Public Investors Arbitration Bar Association Vol. 12 No. 3 Fall 2005

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

FEATURES AND COLUMNS

Presidents Column by Robert S. Banks 1

ProfLipner's "I Love New York Law"
Mistakes Claimants' Lawyers Make by Seth E. Lipner 4

The Futures Industry: From Commodities to the Over-The-Counter Derivatives Markets-Origin, Purpose, Development, Controversy, and Regulation of the Most Volatile Financial Contracts in the World by Kurtis Ward 8

Theories Of Involuntary Fiduciary Liability by Angela H. Magary 29

Expert's Corner
The Roles And Responsibilities Of The Branch Office Manager by Frank A. Sullivan 36

Recent Arbitration Awards by Jason Doss 44

Cases & Materials by Charles W. Austin, Jr. 46

www.PIABA.org

The Bar Journal of the
Public Investors Arbitration Bar Association

From the Editor's Desk

by Andrew Stoltmann
PIABA Bar Journal
Editor-in-Chief
Stoltmann Law Offices, P.C.
10 S. LaSalle Street, 33rd Floor
Chicago, IL 60603
312.332.4200
312.332.4201 fax
Stoltmann1234@hotmail.com

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

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Winter, 2005 issue of *PIABA Bar Journal* is December 30, 2005. All submissions should adhere to the following format:

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

1. One inch margins top, bottom and sides.
2. Single Space text; double space between paragraphs.
3. Do not indent paragraphs.
4. Put the title of the article at the top followed by the author's name and a short author biography.
5. Do not use footers or headers.
6. Use footnotes rather than endnotes.
7. Attachments should be a clear, quality copy suitable for reproduction.
8. Attachments requiring reprint permission should be submitted with written authorization from the prior publisher.
9. PIABA reserves the right edit or reformat materials as required.

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

By mail, send submissions to:

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

PIABA Bar Journal
2005 Board of Editors

Andrew J. Stoltmann
Editor-in-Chief
Chicago, IL

Samuel B. Edwards
Managing Editor
From the Lone Star State
Houston, TX

Seth E. Lipner
Contributing Editor
Garden City, NY

Charles W. Austin, Jr.
Cases & Materials
Richmond, VA

Jason Doss
Arbitration Awards
Atlanta, GA

Mark Tepper
Contributing Editor
Ft. Lauderdale, TX

David Robbins
New York, NY

Jena Borden
East Alton, IL

Melanie Cherdack
Miami, FL

Carl Carlson
Seattle, WA

***PIABA Bar Journal** is a publication of The Public Investors Arbitration Bar Association (PIABA) and is intended for the use of its members. Statements and opinions expressed are not necessarily those of PIABA or its Board of Directors. Information is from sources deemed reliable, but should be used subject to verification.*
No part of this publication may be reproduced in any manner without the written permission of the publisher.

2005 © PIABA

President's Column

By Bob Banks

Supreme Court Nominee Samuel A. Alito, Jr.

As I write this, the Senate Judiciary Committee is preparing for confirmation hearings on Judge Samuel Alito's nomination for Justice O'Connor's seat on the Supreme Court. Much has already been written and said about Judge Alito's conservative judicial philosophy. The media reports suggest that this nomination does not bode well for anyone representing individuals against corporations. To try to gauge what the future might hold for investors in arbitration if the Senate confirms the nomination, I decided to read a sampling of Judge Alito's decisions. I did not find any decisions on investors' rights in securities arbitration, but I did find cases involving securities law and obligations to arbitrate. While the news was not all good, I was somewhat relieved by what I found.

I read several opinions on the validity and scope of arbitration provisions. In the most controversial case I read, *Bazzone v. Nationwide Mutual*, 123 Fed. Appx. 503 (3d Cir. 2005), an insurance agent sued Nationwide Mutual for "redlining" (refusing to write insurance policies for persons in low income areas), which he claimed hurt his homeowner's and automobile insurance business. He was an NASD member because he also sold variable annuities. The agent sued in federal court, but the district court granted Nationwide's motion to compel arbitration. The case was arbitrated before an NASD panel, and the agent lost. On appeal, the agent argued (and the dissent agreed) that the claims were not arbitrable because they were unrelated to the sale of securities, were not governed by NASD rules, and were simply not a part of the agent's agreement to arbitrate as contained in the U-4.

