection efforts from claimant's counsel to satisfy the DFS staff. For example, it is doubtful that counsel's affidavit that a corporate judgment debtor has no assets will be sufficient merely by stating that the debtor has withdrawn its registration from NYSE or NASD. As another example, where a judgment debtor's assets have been purchased or transferred to a new broker-dealer, claimant's counsel may need to at least seek in post-judgment proceedings some discovery on successorship type issues to satisfy DFS staff and be eligible for compensation from the Fund. The above eligibility requirements may be waived by the Department of Financial Services if the respondent is the subject of any proceeding in which a receiver has been appointed.[8]

An additional eligibility prerequisite is that any funds recovered from the judgment debtor or other source must have been applied to the damages complained of by the investor.[9] In practice, this condition is satisfied by counsel's affidavit stating the amount of any funds that have been recovered and that they have been applied to the amount due.

Finally, there is a statutory requirement that investors moving to confirm arbitration awards in a situation where a claim against the Fund may be made shall provide written notice "as soon as practicable" to the Department of Financial Services after the petition to confirm the award has been filed.[10]

OBTAINING A JUDGMENT

A formal " judgment" confirming an arbitration award is required to file a claim against the Fund. Often times an individual respondent may "plead poverty" and indicate he or she is "leaving the industry" and offer a token amount to have the case dismissed. In such circumstances, the "deadbeat" respondent may be willing to consent to have an award entered against him in order for the investor

[5] Fla.Stat. 517.131(1) (a)(2).

[6] Fla. Stat. 517.131(2).

[7] Fla. Stat. 517.131(3).

[8] Fla.State. 517.131(2)(e).

[9] *Id.*

[10] Fla. Stat. 517.131(4).

to be eligible to apply against the Fund. Such a "consent award" may then be converted to a judgment.

Obtaining a judgment confirming an arbitration award in Florida is not difficult but the specifics are beyond the scope of this article. The judgment need not have any special findings in it other than general reference to the award. In the author's experience, in a defunct or otherwise uncollectable respondent scenario, service of process of the motion to confirm the award and obtain a judgment is rarely a problem. If service becomes a problem, "substituted service" upon the state of Florida is available. Florida trial judges will issue "default" orders of judgment confirming arbitration awards upon a sufficient showing that the respondent has been served.

TIMING OF CLAIM AGAINST, AND PAYMENT FROM, THE FUND

The claimant may file a claim against the Fund at any time after receipt of a judgment. However, if a final judgment which forms the basis of recovery from the Fund is overturned on appeal or some collateral proceeding, the claimant must reimburse the Fund for all amounts recovered under the Securities Guaranty Fund Act within sixty (60) days of the final disposition of the appeal or collateral action.[11] Therefore, if an appeal is filed, the better practice would be to counsel the claimant to wait until after the conclusion of the appeal before filing for recovery from the Fund. Once the time for notice of appeal has passed, generally ten (10) days from entry of final judgment. If no notice of appeal has been filed, then the claimant may file the claim forthwith.

The Fund will not issue a check to the claimant until two (2) years have elapsed from the date of certification by the Department of Financial Services that the claimant's claim is eligible.[12] If during that two year period, additional claims against the same respondent have been filed by other claimants or notices have been filed of pending actions for which claims against the Fund may be made, the Department of Financial Services "shall determine those persons eligible for payment or for potential payment."[13] As noted above, where the aggregate of the claims against the respondent to the Fund is $100,000 or more, DFS will then prorate the amount of the claim to the claimant based upon the ratio that the claimant's claim bears to the total claims against that respondent. Thus, in the situation where the respondent does not appear at the arbitration hearing, and the respondent is feared noncollectable, counsel should nevertheless conduct the prosecution of the case vigorously and obtain the highest monetary amount available, including attorneys fees and punitive damages, because this respondent may have multiple claimants against the Fund. Although in Florida eligibility for attorneys fees is determined by the arbitrators and the amount is determined by the court, in this author's experience, where the respondent does not appear at the arbitration hearing, arbitration panels and NASD staff and courts are willing to make an exception to the rule and permit the arbitration award to state a specific amount of attorneys fees assessed against the respondent. Counsel should be prepared to have a detailed breakdown of attorneys fees for submission to the Panel at the arbitration hearing.

CONCLUSION

The procedure for filing a claim against the Fund is straightforward. However, the two year delay before a check is issued makes the process frustrating for claimants and their counsel. Counsel should explain the entire

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[11] *Fla. Stat.* § 517.141(5).

[12] *Fla. Stat.* § 517.141(3).

[13] *Id.*

process to their client to prepare the client for the two year waiting period. Nevertheless, compensation from the Fund is “found money” in those unfortunate circumstances where there are no pockets available to satisfy arbitration awards.

Expert's Corner: Managing Risk - Numbers Don't Lie An Expert's View to Winning Cases

By Mark Passacantando

Mark Passacantando is a Registered Financial Consultant, MBA and Managing Member of Financial Planning Partners, LLC in Boston. He has served as a plaintiff and defense expert in over 100 securities cases and has specialized in investment and risk analysis, variable annuities and bank-sponsored activity in the securities area. Mr. Passacantando is on the Board of Directors of the Financial Planning Association of Massachusetts, Editorial Board of the Journal of Investment Compliance and is an instructor of Personal Financial Planning at Boston University and Harvard University. He can be reached at 800-941-3221, mark_pass@verizon.net or *www.expert123.com*.

We have all seen many practices within the management of investment portfolios that defy conventional wisdom. I was recently testifying in a case in New York where the defendant explained his alleged market timing in the following manner: "The market was talking to me and was telling me when to move all of the assets in and out of the market." This may be one of the ingredients to a negligence claim. However, the fact is that no one can time the market successfully.

Attempting to do so results in missing the large upside moves in the market. For example, staying invested from 12/31/83 – 12/31/03 would result in a 12.89% annual gain. However, simply missing the 100 biggest single day gains would result in an annual loss of 3.41% (See Exhibit C). When and where the next terrorist act will be, what the ultimate price per barrel of oil will be or how high interest rates will go is anyone's guess. The fact is, investor portfolios should not be an area where individual "bets" are placed. Any attempt to do so should be met with appropriate inquisition and action.

MANAGE THE RISK; THE RETURN WILL FOLLOW

People are centered on how much money they invested and how much money they made or lost. This makes sense to all of us because we understand the pure economics of our financial markets and what we attempt to achieve in investing. We also have gotten good at understanding relative performance in using Well-Managed Theory concepts and modeling. Further, we have come to appreciate the individual nature of investment relative to one's goals, investment objectives, time horizon, tax circumstance, etc, pursuant to guidance by NASD Code of Conduct suitability standards. But how much time do we spend focused on the risk side of the equation? How do we use risk metrics in our cases? What is their relevance?

We should start with the understanding that all investments entail some degree of risk. Yes, US Treasuries and the Capital Asset Pricing Model make a case for "riskless investing", but for all practical purposes, investing means risk. Once we establish this, we can understand that there exist different degrees of risk, which, to some extent, is controllable by the broker of financial advisor. Furthermore, this risk is measurable and can be catered to the individual risk tolerance of the investor. While not all advisors use the more advanced tools in ascertaining client specific risk, some may utilize risk questionnaires that quantify acceptable risk levels. Absent such a tool, advisors are left with implied levels of risk given the demographic data of the client. As we know, this often leads to opinion and interpretation…clearly not the preferable way of managing investor assets.

While there are numerous measures of risk available, only a few are needed to perform a meaningful analysis. They are beta, standard deviation and the Sharpe Ratio. Let's explore them in a bit more detail.

Beta is a measure of a security's volatility or a portfolio's volatility. Specifically, it looks to explain the movement in a security given the overall market's movement. For example, a stock with a beta of 1.3 is 30% more volatile than the market. That security will generally move 30% more up or down than the market's move. Utility stocks historically have had betas of less than 1.0 and high tech stocks have had betas of greater than 1.0. All stocks can be researched to determine their beta. Does this behavior match the risk tolerance of the investor when performing a post-mortem in a case?

Standard deviation is a measure of the dispersion of data around the mean or average. The more of a spread above and below the mean, the higher the volatility and the higher the standard deviation. In looking at stocks and mutual funds we look at the dispersion of "actual returns" and make some observation about volatility. Volatile stocks have higher standard deviations. Again, this data exists and can be used *before* brokers and advisors make investment decisions; they should use while looking at their client's risk tolerance. It is available, simple to use and easy to implement.