Judge Alito joined another judge (with one judge dissenting) in affirming Bazzone's duty to arbitrate his redlining claims with Nationwide because of the broad arbitration provision in the insurance agent's U-4. Although the result was anti-plaintiff, the U-4 arbitration language is broad enough to allow reasonable minds to differ on its effect. It requires the arbitration of any dispute:

> arising out of or in connection with the business of any member . . . or arising out of the employment or termination of employment of associated person(s) with any member, with the exception of disputes involving the insurance business of any member which is also an insurance company . . . between or among members and associated persons.

Bob Banks received his BA from Reed College (1977) and his JD from the University of Wisconsin Law School (1982). He has a plaintiffs' securities law practice with an office in Portland, Oregon. He has held several bar leadership positions, and has written and spoken extensively on topics relating to securities law and arbitration. He has been a member of the PIABA Board of Directors for 5 years, and is currently PIABA's president. He may be contacted at rbanks@bankslawoffice.com.

The case also affirmed an earlier ruling that the exception from arbitration of "insurance business" did not apply, because that term was ambiguous and failed to overcome the presumption favoring arbitration. The dissent agreed with that part of the outcome, but for different reasons.

The court reached a different result in *Kaplan v. First Options (In re Kaplan)*, 143 F.3d 807, 815 (3d Cir. 1998). Judge Alito, writing for the majority, affirmed an earlier Third Circuit *Kaplan* ruling that an owner of a brokerage did not consent to the jurisdiction of an arbitration panel in a case brought against him and his firm by a clearing broker because he was not a party to the arbitration agreement. The case also held that res judicata principles would not bind an individual to an arbitration decision made against his firm, even if he was the sole shareholder and had controlled the firm's arbitration.

In another case, *Trippe Mfg. Co. v. Niles Audio Corp.*, 401 F.3d 529 (3d Cir. 2005), Judge Alito, writing for the court, reversed in part an order compelling arbitration. There, Niles signed a distributorship agreement with Weber that included an arbitration clause. Weber later sold its assets to Trippe, and as a part of the sale Trippe assumed those obligations Weber owed to Niles after August, 2001. Niles sued Trippe for breach of the distributorship agreement and to compel arbitration. The district court ordered all disputes between the parties to arbitration. Judge Alito reversed the district court in part. He held that Trippe did have a duty to arbitrate with Niles (even though it had no contract with Niles) because it assumed Weber's obligations under the distributorship agreement. However, Trippe had a duty to arbitrate only those claims that arose after August, 2001; it had no duty to arbitrate claims unrelated to the obligations that it had assumed.

In *Luden's Inc. v. Local Union No. 6 of the Bakery, Confectionery & Tobacco Workers Int'l Union*, 28 F.3d 347, 364-365 (3d Cir. 1994), Judge Alito wrote a dissenting opinion, siding with the employer and arguing that the claims there were subject to arbitration. There, a 1988 collective bargaining agreement contained an arbitration provision. The agreement expired, and the majority, apparently sua sponte, found that the parties were operating under an implied-in-fact agreement containing the same arbitration requirement found in the 1988 agreement. While the result was in favor of the employer and against the employees, the reasoning in Judge Alito's dissent was not illogical.

Two of Judge Alito's opinions on the duty to arbitrate, *Bazzone* and *Luden's*, may simply express a propensity for finding in favor of employers over employees. Based on the decisions discussed below, however, I think that would be an unduly simplistic and pessimistic analysis. I prefer to read these decisions to say that Judge Alito adheres to precedent, and that he applies a presumption in favor of arbitration. He will scrutinize contracts with arbitration clauses to determine whether the claims being asserted come within the scope of the agreement to arbitrate. In most cases (*Bazzone* arguably being an exception), he will strictly construe those obligations. While strict contract constructionists are not usually friends of consumers or investors, these cases do not foreshadow any bias for or against any party in the customer against brokerage firm context.

I read one Alito decision involving arbitration procedure. In *Hay Group, Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404 (3d Cir. 2004), Judge Alito refused to enforce a discovery subpoena duces tecum in an arbitration, writing that subpoena power under Section 7 of the FAA is limited to compelling non-party witnesses to bring documents to a hearing. Although I believe discovery subpoena power is oftentimes as important for claimants as it is for respondents, many PIABA members have advocated for just such an interpretation of the FAA.