The Sharpe ratio, developed by William Sharpe, is used to measure risk-adjusted performance. In a portfolio, it is calculated by subtracting the risk-free rate of return from the actual rate of return and dividing it by the standard deviation of portfolio returns. The Sharpe Ratio tells us whether the returns of the portfolio are because of smart investment decisions or a result of excess risk. Most mutual funds have Sharpe Ratios already calculated so that you can incorporate it into a buy, hold or sell decision. A buy and hold often results in a Sharpe Ratio of between .5 and 3.0. A Sharpe Ratio of over 1.0 is "pretty good" and "outstanding funds" usually have Sharpe ratios over 2.0.

How else is risk managed? In addition to the suitability concept, which is a *relative* concept familiar to all of us, there are several *absolute* techniques available to every investor. I have found panels especially interested in understanding what is available to manage risk. Many of these techniques can be discussed in your cases: *position sizing* (the conscious choice to purchase shares or bonds in a way that the purchased position represents some predetermined dollar size or percentage size of the overall portfolio or of the asset category*, predetermined purchase points* (and predetermined sell points) (the manner in which an investor understands fair valuation of a company stock and what price represents a price that is too rich at a given time and what price represents a stock that is undervalued and should be purchased), *mental and mechanical stop loss orders* (the process by which an investor sets a percentage below the current market value and states the stock should automatically be sold at 8%, 10%, 12% or 15% declines in market value, using *standard risk measures* at the security level and at the portfolio level to decide when to buy and when to sell (for example, determining that a beta of 1.0 is equal to market risk, one may develop a policy that only stocks with a beta less than 1.0 or a portfolio in total should have a weighted-average of less than 1.0 is utilizing quantifiable risk measures to manage risk) and using *derivative instruments* only to hedge existing market or security specific risk (such as the purchase of a put contract on the market or on a particular portfolio security).

I once worked with two investments professionals who had essentially the same portfolio return over a 5-year period of 47%. Both professionals claimed to have been very successful and were touting their performance in an attempt to gather more assets. Upon further review, it became interesting to note how they each arrived at their 5-year average return of close to 10%. One manager had consistently returned an average return with low volatility from year to year given a standard deviation of about the market rate of 19%. The other manager had much wider swings in performance with a standard deviation measured at approximately 35. Here, the risk metrics for a portfolio are known at the outset of managing the portfolio. The client's specific risk tolerance is also known at the outset. General market performance is unknown and uncontrollable for all market participants. Does it make sense to end up in the same place on a return basis but doing so while taking on more risk? Should liability to decide on that course of action attach to the advisor?

Based on the foregoing, you can see that tools and techniques exist to measure and manage risk in a portfolio. It is therefore prudent to identify and implement such tools which are essentially free of charge and commonly available to all market participants. It would be wise to consider their use and be able to evidence their use in a given portfolio or across all portfolios. Why wouldn't an advisor choose to use such tools? Advisors are paid well to manage the wealth using the latest tools, techniques, training and science. Similarly, one wouldn't want to fly an airplane without the benefit of standard, pre-flight safety checks, weather forecasts and high tech radar equipment when flying would they? Well why would someone engage in the very humbling exercise of exposing hard earned wealth to the very unforgiving currents of the stock market?

SIT DOWN WITH YOUR LEAD STORY – AND THEIRS?

Regardless of what side of the isle one may find himself, it may make sense to understand the drivers of the case….the main focal points of the plaintiff and of the defense. Once those issues are established, a well-equipped expert or other professional should be able to gather evidence to support those focal points above and beyond the testimony "In my expert opinion…". We have the benefit of statistical data dating back to 1929 that can be used to support one's actions or inactions in a given case.

What is the defense's lead story? Do they have a story to tell? SEC Rule 4445 requires that advisors have a basis upon which a recommendation is made. It states that reliance on an analyst's report can establish an adequate basis of reliance. While we now know the inherent weaknesses in the analyst reports of the pre-2000 era, it nonetheless presents an argument for the defense. Beyond analyst reports, was there independent research either conducted in-house or by the by the advisor? How did you build a portfolio of stocks, bonds and mutual funds? Advisors must use some form of logic and prudence in selecting securities and be able to evidence such review and due diligence. A portfolio, for example, that was built one security at a time and seeing the affect each security has on the portfolio is an excellent way to evidence prudence and diligence. For example, if a portfolio has 7 industries represented and the addition of another security (e.g. an exchange traded fund) can be shown to reduce portfolio beta by .005, has a correlation to other stocks of .8 and covers an additional industry such as utilities, the advisor and the defense have gone a long way supporting the necessary due diligence. Conversely, the absence of applying this particular process or another logical, systematic process like it seriously calls into question the design portfolio composition and risk management strategies of the advisor.

TRUE DIVERSIFICATION

Like any other industry, the investment industry has standards, principles and techniques that operate at all times. It is important to identify which are present in a given portfolio. It is also important to observe which standards, principles and techniques should be operating, question their existence and test their effectiveness. Standards may come from industry practice, Modern Portfolio Theory, Capital Asset Pricing Model, Black-Sholes theory, Association of Investment Management and Research ("AIMR"), industry consultants like Cambridge Associates and Russell, the Certified Financial Planner Board of Standards and others. It is important to realize that the management of a portfolio is the result of a series of decisions. It is in analyzing those decisions in retrospect that provides us the opportunity to win a case. Let's educate the ultimate decision makers as a goal. But first, let's do the financial analysis ourselves.

At the beginning of an analysis is a diversification and asset allocation question. As we already know, diversification is a key investment concept. However, did you know that it is a primary risk management tool whose value can be mathematically calculated? Did the financial advisor employ a *conscious* strategy of allocating the assets within the portfolio among the three asset categories of stocks, bonds and cash? Why is this important? We know from various studies that the single most important decision in managing assets is the asset allocation among asset categories. This decision helps to explain (i.e. from a statistical standpoint, the independent and dependent variable) at least 91.5% of the investment performance, either positive or negative (See Exhibit B). Security selection only explains about one percent! If there is a lack of asset category diversification or the percentage choice among the categories is improper, then the portfolio is positioned for underperformance. Various models exist for insight about what percentages are maximal in a given situation. As we know from our casework, the asset category choices are driven, in part, by the suitability criteria outlined in NASD Conduct Rule 2310 including age, investment experience, net worth, tax situation, etc. However, it shouldn't stop there! Investment theory and practice tells us there are "rules of the road" that require the implementation of risk/return management in an absolute sense. Herein lies the opportunity to use Nobel Prize winning individuals and Modern Portfolio Theory. Keep in mind that it may be useful to reference or incorporate other Nobel Prize winners like Merton Miller, William Sharpe, Fischer Black and others.

Harry Markowitz won the Nobel Prize in 1990 for work he performed in the late 1950s in finance, particularly in the risk and return area and Modern Portfolio Theory. He has proven that there lies an optimal area where any portfolio mix of stocks and bonds should lie (See Exhibit D). His theory shows that a portfolio of investments should be carefully selected so that for each unit of risk undertaken by the investor is adequately rewarded by the maximum units of return. This possible range of optimization is referred to as the "efficient frontier". The investor is only being served when his assets, exposed to risk by definition of being in the market, is being compensated optimally for the risk he undertakes. Any choice not on the frontier, therefore, is needlessly exposing the investor to unnecessary risk. He also showed that risk should not be viewed as the risk of each asset in isolation, but the contribution of each asset to the risk of the aggregate portfolio. If the fiduciary standard of care question can be answered in the affirmative, there is an obligation to position the client on the efficient frontier. Here the questions in your case become:

- "Why is this asset category choice selected"? (i.e. is there an Investment Policy Statement governing the allocation or possibly overriding the correct choice?)
- "Was the proper risk analysis performed"?
- "Who is responsible for any underperformance or loss in principal if the Efficient Frontier is not achieved"?

Once the asset category decision has been established, it is time to look at the choices *within* the asset categories. In the stock area, it means choosing between and among the industry *sectors*. Standard & Poor's recognizes 9 major Global Industry Classification Standards or "GICS". It is safe to say that if someone claims to have diversified adequately, there should be exposure to most or all of the 9 industries. In the institutional circles that I have been part of, it was mandatory to establish some exposure to the industries on the notion that the future is an unknown. Recognizing that to be true, it is literally impossible to foresee which industries will outperform and which will underperform. Additionally, money manager's performance is often measured against an index such as the S&P500, a commonly used benchmark. If the client's industry allocation is different than the benchmark industry composition (e.g. in Year 2000, the Committee that decided which companies are added and dropped in S&P500 had developed an index which was approximately 40% technology!), then a financial advisor has taken deliberate risk possibly leading to underperformance and may be subject to criticism. Those in the industry call this "tracking error" and pay close attention to such variances. If this is the fact pattern, shouldn't the decision to engage in active "tracking error"(i.e. an intention to deviate) be called into question?

Other choices in the stock category are sector choice and stock choice. Sector choice is the decision from which sector to invest. For example, within the technology industry there are several sectors such as personal computer makers, storage, networking, portals, software, etc. Within each sector are individual stock choices. For example, in the personal computer sector, one can choose among Dell Computers, Gateway, Apple, iMachines, etc. I think you will agree, that a portfolio choice at any point is the result of many carefully chosen decision points. While it is not absolutely necessary to cover all industries, sectors, and stocks, there should be some documented effort to achieve proper diversification within the context of a given portfolio.

Bonds also follow a similar logic. Within the bond category, a choice must be made regarding what types of bonds to use. Within the bond class there are U.S Treasury issuances, agencies like GNMA, FNMA and others, high quality corporate bonds and low quality or junk corporate bonds (those under BBB per Standard and Poor's). There are also derivative choices to make such as what amount of zero coupon bonds to use, if any. Similar questions arise as to what types of bonds are chosen and what amount of assets is placed into each. Also keep in mind that there are "bond-like" investments that have characteristics of a bond, but in the author's opinion, should not be used in calculating asset class calculations. Those assets include preferred stock, certain utilities and Real Estate Investment Trusts or " REITS".

In summary, asset allocation and diversification must be considered in the analysis of a negligence claim absent any authoritative document to the contrary. The good news is that these metrics can be calculated with relative ease. The not so good news is that the focus of most post-mortem analysis is stock selection and performance only.

UNCOVER AND EXPOSE THE MYTHS

It is safe to say that no one knows how and what the market will do. Therefore it is important to employ the available tools and techniques that can help us determine what an advisor was faced with at a given point in time. It is also important to determine whether psychology and behavioral finance played a role in the decision-making. Certain behaviors have been explained. For example, we know that portfolio rebalancing can add real value (Buetow et al, 2002), and that dollar-cost averaging can provide additional wealth over time (Statman, 1995), In the meantime, here are some of the misconceptions, myths and practices to think about in your cases:

A) "The whole market went down…that's why you lost money"! - Yes, this is true for certain periods of time. However, how much of the decline is attributable to the market tide and how much is attributable to the financial advisor's choices? Here, the good news for both plaintiffs and defendants is that we can now calculate those numbers. In other words, the market-explained increase or decrease, or "systemic risk", is a variable that can be explained and calculated. On the other hand, the increase or decrease that is explained exclusively by the stock or bond choices, or "non-systemic risk", can also be calculated. How powerful would it be to state unequivocally that, for example, 40% of the 50% decrease in portfolio market value was attributable to specific stock market selection and be able to evidence that fact? The method of calculating each is available and can be a powerful tool in explaining what happened and why without opinion or conjecture. My experience is that finders of fact like "black and white" fact patterns and relevant links to authoritative documents and facts. Here is an opportunity to have an expert calculate the numbers, educate the panel in an arbitration and make a definitive case for the cause and effect of a portfolio movement up or down.

B) "Everyone was moving into that sector or stock" - This so called "herd mentality" means that people are doing what is popular at a point in time. This approach lends itself to the practice of advisors (Nofsinger and Sias, 1999) to buy when everyone else has bought, thereby costing the most for the investor on the buy and, selling when everyone else has sold, thereby obtaining the lowest price. The result is that investors or advisors that follow the crowd can miss opportunities to realize major gains. Furthermore, the herd mentality does not promote statistical, fundamental or technical analysis in portfolio design, but rather investment behavior that is driven by unknown events. This is hardly an approach that can support prudence and diligence in support of a defense claim. Following others and chasing returns has been shown to be factually imprudent and leads to underperformance. Most of last year's winners are this year's losers. See the supporting data on hot performing styles of one 5-year period and what happened in succeeding 5-year periods starting in 1980 and ending in 2003 (See Exhibit A). Often this chasing leads to investing in the worst performers…it simply does not work.

C) "Expenses don't matter"! - The fact is, expenses do count. We are in a market environment where advisors charge asset management fees on top of mutual fund, ETF and variable annuity fees. The smallest reduction in fees can have a large impact on performance and advisors are aware of this. Minimizing fees are a fact of life and advisors owe that duty of fee minimization to their clients. In managing two separate, yet similar $100,000 ETFs each earning 7% for each of 10 years, ETF or Mutual Fund A's fee of .1% or 10 basis points (for example those ETFs offered by Fidelity are now 10 basis points) vs. ETF or Mutual Fund's B fee of 1.36% will result in a portfolio value of $194,757 vs. $171, 541…one small investment decision can makes a huge difference!

CONCLUSION

We don't know what the next wave of cases and causes of action will look like. Whether it is the underfunded pension liability impact on stock selection, cases against financial planners or mismanagement in the bond asset category, one thing is for sure…directed and well-choreographed number crunching can go a long way to winning a case. The ability to take the opinion away from the attorney, expert and decision maker and to present hard facts supported by detailed empirical data is key on the road to claiming victory. Doing the right thing and putting into practice the tools of the trade appear to be well serving antidotes. Risk management will continue to be at the center of effective and successful money management. Risk management must be managed proactively. It should also be measured by the expert retroactively. If we are successful in separating the fact from fiction in these cases and we apply the quantitative tools currently available, we will become more successful. We might also be able to answer whether anyone can support a stock decision to buy a company which had an IPO four months ago at $100, currently is at $300+ and 'is believed to hit $400 by year end? Only the GOOGLE stockholders who are buying on hope, promise and the high tech mantras of the past will know. Will we see Google stock in our client's portfolios? Only time will tell.

Exhibit A

The danger of chasing returns

	'80 -'84	'85 -'89	'90 -'94	'95 -'99	'00 -'03
Large-Cap Value	★				★
International	↓	★	↓	↓	
Small-Cap		↓	★		
Large-Cap Growth				★	↓

★ **Best Performer** ↓ **Worst Performer**

Past performance cannot guarantee future results.

Exhibit B

The mix drives the return…

A Nobel Prize winning study showed that 91.5% of your return comes from asset allocation

EXAMPLE:
80% growth
20% income

30-year average annual return

10.71%	**from asset allocation**
0.54%	**from security selection**
0.24%	**from other factors**
0.22%	**from market timing**

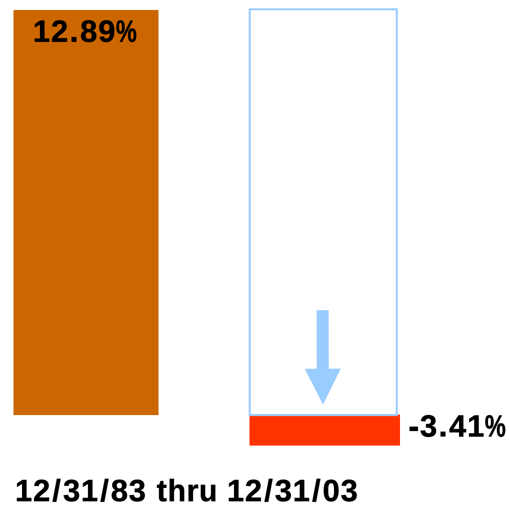
11.71% **11.71%**

Source: Brinson, Gary P. et al. "Determinants of Portfolio Performance," Financial Analysts Journal, July/August 1986. Updated in Financial Analysts Journal, May/June 1991.
Investment timeframe is from 12/31/73 to 12/31/03.
Past performance does not guarantee future results.

Exhibit C

The danger of market timing

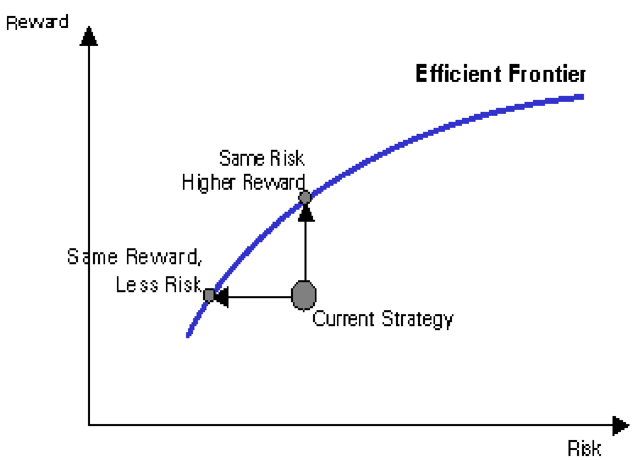
- Here's what would have happened to your investment if you tried to time the market and missed the 100 best market performance days over the 20-year period.



This is for illustrative purposes only and not indicative of any one investment.
Past performance is no guarantee of future results.