My optimistic view of Judge Alito is based on the securities class action cases that I read. There, he was not anti-investor. In *In re Burlington Coat Factory Sec. Litig*., 114 F.3d 1410, 1435 (3d Cir. 1997), and in *In re Westinghouse Sec. Litig*., 90 F.3d 696, 717 (3d Cir. 1996) he reversed district court decisions which had dismissed securities class actions on Rule 12(b)(6) grounds, and reinstated the cases. In an ERISA case, *Dailey v. National Hockey League*, 987 F.2d 172 (3d Cir. 1993), Judge Alito wrote a dissenting opinion in which he disagreed with the majority affirming a dismissal, and opined that the plaintiff had pled claims for breach of fiduciary duty and violations of his ERISA rights. In a RICO case, *Kehr Packages v. Fidelcor, Inc.*, 926 F.2d 1406, 1419 (3d Cir. 1991) Judge Alito dissented from the majority, construed RICO provisions broadly, and disagreed with the dismissal of a case alleging investment fraud.

Only one of the Alito securities cases that I reviewed expressed an opinion against the investors. In *Yang v. Odom*, 392 F.3d 97 (3d Cir. 2004), a statute of limitations case, Judge Alito dissented in part. He agreed with the majority that a deficiency in a class representative will toll the statute of limitations so that an appropriate representative can appear. But, he found on the record that class certification had been based on "defects in the class itself," rather than "deficiencies" of the class representative." In those instances, he wrote, the statute of limitations should not be tolled.

In reporting on Judge Alito's nomination, the media has focused its attention on cases in which he came down against abortion rights and gun control. As a citizen concerned about those issues, I have some reservations about Judge Alito. But, as a PIABA member representing investors who have been wronged by the brokerage industry, I see no cause for alarm. Given the Bush administration's views towards lawyers representing fraud victims, we could do a lot worse.

ProfLipner's "I Love New York" Law Column: Mistakes Claimants' Lawyers Make

Seth E. Lipner[1]

Seth E. Lipner is Professor of Law at the Zicklin School of Business, Baruch College, CUNY, and is a member of Deutsch & Lipner, a firm which represents investors against the financial services industry. He can be contacted at ProfLipner@aol.com

Introduction

Claimants' lawyers, especially those new to securities arbitration, routinely make errors. I know, because I've made these errors myself. In this article, I've compiled the top five errors made by me and my colleagues. To err is human. To do it after reading this article will needlessly cost you and your client time and money.

The Top Five List

1. **Inadequate Pre-Filing Preparation**

Undoubtedly, the most costly mistake can be having factual errors in the Statement of Claim. In arbitration, partly because of the nature of the tribunal, Claimants have a significant burden of proof. And since an investor's injuries are not "physical", a lawyer is making a mistake if s/he expects sympathy alone to shift that burden. Even a brokerage firm's systemic fraud or a broker's obvious violation of industry rules is sometimes not enough for the arbitrators to give your client the "benefit of the doubt".[2]

In that environment, any slip will be fatal. Since the defense's closing argument is certain to center around the Claimant's credibility, your efforts to achieve consistency must start at the pre-filing stage. This must be a team effort by lawyer and client. After listening to a client's tale and reviewing the basic documents, an experienced lawyer will know immediately where the defense will head; the client does not know that direction, but the client knows the side-facts - investment history, relationship details, instances of "supervision", etc. It is up to the lawyer to ferret them out early, in order to avoid the inconsistencies upon which the defense will inevitably harp.

At a minimum, therefore, clients ought to be asked by the lawyer to provide (a) all monthly account statements, correspondence and documents concerning the respondent; (b) tax returns for the past three (3) years at a minimum; and, (c) monthly account statements from all other brokerage firms where the client maintained accounts, even if those accounts are now closed.[3] Indeed, providing a client with the entire Notice to Members 99-90 list (the Discovery Guide) and reviewing those documents pre-filing is a prudent course to follow in many cases.

While it is not always necessary to provide a highly-detailed factual statement in the Claim, it is often useful to do so. Not only does such a recitation help begin the persuasion process (when and if the arbitrators read the Claim), but it helps the client to get his own

---

[1] Previously printed in PIABA Annual Meeting Materials, 2005

[2] In fact, the strategy of relying too heavily on the complaints of others can backfire if the arbitrators sense that the Claimant's grievance has an element of "me-too-ism" in it.

[3] Be sure separately to mention uncertificated mutual fund shares and IRA and 401k accounts. Some investors don't think of those things as "securities accounts".

facts straight and to focus on details. Since the hearing will be about details, the earlier the client focuses on them the better. And the more that is committed to writing when events are fresh in the client's mind, the easier it will be for that client to use the Claim to recall those events when he testifies a year-and-a-half later.

Indeed, the factual portion of a Statement of Claim is far more important than the portion reciting the legal "claims" being asserted. Clients must be encouraged to take active part in the drafting and review stages - in making the claim "perfect". And it must always be remembered that many arbitrators are not lawyers, and some arbitrators who are lawyers are not experienced litigators. In such an environment, a good "telling" and plain language are far more important than making the right legal incantations.

When lawyers do inadequate pre-filing preparation, the result is not just the danger of inconsistency. Failure to develop fully all the facts at the earliest stage leads to the kind of cookie-cutter approach that does not serve the interests of the securities arbitration clients. Unlike a personal injury case (where the moment of the accident is isolated and easily-defined), securities arbitrations are about "relationships" - often long-term, confidential relationships. The lawyer who does not take time to develop the facts early is making a BIG mistake.

2. Relying Too Much On The Expert

Too many lawyers rely on their expert to prove their case. In doing so, the lawyer neglects his role, and the lawyer also damages the expert's credibility. Most arbitrators are skeptical of experts - and rightly so. The expert's opinion is perceived as being "bought" and not objective. The expert too often encroaches into the domain of the arbitrator - for example opining on how the arbitrators should interpret certain facts.

When a lawyer looks to the expert to become the advocate - to explain and prove up the case to the arbitrators - that lawyer is feeding the arbitrators' perception of non-objectivity. The best advice I can offer is: the less the expert "opines" the better.

That's not to say experts aren't useful. They can be critical in explaining complex investments; they are needed to quantify risk and/or damages; and they can explain obscure supervisory procedures. Experts who turn into advocates inevitably go too far out on the limb, where a skilled attorney on the other side of the table can most easily do damage on cross-examination.

Similarly, experts who just tell the arbitrators what the arbitrators already know are a turn-off. If an arbitrator concludes that "even I know more than that expert", calling that expert was a mistake. The care and feeding of experts is important. In the "expert business", there is sometimes an incentive for experts to inflate their expertise - but that inflation almost always comes out on cross. At the same time, actual "been there, done that" experts can be hard to find when dealing with complex investments. Ex-securities industry folks sometimes have un-revealed baggage. And if their prep is weak because, e.g. they are over-committed - it's a mistake to have experts opine too much for too long.

In short, experts are hard to control. They can help, but they can hurt. The main point here, however, is not that they can hurt - but rather that they can't help overcome the main burden every arbitration claimant faces - the burden of establishing a credible claim. In the end, all Claimants must win that credibility contest, and as to that part of the contest the expert can't help the Claimant. The expert can assail the Respondent, but the expert can't help the Claimant's credibility.

3. Going On Too Long

Arbitration is often boring for the arbitrators. They are usually locked, in a windowless room, with lawyers, sweating clients, used-stock salesman (a/k/a "brokers") and maybe some long-winded experts. If you are not Ted Eppenstein, you need to keep it short and pithy.

Start with a chronology and a book of well-organized exhibits. The failure to have a good road map and ordered documents adds to the arbitrators' pain. Pre-marked exhibits are a virtual must, and most experienced securities arbitration attorneys prepare a "book". A common mistake is to not number the pages of multiple-page exhibits. It is quite painful watching three arbitrators fumble with your documents. "What page are we on? Does anyone know? I seem to be missing the third page" is heard too often in arbitration.

Another mistake is demonizing your adversary (even if he deserves it). Arbitrators don't like lawyer-squabbles since the case is about the clients. Don't get drawn into such a fight. And if, at

hearing time, there are still document issues, pick your spots; don't whine on. It's time to get on with it. Pick on the Respondent. If the arbitration conduct was bad, blame it on the party. Try not to blame the lawyers (even though it is really them).