Exhibit D

Efficient Frontier



Expert's Corner: Annuities

By Craig J. McCann, PhD, CFA and Kaye A. Thomas

Tax-deferred variable annuities (hereafter "annuities") are contracts with insurance companies through which the public can invest in portfolios of stocks and bonds similar to mutual funds.[1] Annuities are costly, complex investments sold based on typically insignificant tax or insurance benefits by financial advisors with strong financial incentives adverse to those of their customers. These financial advisors receive generous commissions for selling annuities to investors who would be far better served by investments in individual stocks and bonds or mutual funds.

Regulatory scrutiny of variable annuity sales practices and private litigation have focused on the investment risk of subaccounts, on annuity "switching" and on the purchase of annuities within IRAs. In this paper, we demonstrate that in most situations, investors being sold annuities will pay more taxes and have less wealth in retirement as a result of the tax treatment of investments within tax-deferred annuities. We also report the results of scientific literature which demonstrates that the death benefit feature is worth a tiny fraction of what insurance companies charge investors for this feature.

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SECTION I. INTRODUCTION

Variable annuities are investment contracts sold by insurance companies through brokers. The amount paid for an annuity is allocated across managed pools of securities called subaccounts. Annuity purchasers typically have many subaccounts available to choose from within an annuity. Subaccounts are similar to stand-alone mutual funds offered by mutual fund companies. In fact, mutual fund companies may offer stand-alone mutual funds with the same names and essentially identical portfolios as the subaccounts offered within annuities. The value of an annuity fluctuates as a result of changes in the net asset values of the subaccounts and because of fees assessed by the insurance company.

The returns to an annuity are not taxed prior to the start of scheduled withdrawals. When the withdrawals begin, the returns accumulated within the annuity are taxed as current income rather than at the lower capital gains tax rate, even if the returns are entirely capital gains. It is possible - even likely - that investors buying annuities will

[1] We focus in this paper on annuities whose market value can rise and fall and the returns to which are not taxed immediately. Fixed annuities offer fixed returns and fixed payouts during retirement. Much of our discussion applies with slight modification to fixed annuities.

actually end up paying more in taxes and having less after-tax wealth at retirement, because of the harm caused by the tax benefit claimed for tax-deferred annuities. ("death benefit"). If the purchaser of an annuity dies before the investment is redeemed or payments upon retirement start, a designated beneficiary is guaranteed to receive at least the amount invested less any withdrawals. This feature pays off if the aggregate value of the investments in the subaccounts has declined net of withdrawals since the initial investment.

Variable annuities are typically more expensive than analogous mutual funds and their expenses are not easily understood. Management fees are assessed against the subaccounts much like mutual fund expense ratios. In addition, the insurance company assesses a fee referred to as the Mortality and Expense risk charge. This expense is substantial and is inaptly named since, contrary to the implication of its name, only a miniscule portion of it goes to funding the death benefit. The Mortality and Expense risk charge is economically equivalent to the 12b-1 fees assessed by load mutual fund companies to fund substantial upfront commissions paid to brokers who sell the investments. In addition to these ongoing expenses, variable annuities have high surrender charges for many years and any withdrawals prior to age 59½ will be subject to IRS early withdrawal penalties.

The market for annuities has grown dramatically. The National Association for Variable Annuities estimates that the net assets in variable annuities as of December 31, 2004 was over $1.1 trillion, an increase of

Annuities contain an insurance-like feature commonly referred to as a Guaranteed Minimum Death Benefit

40% since the end of 2002.[2] Given their tax disadvantages, illiquidity and trivial insurance benefits, the phenomenal growth in the sales of annuities can only be attributed to the powerful incentives offered to salesmen and the industry's obfuscation of the true costs and benefits of annuities.

SECTION II. ANNUITY HALL OF SHAME

With apologies to Winston Churchill, we can say this about tax-deferred variable annuities: never in the field of financial products has so much been sold to so many when suitable for so few.[3] This is not to say that the product is never suitable. Yet annuities are so lucrative for those in the business of selling them that they have become subject to an array of abuses. Here is a sampling of some of the chief issues.

Purchases in Qualified Accounts.

The tax deferral feature of annuities is much oversold, as we explain in detail later. In limited circumstances this feature can be the saving grace of an otherwise undesirable choice of investment vehicle. However, an annuity may be suitable for the portion of a portfolio that is invested to generate current income—bonds, or possibly REITs—if the income will be deferred over a long enough period.

Within an IRA or other qualified account, the advantage of an annuity in producing tax deferral disappears. Income in such an

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[2] *See http://www.navanet.org/press/Q4%202004%20%20Industry%20StatsFINAL.htm* and *http://www.navanet.org/press/03-04-03.htm*.

[3] See Jane Bryant Quinn, "One Faulty Investment" Newsweek, August 30, 2004 at *http://www.msnbc.msn.com/id/5782782/site/newsweek/print/1/display*. and "What's Wrong With Variable Annuities?"SmartMoney.com (2004) at *http://www.smartmoney.com/retirement/investing/index.cfm?story=wrongannuities*

account is already deferred, so this potential "benefit" is wasted. Deferred variable annuities are inappropriate for such accounts for the same reason tax-exempt bonds are inappropriate: the investor incurs the added expense associated with a product that is intended to produce a tax advantage, without securing the benefit of that tax advantage.

Sales to Retirees.

An immediate annuity may be a reasonable choice for a retiree who is concerned about outliving his or her savings. The added expense associated with the variable annuities that are the subject of this article cannot be justified unless the annuity is held for an extended period of time—perhaps for decades, as our analysis will show. It follows that variable annuities should not be sold to individuals who are retired or close to retirement. Yet a great many variable annuities are sold to these individuals. Given the limited period of deferral, there is no reasonable prospect for the tax deferral benefit to outweigh the costs.

Unsuitably Risky Subaccounts.

Variable annuities offer the opportunity to choose among subaccounts that resemble mutual funds. Like mutual funds, some of these underlying investments are likely to be unsuitable, especially if they expose the investor to an inappropriately high level of risk. Some investors have suffered grievous losses when they failed to understand the risk to which they were exposed in these subaccounts.

Annuity Switching.

Approximately 70% of annuity purchases are the reinvestment of the proceeds from the sale of existing annuities. Annuity switching is analogous to mutual fund flipping and are highly suspect. Most switches pay the broker significant commissions and involve the reestablishment of maximum surrender charges, while providing the investor with little benefit over their existing annuity.[4]

The SEC found that a supervisor failed to supervise a registered representative who violated Rule 10b-5 by switching annuities and by failing to inform his customers that the switches did not provide his customers with any benefits, but paid him substantial commissions.[5] Waddell & Reed recently settled with the NASD and some state regulators over rampant annuity switching abuses.[6]

Material Omissions and Misrepresentations About Costs and Benefits

Annuities are sold as tax advantaged products. Whether the sales force describes annuities as tax advantaged or tax deferred, the sales pitch is materially false for the vast majority of annuity purchasers. Potential

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[4] Under certain circumstances, annuity switches might benefit investors, especially if the value of the subaccounts has risen dramatically since the contract was first entered into. In this case, switching would allow the investor to ratchet up the floor on the investment value set pursuant to the guaranteed minimum death benefit. Milevsky, Moshe Arye and Kamphol Panyagometh, "Exchanging Variable Annuities: An Optional test for Suitability", *working paper*, December 19, 2003 at *http://www.ifid.ca/pdf_workingpapers/WP2003DEC19.pdf*.

[5] *In the Matter of Donna N. Morehead*, Securities Exchange Act of 1934 Release No. 46121, June 26, 2002.

[6] *See* "Waddell & Reed, Inc. Agrees to Pay $5 Million Fine, up to $11 Million in Restitution to Settle NASD Charges Relating to Variable Annuity Switching", NASD News Release at *http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013886&ssSourceNodeId=551*

investors should be truthfully informed of the likely tax impact of any annuity purchase. This disclosure need not be burdensome or complicated. The likely tax impact is a function of the investor's age, time to retirement, current and future marginal tax rates and the proposed asset allocation within the subaccounts.

Annuities are sold as insurance products. The insurance benefit is a complex, but substantively trivial benefit. Nonetheless, the power of its false appeal is evidenced by the enormous success the industry has at selling annuities to older, more conservative investors.

In the next two sections we explain how marketing materials currently used by insurance companies to sell annuities materially misrepresent their benefits and omit material information about their costs.[7]

SECTION III. TAX DEFERRAL

Investment earnings that accumulate in an annuity are not taxed until withdrawn. Tax deferral can be a powerful tool in building wealth. Unfortunately, the benefit of tax deferral in an annuity is more than offset by other factors. Promotional materials for annuities demonstrate the power of tax deferral while obscuring the other factors that eliminate the benefit. The obvious purpose is to create the misleading impression that the annuity provides the investor with a way to build significantly greater after tax wealth.