Then prove only what you need to prove to win. If you don't *need* to prove malicious intent, don't harp on it. I'm not saying ignore it, but don't harp on it. Often proving negligence is enough to win. (But see Mistake #4).

Of course, the more time any witness spends of the stand, the greater the chance of damage. That applies to clients, experts, brokers and supervisors. And, if it is Respondent's witnesses damaging Respondent's case, the arbitrators need to be listening (and to care) when the damage comes out. So keep the presentation moving. Stick to the main points. Snoring is not always caused by the arbitrator's age.

4. Not Answering The Most Important Question

The single most important question in an arbitration is usually asked by Respondent's counsel, in a tone of over-acted incredulity: "Why would a broker dooooo that?" Whether you think that question directly relevant or not, it is an important question. Arbitrators, who see and hear a few days' testimony about years of events, often have difficulty determining the "whole truth". Inevitably, arbitrators find assistance in determining "truth" by looking at the motivations of the people involved.

The Respondent has an easy time of ascribing to Claimant the motivation the Respondent wants to ascribe - greed a/k/a the desire to make money.[4]

But why would a broker recommend, for example, risky securities when lower risk ones were out there that offered the same (or larger) commissions? To win, the investor's lawyer must answer that question.

The answer may be commission-related but it can also be a product of the inexperience or hubris of the broker, who, like the professional baseball player, does not have to go to college. Perhaps the broker needed to promise high returns to win the account. Or the company was pushing the security. Or maybe it was a just a "rookie" mistake.

Whatever the reason, the investor must answer this main question: Why did the broker do what s/he did? And then, of course, the lawyer must be ready when the defense shifts to "So what's wrong with that? No one held a gun to the Claimant and forced him to invest as we recommended. Everyone knows, even my grandmother, that there's risk in any investment. There is always risk to principal."

5. Making Complex or Incredible Damage Claims

It has been my experience that arbitrators, more often than not, get liability issues right. However, it is also my experience that they usually get damage issues wrong. Sometimes horribly wrong.

Screwy damages may just be a feature of the arbitration environment, where arbitrators aren't currently required to give reasons[5], and deliberations often result in compromise among the panel. But, that aside, regardless of the "math", it is a mistake *not* to give the arbitrators a compelling number to award. Not just the biggest number, or the "statutory measure", but a compelling number.

What is a compelling number? One that will strike the arbitrators' sense of fairness. One with which, during the arbitrators' deliberations, even the most jaded of arbitrators will say: "Yes. That's the right thing to do."

Obviously, the facts must control. Time period and set-off issues arise in many cases and the Claimant's attorney must be prepared with arguments justifying the period for damages and

[4] Of course, there's nothing inherently wrong with wanting to make money. But sarcasm about "risk" sometimes works for Respondents. It doesn't work for Claimants.

[5] Although this may improve somewhat with the NASD's new Explained Decisions rule, which requires arbitrators to set forth fact-based reasons for their Awards. However, the rule does not require them to explain the math of their numbers.

the composition of damage within that period. Calculations that simply accrue the losses and ignore gains or dividends are usually not accepted. Loss measurement must always be from a definable point, and must, again, strike the arbitrators as "fair". The damages must pass the smell test and not give off a bad odor.

Readable charts (9th grade level) are a must. If you are relying on a statute for computing damages or interest, attach a copy of the statute.

It is a mistake to put forth a damage calculation that supports your adversary's argument that this case is evidence of the Claimant's "greed", "sour grapes" or that old standby: "20-20 hindsight" (as if hindsight weren't always 20-20). The damage request must be compelling.

What Should You Do?

Having described these five common mistakes, I feel the need to be more positive and list five things Claimant's lawyer's should do:

1. Teach your client to speak with a British accent. It enhances credibility.

2. Highlight relevant portions of exhibits. Then leave all un-highlighted copies home (in case anyone objects).

3. Offer your client a modest fee reduction if s/he says "Because I trusted [the broker]" more than 25 times.

4. Hire an actor/actress to play your client; after all, the broker has never met him/her.

5. Advise your client to relax, and just tell the story in ***your*** own words.

FINAL THOUGHTS

Aside from these more humorous suggestions, there is only one recipe for success, and it is simple - take good cases, develop the facts, and be more prepared than your adversary. But avoiding the mistakes ("while keeping your errors to a minimum," as Tom Fehn says), is absolutely crucial in every case.