Material currently appearing on the web site of a prominent insurance company provides a good example. In a guide to variable annuities for "informed investors," the company offers an illustration of "just how effective tax deferral can be." The illustration assumes an investment of $100,000 that earns a steady annual return of 8% over a period of 30 years. A tax rate of 33% prevails throughout this period. If the earnings are subject to tax at this rate on an annual basis, earnings will compound at the rate of 5.36% (67% of 8%), and the investor ends up with $478,931. If instead the investor can defer the income tax, earnings will compound at 8%, growing to $1,006,266. After paying the 33% tax, the investor is left with $707,198.

The example is accompanied by a lengthy disclaimer, but the company clearly intends to create the impression that the tax deferral feature of an annuity will make a huge difference (a staggering 48% in its example) in the investor's after tax wealth at retirement. The "informed investor" is led to believe it would be foolish to invest in a way that will leave him or her with less than $500,000 when there is an alternative that will turn the same investment into more than $700,000 through the magic of tax deferral.

The example is technically correct, of course. The results given in its illustration of tax deferral do indeed follow from the assumptions. The problem is that the assumptions are wholly counter-factual. When we make realistic assumptions about the tax consequences of investing, we find that the annuity may provide little or no net benefit. Even when there is a net benefit, it is likely to be overwhelmed by the costs described in Section V.

Period of Deferral

The example uses a 30-year period of deferral. This is important because differences in investment results that stem from tax deferral are not proportionate to the period of deferral. Instead, these differences grow slowly at first and then, if the deferral period is long enough, they grow much more dramatically. Someone who does not know this might guess that a ten-year deferral

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[7] A truthful disclosure would tell potential investors exactly what compensation the salesman and his employer would receive if the investor purchased the annuity. Such disclosure would cripple sales efforts.

period would produce roughly one-third the benefit of a thirty-year deferral period. The reality is quite different. Using the assumptions in the insurance company's example, a thirty-year deferral produces a benefit of $228,267. Using the same assumptions, a ten-year deferral produces a benefit of just $9,087.

Annuities are rarely sold to investors who are thirty years away from retirement. Most are sold to investors who are much closer to retirement, or even already retired. The companies selling these annuities are well aware of this fact, yet they use a 30-year period to illustrate the tax benefit of deferral. The reason is obvious: a difference of $228,267 in retirement wealth is dramatic enough to overcome objections to undesirable aspects of variable annuities, such as hefty surrender fees. A difference of $9,087 would be unlikely to generate the same level of purchasing desire.

The insurance company's illustration does not mention, even in the lengthy disclaimer, that the typical period of deferral is much shorter, and the potential benefit of deferral is dramatically smaller in a shorter period. The evident purpose of choosing a 30-year period for the illustration is to mislead potential purchasers into believing that the annuity is likely to produce a far greater tax deferral benefit than can reasonably be expected.

Tax Rates

Earnings produced by taxable accounts are not all taxable at the rates that apply to ordinary income. For many years we have had favorable rates for long-term capital gain, and more recently the same favorable rates apply to qualified dividend income.[8] Annuities do not preserve the benefit of these lower rates. On the contrary, they convert capital gain and qualified dividend income into ordinary income that is taxed at higher rates. The disclaimer in the sales material mentions the possibility that lower rates may apply to investment income, but does not explain the significance of this fact.

This omission is particularly egregious in light of the 8% growth rate used in the example. A portfolio composed entirely of taxable bonds could be expected to produce nearly all its earnings in the form of interest income, which is taxed at rates comparable to the rate used in the illustration. Yet, bond investments cannot reasonably be expected to produce earnings at 8% over an extended period of time. To achieve that result, it would be necessary to allocate a substantial percentage of the portfolio to stocks. In a taxable account, stocks can produce long-term capital gain and qualified dividend income taxable at 15%, yet the example in the sales material assumes that all income in the taxable account will be taxed at the same 33% rate that applies to annuity income.

To show the significance of this factor, we calculated the results of the insurance company's example with the following change in assumptions. We assume that half the taxable account would be allocated to bonds earning 6% (taxed as ordinary income at 33%) and the other half would be allocated to stocks earning 10% (taxed as long-term capital gain and qualified dividend income at 15%).[9] The annuity is also divided equally between stocks and bonds, and we assumed no rebalancing. The results, after 30 years, still give an advantage to the annuity, but the advantage is much smaller than the insurance company's published example

[8] Application of these rates to qualified dividend income is set to expire after 2008 but efforts are under way to make these rates permanent.

[9] Stocks sometimes produce income that is taxed at higher rates (short-term capital gains or nonqualified dividend income), but this is not an important factor in the analysis, partly because investors have it within their power to largely avoid these forms of income, and partly because many annuities have greater than 50% of their assets allocated to stocks.

suggests, because now we are accounting for one of the major drawbacks of annuity investing: converting long-term capital gain and qualified dividend income into income taxed at the higher rates applicable to ordinary income. According to their example, the investor's wealth increases by $228,267 after holding the annuity 30 years, but when we account for the lower tax rates that are available for capital gain and qualified dividend income in a taxable account, the 30-year benefit is only $68,941.

What if the investor holds the annuity for a shorter time period? After 10 years, under these assumptions, the annuity produces $7,320 *less* wealth than the taxable account. In this shorter time frame, the disadvantage of converting capital gain into ordinary income is greater than the benefit of deferral. The investor has to hold the annuity 20 years just to break even. Using these assumptions, an annuity will produce an overall tax benefit only if the deferral period is quite long indeed, and even then the benefit will be much smaller than the promotional material suggests.

The asset allocation for many annuities is greater than 50% to stocks, so that even more than 20 years will be needed to reach the break-even point when the benefit of deferral catches up with the detriment of converting capital gain to ordinary income. As noted earlier, most annuities are sold to individuals who are fewer than 30 years away from retirement, and many are sold to people who are already retired. A majority of the purchasers will see a net tax *detriment*, not a benefit, from investing through annuities rather than taxable accounts. Even in the fine print of the disclaimers, there is nothing in the sales materials of insurance companies that would suggest this is true.

Capital Gain Realizations

It gets worse. In our discussion so far we have assumed that all the earnings in a taxable account are currently taxable. Yet a significant portion of those earnings come in the form of capital gains that can be deferred indefinitely. Investors who choose index funds or tax-managed funds for their stock investments may see their wealth grow substantially from appreciation in their stock holdings, while reporting little or no capital gain. Even in a stock mutual fund that is not geared toward tax efficiency, realizations can be expected to represent a fraction of the overall growth in value. This means that a substantial amount of tax deferral is possible even in a taxable account. It is misleading to compare the deferral benefit of an annuity with the results that would occur in an investment account that produces no deferral, because the bulk of the earnings from stocks come in the form of capital gain that can be deferred. As noted earlier, the insurance company's example of the benefit of tax deferral uses an earnings rate that would be unreasonably high if the portfolio did not include a substantial allocation to stocks.

To see how a more realistic taxable account would compare with an annuity, we developed our model to account for the deferral of capital gains. Once again we are dividing the account equally between bonds earning 6% and stocks earning 10%. The difference is that we are now assuming half of the income produced by the stock portion of the account represents unrealized capital gains. In this scenario the taxable account gains the benefit of deferring part of its income so it performs better than in the previous scenario where we assumed all the earnings in the taxable account were fully taxable. We find that under these assumptions the taxable account outperforms the annuity even after 30 years. The break-even point, when full deferral under the annuity catches up with partial deferral for capital gains (combined with lower tax rates for capital gains) occurs in year 33.

Many investors are able to defer far more than half of their stock income. If we reduce the realization rate for capital gains to levels easily accomplished through the use of index funds or tax-managed funds, the results produced by the taxable account will almost always outstrip the results produced by the annuity. In addition, we have assumed the taxable stock account is cashed in at the end, with tax being paid on all previously unrealized capital gains. In reality, many taxpayers avoid capital gains realization permanently by holding appreciated stocks until death. In short, we are being generous in suggesting that the annuity may be able to catch up with the taxable account by year 33.

Conclusion on Tax Benefits

Investors who are drawn into annuity investments by the promise of tax benefits are victims of misrepresentation. In any case where a substantial portion of the annuity is invested in stocks, the investor can expect to end up with less wealth, not more, than if the investments were retained in a taxable account. This is true even before taking into account the Mortality and Expense risk charge, which is another significant drag on earnings. As discussed next, investors who believe the bulk of this charge pays for insurance benefits are sadly mistaken.[10]

SECTION IV. GUARANTEED MINIMUM DEATH BENEFIT

The Benefit

Annuities offer an insurance like feature allowing it to be sold by insurance companies as an insurance product. This Guaranteed Minimum Death Benefit ("GMDB") feature guarantees that the designated beneficiary will receive at least the amount of the net investment in the contract if the investor dies before beginning scheduled withdrawals. Thus, if the investor dies at time when the aggregate value of the subaccounts is less than net investment in the contract, the insurance company pays out the value of the subaccounts plus the amount of any shortfall.

The GMDB is an amalgam of two options, a traditional life insurance policy wherein the death benefit is a put option on the aggregate value of the subaccounts. In the simplest case, the GMDB delivers an immediately expiring put option with a strike price equal to the net investment in the account to the beneficiary. If the owner dies, the beneficiary accepts the value of the contract or - if the contract is worth less than the net investment - a return of the net investment.[11]

Although the mathematics becomes hairy, valuing this benefit is not that difficult conceptually. The GMDB can be thought of as a series of put options on the value of the subaccounts expiring each month into the distant future with the strike price of all the options equal to the net investment in the contract. These options are relatively easy to value. Roughly speaking, by multiplying these put option values by the probability that the investor will die each month into the future and summing up the products we can determine the maximum value of the GMDB.

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[10] Reichenstein, William, "An Analysis of Non-qualified Tax-Deferred Annuities", *Journal of Investing*, Summer 2000, 1-12. and Reichenstein, William, "Who Should Buy a Non-qualified Tax-Deferred Annuity", *Financial Services Review*, 11 (2002) 11-31. At death, the heirs do not receive a stepped up basis for the value of the subaccounts in an annuity like they do with mutual funds making the tax-deferred annuity doubly tax-disadvantaged relative to mutual funds.

[11] Some annuities have more complicated GMDBs. For example, instead of guaranteeing to pay out the net investment if the investor dies, the contract might guarantee to pay the highest contract value on specified dates during the life of the contract, typically the anniversaries of the contract date. In other cases, the GMDB guarantees to pay the net investment increased by a fixed percent per year with the guarantee typically capped at twice the value of the net investment. GMDBs with guarantees that ratchet up on anniversary dates or that increase at a fixed percent per year can also be thought of as traditional insurance contracts that deliver immediately expiring put options with strike prices that are contingent on interim aggregate subaccount values or on the length of time between the contract purchase and the investor's death.

The GMDB will be worth more 1) the more risky the assets held in the subaccounts, 2) the older and the poorer the health of the investor, and 3) the lower the current value of the subaccounts relative to the net investment in the contract. If the subaccounts hold only money market funds, the GMDB will be literally worth nothing. If the subaccounts hold only bonds, the GMDB will be worth almost literally nothing. The value of the GMDB will be greatest if the subacconts hold mostly stocks. But even there, the GMDB will only be worth between 2 and 3.5 basis points per year to a 50-year old annuity purchaser. Even if the annuity is going to be held for 30 years, the present value of the GMDB less than 1% of the contract value on day 1.

The Cost

Investors are charged both management fees within the subaccounts and an annual Mortality and Expense risk fee based on the overall value of the subaccounts. This additional fee is substantial, typically around 1.25% per year, and is virtually 100% used to fund commissions paid to brokers and to provide profit to the insurance company. While the insurance industry has improved its fine print disclosures in recent years, it continues to obfuscate the true economics of annuities and mislead investors. The Mortality and Expense risk charge has nothing to do with mortality risk since it is largely invariant to mortality risk factors and to the volatility of the underlying assets. Moreover, as a fixed percentage, the charge increases with the value of the subaccounts even though the already miniscule value of the guarantee declines as the subaccounts increase in value.

Given the high initial surrender charge and ongoing Mortality and Expense risk charge it is clear that the insurance industry is at no risk from selling this defective product to unsuspecting investors.[12]

SECTION V. CONCLUSION

Annuities stand out as the investment most likely to be unsuitable since in virtually every instance, the investor would have been better served by mutual fund or a portfolio of individual stocks. That variable annuities hold more than $1 trillion in assets is a testament to the powerful incentives created by the insurance industry with generous commissions and the massive fraud they engender.

Brokers should explain to prospective purchasers in clear, frank terms annuities' terrible tax disadvantages. Brokers selling annuities should also explain to clients that the guaranteed minimum death benefit is in fact worth less than 1/20 of 1% per year and the 1.25% annual Mortality and Expense risk charge is really assessed to pay his commission for selling the product.

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[12] *See* Milevsky, Moshe Arye and Steven E. Posner, "The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds", *The Journal of Risk and Insurance*, 2001, Vol. 68, No. 1, 93-128.

Recent Arbitration Awards

By Jason Doss

Jason Doss is an attorney with the law firm of Page Perry, LLC in Atlanta, Georgia and has been a member of PIABA since 2001. His practice focuses almost exclusively on representing private investors in securities arbitrations against brokers and their firms. Mr. Doss graduated from the University of Florida with a B.A. in Environmental Science in 1997. He received his J.D. degree from Florida State University College of Law in May 2002. While at Florida State, he received the Mock Trial Best Advocate Award and the Mock Trial Coaches Award. He is a member of the Florida and Georgia bars.

Lawrence Praml v. Linsco Private Ledger Corporation
NASD Case No. 03-09127

Claimant alleged that Respondent improperly recommended that he purchase variable annuities in his retirement account. Claimant also alleged that these variable annuities were heavily invested in growth mutual funds and were unsuitable given his age, investment experience and his financial goal of retirement.

Claimant asserted the following causes of action: *respondent superior*, unjust enrichment, breach of contract, common law fraud, violation of the Minnesota Consumer Fraud Act and violations of the Minnesota blue sky laws. Claimant requested an award in the amount of $107,200 in compensatory damages, plus attorney's fees, costs, interest, punitive damages, and any other relief deemed just and equitable.

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

1. The Panel found Respondent liable for $91,581.00 in compensatory damages, statutory pre-judgment interest, and forum fees.

2. The Panel also awarded Claimant attorney's fees in the amount of $30,527.00 and punitive damages in the amount of $247,680.00.

The award is significant because of the large punitive damage award in connection with the improper sale of variable annuities.

Claimant's Counsel - Harvey H. Eckart and Amy M. Leonetti of Eckart & Leonetti, P.A., St. Paul, Minnesota.

Respondent's Counsel - Amanda C. Hawley and Robert B. Harris of Linsco Private Ledger Corporation, Boston, Massachusetts.

Karen F. DeShazo v. Edward D. Jones and Mark Schwartz
NASD Case No. 03-05851

The case involved the improper sale of a variable annuity and mutual funds from Edward Jones's "preferred" fund families, both sold within Claimant's retirement accounts. Claimant alleged that she was induced by the financial advisor to take a "lump sum" payment of her pension fund instead of the traditional monthly annuity payment that was guaranteed for the remainder of her life prior to the age of 59 1/2.

Claimant asserted the following causes of action: violation of the Kansas Securities Act; misrepresentations and omissions; negligence; and breach of fiduciary duty. Claimant requested that the Panel award compensatory damages in the amount of $173,500.00, punitive damages, interest, attorney's fees, and costs.

Respondents denied the allegations in the Statement of Claim and requested that the claims be dismissed in their entirety.

1. The Panel found Respondents jointly and severally liable for compensatory damages and pre-judgment interest in the amount of $193,550.00.

2. The Panel also held Respondents jointly and severally liable for attorney's fees in the amount of $14,232.00 pursuant to the Missouri Securities Act and for forum fees.

In addition to the variable annuity aspect of the case, the award is significant because the mutual funds were all from the Edward Jones' "preferred" fund family. Edward Jones was the subject of SEC sanctions for this conduct.

Claimant's Counsel - John J. Miller, Kansas City, Missouri

Respondents' Counsel - Jennifer Alexander Briner, in-house for Edward D. Jones & Co.

Jo Ann Oster et.al. v. CIBC World Markets Corp., Oppenheimer & Co., Inc. a/k/a Fahnestock & Co.
NASD Case No. 03-07858

This case involved a group of investors, who were customers of CIBC Oppenheimer and lost money in a CIBC Oppenheimer approved hedge fund named *Red Coat*. CIBC World Markets Corp. is a corporation formerly doing business as CIBC Oppenheimer. Claimants alleged that prior to CIBC Oppenheimer offering any approved hedge fund to its investors, it represented that it conducted extensive and continuing due diligence on the hedge fund and the hedge fund's managers. Claimants alleged that, in fact, CIBC Oppenheimer had conducted no significant due diligence on *Red Coat* prior to its approval. In addition, Claimants alleged that after *Red Coat* was approved by CIBC Oppenheimer, Respondents began soliciting Claimants to invest in *Red Coat*. Claimants also alleged that Respondents failed to disclose that CIBC Oppenheimer would receive compensation from *Red Coat* from sales to its customers. After recommending *Red Coat* to its customers, CIBC Oppenheimer cancelled its selling agreement with the hedge fund. Thereafter, Claimants attempted to liquidate their investments but were unable to do so for a period of one year from the date of the investment.

Claimants asserted the following causes of action: breach of fiduciary duty; unsuitability; constructive fraud; fraud; violation of federal and state securities laws, violation of NASD and NYSE Rules; and failure to supervise. Claimants requested that the Panel award $5,659,000 in compensatory damages, unspecified punitive damages, pre-and post-judgment interest and costs, including attorney's fees.

Respondents denied the allegations set forth in the Statement of Claim and requested dismissal and attorney's fees and costs.

The Panel collectively awarded Claimants compensatory damages in the amount of $3,554,447.00.

The award is significant because, according to Claimants' counsel, it represents the first reported hedge fund decision against a selling broker-dealer.

Claimants' Counsel - Philip M. Aidikoff and Keith Fraser of Aidikoff & Uhl, Beverly Hills, California.

Respondents' Counsel- Neil Stoltman and Lana C. Vernon of Mayer, Brown, Rowe & Maw, Los Angeles, California.

Patricia Guillen-Loth & Francois Loth v. American Express Financial Advisors, Inc.
NASD Case No. 04-00369

Claimants alleged that Respondent improperly recommended variable annuities, Class B mutual funds, and limited partnerships, notwithstanding that Francois Loth was a sixty-six year old retiree and his wife, Patricia, was forty-four years old and diagnosed with primary pulmonary hypertension and deemed permanently disabled. Claimants also alleged that each time Claimants complained about their losses, the registered representative reassured them that he was properly managing the Accounts and as long as they held onto their investments, they would not lose money.

Claimants asserted the following causes of action: breach of fiduciary duty; fraud; constructive fraud; elder abuse; unfair or deceptive practices against senior citizens; failure to supervise; violation of federal and state securities laws; violation of statutory and common law; violation of NASD & NYSE rules; and unauthorized trading. Claimants requested that the Panel award them $530,000.00 in compensatory damages, unspecified punitive damages, pre and post-judgment interest, rescission, lost opportunity costs, disgorgement and restitution of all earnings, profits, compensation and benefits received as a result of Respondent's unlawful acts.

Respondent requested dismissal of the Claimants' Statement of Claim in its entirety.

1. The Panel found Respondent liable to the Claimants for compensatory damages in the amount of $490,612.00.
2. The Panel awarded $159,000.00 in punitive damages, pursuant to *Small v. Fritz Companies, Inc*., 30 Cal 4th 167 (2003).
3. The Panel also awarded post-judgment interest at an interest rate of 10% of the entire $649,612.00 award and assessed forum fees against Respondent.

The award is significant because of the high punitive damage award in connection with the purchase and sale of the unsuitable investments and in connection with the registered representatives recommendation(s) to hold the investments, which caused the Claimants to incur additional losses.

Claimants' Counsel - Philip M. Aidikoff and Orousha Brocious of Aidikoff & Uhl, Beverly Hills, California.

Respondent's Counsel- Chad Weaver and Teri Zimring of Edgerton & Weaver, LLP, Hermosa Beach, California.

Karen Howsam, Individually and as Trustee for the E. Richard Howsam, Jr. Irrevocable Life Insurance Trust, dated May 14, 1982 (Claimants and Counter-Respondents) v. Dean Witter Reynolds, Inc., Robert P. Howard and Paul J. Siler
NASD Case No. 97-01394

The case related to the purchase of various limited partnerships. Claimants alleged that these investments were unsuitable and that Respondents failed to disclose the nature and/or amounts of commissions earned off such limited partnerships. Claimants also alleged that Respondents failed to disclose the potential tax consequences of a proposed tax bill (HE3838) that would have replaced the nineteen-year depreciation with a thirty-year depreciation. Claimants asserted that this tax bill would have taken away or diminished the potential tax benefits of real estate ownership. Claimants also alleged Respondents failed to disclose that the limited partnerships continued to purchase properties in the declining real estate market after the proposed tax bill, and Respondents failed to disclose the specific properties which would be purchased by such limited partnerships.

Claimants asserted the following causes of action: breach of fiduciary duty; misrepresentation; unsuitability; failure to conduct due diligence; and concealment. Claimant requested the Panel to award compensatory damages in excess of $1,000,000, plus pre-judgment interest, attorney's fees, and costs.

Respondents denied the allegations in the Statement of Claim and asserted various affirmative defenses, which included but were not limited to statute of limitations and/or repose. In Respondents' counterclaim, they requested that the Panel enter an award adjudicating the eligibility of Claimants' claims pursuant to Rule 10304 of the NASD Code of Arbitration, prior to addressing the merits of the dispute, declare all claims set forth in Claimant's Statement of Claim are ineligible for submission to NASD pursuant to Rule 10304 of the Code.

1. The Panel found Respondent liable for compensatory damages in the amount of $1,342,267.61, inclusive of pre-judgment interest, plus post-judgment interest.

2. The Panel dismissed Respondents' counterclaim with prejudice.

This case is significant because of the United States Supreme Court holding that (1) interpretation of NASD rule imposing six-year time limit for arbitration was a matter presumptively for the arbitrator, not for the court and (2) parties' contract did not call for judicial determination of whether arbitration was time-barred. *Howsam v. Dean Witter Reynolds, Inc.,* 537 U.S. 79, 123 S. Ct. 588 (2002).

Claimant's Counsel - Alan C. Friedberg of Pendleton, Friedberg, Wilson & Hennessey, P.C., Denver, Colorado.

Respondents Counsel - Joseph C. Coates of Greenberg Traurig, P.A., West Palm Beach, Florida

Brenda Exline v. ABD Insurance and Financial Services, Darryl Clark Marks, Rothman Marks, Inc. Rothman Marks Portfolio Management, LLC, and Rothman Marks Charter Fund, L.P.
NASD Case No. 04-03461

Claimant alleged that Respondents mismanaged her accounts by investing in various growth and technology stocks, which according to Claimant were both unauthorized and unsuitable. Claimant alleged that Respondents ignored Claimant's investment objectives and failed to implement appropriate asset allocation or hedging strategies. Claimant further alleged that Respondents failed to implement a supervisory system to prevent Respondent Marks from engaging in reckless conduct.

Claimant asserted the following causes of action: violation of state and federal securities laws; common law fraud; breach of fiduciary duty; negligent misrepresentation; violation of NASD and NYSE Code of Conduct; failure to supervise; breach of contract; negligence; unsuitability; and unauthorized trading. Claimant requested that the Panel award compensatory damages in the amount of $775,000, plus $250,000 in punitive damages, interest, and attorney's fees.

Respondents denied the allegations set forth in the Statement of Claim and requested dismissal, attorney's fees and costs. In addition, Respondents requested that the Panel include in its award a directive to expunge any and all references to this matter from Darryl Marks's CRD.

1. The Panel found Respondents jointly and severally liable for compensatory damages in the amount of $450,000.

2. The Panel found Respondents jointly and severally liable for pre-judgment and post-judgment interest at the rate of 3.5% per annum.

3. The Panel also held that Respondents Rothman Marks, Inc., Rothman Marks Portfolio Management, LLC, and Rothman Marks Charter Fund, L.P. were bound by the determination of the arbitration Panel on all issues submitted despite the fact that none of the above named Respondents submitted an executed uniform submission agreement. The Panel determined that those Respondents were bound by the determination of the arbitration Panel because they filed an answer to the Statement of Claim and appeared through counsel at the hearings.

This case is significant because the Claimant was objectively considered as a sophisticated business woman given that she had owned the largest woman owned advertising agency in Colorado**.** Despite her sophistication in business matters, she was not a sophisticated investor. Furthermore, the broker Darryl Marks was Claimant's former boyfriend. Despite these difficult facts, Claimant prevailed.

Claimant's Counsel - Erwin J. Shustak of Shustak Jalil & Heller, P.C., San Diego, CA.

Respondents' Counsel - Thomas Mauriello of the Law Offices of Thomas D. Mauriello, San Francisco, CA.

Donald R. McFarland v. Edward D. Jones & Company
NYSE Docket No. 2004-015146

Claimant alleged that Respondent mismanaged his accounts by investing in various growth and technology stocks, which according to Claimant were both unauthorized and unsuitable. Claimant also alleged that Respondent at one point recommended that Claimant mortgage his home to purchase stocks. Claimant was a former broker.

Claimant asserted the following causes of action: breach of fiduciary duty; failure to supervise; violation of SRO rules and regulations; unauthorized trading; intentional and negligent misrepresentation; unsuitability; violations of federal and state securities laws. Claimant requested that the Panel award $400,000 in compensatory damages, punitive damages, attorney's fees and costs.

Respondents denied the allegations set forth in the Statement of Claim and requested dismissal, attorney's fees and costs.

1. The Panel found Respondent liable and awarded $154, 698.86 in compensatory damages.

2. The Panel also awarded $69,614.49 in attorney's fees and $12,786.16 in costs to Claimant.

This case is significant because the Panel awarded damages to the Claimant despite the fact that he was a former broker.

Claimant's Counsel - A. Daniel Woska, Esq. of Woska & Hayes, LLP, Oklahoma City, OK.

Respondent's Counsel - Kimber L. Monroe, Esq.

Delores Sancetta v. Salomon Smith Barney, Inc.
NASD Case No. 03-04913

This was a suitability case involving a discretionary account managed under Smith Barney's Portfolio Management or "PM" program. Claimant was a retiree with numerous accounts at Smith Barney. The largest was a PM account managed by the FC on a discretionary basis. Claimants stated investment objectives were aggressive growth. The account peaked in February 2000 at approximately $4.5 million. As the market declined in 2000 and 2001, Claimant alleged that her investment objectives changed and became more conservative. In fact, Claimant visited her broker repeatedly, expressing concern and asking the FC to pull her out of the market. On one occasion, Claimant brought her accountant with her to the meeting with the FC. Each time Claimant expressed concern, the FC advised her to "stay the course" and the account declined more than $3 million from its peak. Over the duration of the relationship, however, the account made more than $1.6 million.

Claimant asserted the following causes of action: violation of industry rules; unsuitability; violation of § 517.301, Florida Statutes; negligence and negligent supervision; and breach of fiduciary duty. Claimant requested damages in excess of $2,000,000 in statutory damages, interest, costs, and attorney's fees pursuant to § 517.211, Florida Statutes.

Respondents denied the allegations set forth in the Statement of Claim and asserted affirmative defenses.

- The Panel found Respondent liable for negligence and breach of fiduciary duty and awarded Claimant compensatory damages in the amount of $890,884.45, plus pre-judgment interest in the amount of $294,431.21.

This case is significant because the arbitration Panel awarded damages for "lost profits."

Claimant's Counsel - Scott J. Link, Esq. and Ryon McCabe, Esq. of Ackerman, Link, Sartory, West Palm Beach, Florida.

Respondent's Counsel - Joseph C. Coates III, Esq. of Greenberg Traurig, P.A., West Palm Beach, Florida.

Michael T. Giesler and Lynda D. Giesler v. Morgan Stanley f/k/a Morgan Stanley DW, Inc. NASD Case No. 03-06593

This was a suitability case involving the mismanagement of Claimants' accounts by independent money managers who were recommended to the Claimants by Morgan Stanley. Claimants were retired and living on fixed income generated by the accounts. Despite the need for immediate income, the independent money managers invested the accounts in aggressive equity investments. The Statement of Claim alleged that Morgan Stanley had a duty to supervise the accounts being managed by the independent money managers. For fifteen years prior to the money managers gaining discretionary authority over the accounts, Claimants' accounts were solely managed by Morgan Stanley. Over those prior fifteen years, the value of Claimants' accounts had grown in value.

Claimants asserted the following causes of action: violations of industry rules, violations of Chapter 517, Fla. Stat., breach of contract, breach of fiduciary duty, common law fraud and negligence. Claimants requested that the Panel award $800,000 in compensatory damages, pre-judgment interest, rescission, attorney's fees, punitive damages and costs.

Respondent requested that the Statement of Claim be dismissed in its entirety and that Respondent be awarded its fees and expenses, including forum fees and all other costs of the proceeding. Respondent also filed a counter-claim for indemnification.

The Panel found that the Respondents were negligent and awarded Claimants $48,000 in compensatory damages. All other claims including the counterclaim was denied in its entirety.

This claim is significant because the Panel applied the "no netting" rule and rendered a favorable award despite the fact that the Claimants had no NOP losses.

Claimants' Counsel - Darren C. Blum, Esq. of Blum, Silver & Schwartz, LLP., Plantation, Florida.

Respondent's Counsel - Peter W. Homer, Esq. Homer & Bonner, P.A., Miami, Florida.

J. Steven Beinhauer et.al v. Lawson Financial Corporation, Robert W. Lawson and Paul Joseph Ballon, Jr.
NASD Case No. 01-05129

This case involved the unlawful sale of highly speculative municipal revenue bonds to Claimants. These investments were sold to the Claimants as safe, secure and suitable for the retired couple who had no other source of income. Respondents represented to the Claimants that of the over 1200 municipal bonds sold through Lawson Financial, only 13 of them had resulted in default. Respondents did not adequately inform Claimants of the risks associated with the bonds going into default and represented to the Claimants that each bond had a debt reserve that in essence guaranteed its safety. Most of the municipal bonds recommended ended up in various stages of default.

Claimants asserted the following causes of action: violations of Sections 517.301 and 517.211, Fla. Stat.; breach of fiduciary duty; unsuitability; misrepresentations and omissions; violations of the Fla. Admin. Code and negligence. Claimants requested that the Panel award compensatory damages greater than $1,400,000 but less than $2,000,000; punitive damages; rescission; interest; costs, and statutory attorney's fees.

Respondent requested that the Statement of Claim be dismissed in its entirety and that Respondent be awarded its fees and expenses, including forum fees and all other costs of the proceeding. In addition, Respondents requested that the Panel include in its award a directive to expunge any and all references to this matter from Respondents' registration records maintained by the NASD Central Registration Depository (CRD).

The Panel found Respondents jointly and severally liable for violations of Sections 517.301 and 517.211, Florida Statutes, breach of fiduciary duties, misrepresentation and omissions, and negligence.

1. The Panel required Respondents to re-purchase or rescind many of the municipal bonds underwritten by Lawson Financial at the purchase price.

2. The Panel awarded costs to the Claimants in the amount of $23,930.54.

3. The Panel required Respondents to reimburse Claimant for the filing fee.

4. The Panel awarded attorney's fees to be determined by a court of competent jurisdiction.

This case was significant because the Claimants were able to impose Chapter 517 liability on Lawson Financial as the underwriter of the municipal bonds.

Claimants' Counsel - Jeffrey Coleman, Esq. of the Coleman Law Firm, Clearwater, Florida.

Respondents' Counsel - Amy Hass, Esq. and Peter J. Anderson, Esq. of Sutherland Asbill & Brennan, LLP, Atlanta, Georgia.

Priscilla J. Gontram, Individually and as Trustee of the Priscilla Gontram Trust v. Salomon Smith Barney and David McKay
NYSE Docket No. 2003-012086

This case involved the mismanagement of an account held by Claimants. Claimants alleged unsuitable and unauthorized trading in high-risk, highly volatile securities. Ms. Gontram was a stay at home mother who received a lump sum of $1.3 million as a result of a divorce settlement. The SSB account was opened in 1994 and aclaim was not filed until 2002. Claimants alleged that the accounts were aggressively invested which allowed Mr. McKay and SSB to earn more than $100,000 in fees, commissions, and margin interest. Claimant requested damages from 1997 going forward. In its Answer, SSB cited to trading in the account prior to 1997 in an attempt to show that the Claimant had a history of speculative investing.

Claimants alleged the following causes of action: unsuitable recommendations; unauthorized trading; fraud; negligence; breach of fiduciary duty; failure to supervise; mismanagement; wrongful transfer of assets and funds; violations of state blue sky laws; and violations of NASD and NYSE Conduct Rules. Claimants requested that the Panel award compensatory damages in excess of $1 million, punitive damages, attorney's fees, costs, and pre-judgment interest.

The Panel awarded Claimant $709,465.00, including $427,068.00 plus simple interest, compounded annually, at a rate of three percent, from October 2000 through October 2004, and $228,805.00 in compensatory damages without interest.

This case is significant because the Panel found that Respondents waived their statute of limitations defense because Respondents used trading in the account prior to 1997 as a defense in the Answer. This allowed Claimants to increase the net out-of-pocket damages.

Claimants' Counsel - Janet K. DeCosta, Esq.

Respondents' Counsel- Bruce Campbell, Esq. of Portland, Oregon and William A. Hohauser, Esq. of New York, New York.

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Upcoming Events:

7th Annual Securities Law Update, September 28, 2005.
La Costa Resort and Spa. Carlsbad, California.

PIABA 14th Annual Meeting September 29 -October 1, 2005. La Costa Resort and Spa. Carlsbad, California.

PIABA Board of Directors Meeting, October 2, 2005.
La Costa Resort and Spa. Carlsbad, California.

California Mid-Year Meeting, March 4, 2006,
Crowne Plaza @ LAX. Los Angeles, California.

PIABA Board of Directors Meeting, March 11-12, 2006,
Location to be announced

Midwest Mid-Year Meeting, March 18, 2006
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.