The Futures Industry: From Commodities to the Over-The-Counter Derivatives Markets-Origin, Purpose, Development, Controversy, and Regulation of the Most Volatile Financial Contracts in the World.

By Kurtis J. Ward

Kurtis J. Ward has spent the last 17 years in the futures industry as a commodity futures and introducing broker. Now a lawyer, Kurtis devotes his law practice to representing investors nationwide who have investment-related disputes with brokerage firms, brokers, investment advisors, banks, and insurance companies. He is an Arbitrator with the National Futures Association (NFA) and also serves as an Arbitrator with the National Association of Securities Dealers (NASD). He is a member of the Public Investors Arbitration Bar Association (PIABA). Kurtis can be reached at (405) 210-3969 or by visiting www.KurtisWard.com.

INTRODUCTION TO THE FUTURES MARKETS

The Futures markets are often overshadowed by the highly prolific and actively traded securities markets. Only a few token moments on the popular financial television programs are devoted to the Futures Markets with just a handful of prices quickly flashed across the screen as the program fades away for commercial break.

Lack of television coverage may seem to indicate that Futures are somewhat insignificant as compared to the securities markets. However, such a caricature borders on economic heresy as Futures are no longer confined to traditional commodity markets from which they evolved. Historically, Futures were called "Commodities" or "Commodity Futures". However, explosive growth during the last two decades has occurred with Futures contracts expanding into many new frontiers such as "energy" (crude oil, unleaded gas, heating oil, natural gas, and electricity), "currencies" (British Pound, Japanese Yen, Swiss Franc, Euro Currency, and U.S. Dollar Index), "interest rates" (Eurodollar, T-Bonds, T-Notes), and "stock indexes" (S&P 500, Nasdaq, Dow Jones). Today, the term "Commodities" (although still in use) is slowly being replaced in favor of the more general and all-inclusive term, *Futures*.

Entities concerned about fluctuations in these markets transcend the typical grain and livestock producers of past decades. Today, oil and gas producers, mutual fund companies, hedge funds, domestic and multinational corporations, publicly traded companies, utilities, municipalities, states, foreign countries, insurance companies, banks, and other institutions realize their financial stability is not guaranteed should they fail to properly manage their price risk exposure. Futures and Options are the essential tools that market participants use in order to reduce price risks and insure the predictability of profits as they strive for long term financial viability.

The regulatory framework of the Futures Markets was initially designed to guarantee that all transactions would be traded on regulated exchanges through regulated intermediaries subject to a margin requirement system.

During the last two decades, Futures have evolved into other financial products called "Derivatives" which trade *off-exchange* on the Over-the-Counter (OTC) Market in contrast to the typical Futures contracts. During the 1990's, the OTC Derivatives mushroomed into a market that was three times

larger than *exchange traded* contracts.[1] Subsequently, entities trading in Derivatives suffered millions of dollars in losses due to alleged fraud, lack of expertise, poor internal supervision, and improper leverage, while others blatantly failed to appreciate the underpinnings of Derivatives and the colossal risks associated with these financial instruments. Despite the controversy surrounding Derivatives, courts held that these instruments were not securities, therefore, they could not be regulated as such.[2] To solidify their existence, Congress amended the Securities Act of 1933 in the Graham-Leach-Bliley Act to exclude non-security based swaps (swaps are the most common type of Derivative contract) from the definition of a security.[3] Finally, Congress went even further to resolve any question as to the legitimacy of Derivatives when it enacted the Commodity Futures Modernization Act of 2000 (CFMA), which provided for legal certainty for these off-exchange traded contracts, prevented the SEC from regulating security-based swaps, and settled the issue as to who would regulate this largest sector of the Futures industry.[4]

The purposes of this article are to (1) explain the foundational function of *Hedging* and the market participants engaged in this risk management activity, (2) elucidate the historical oversight of the *exchange traded* Futures Markets, as well as its overseer, the Commodity Futures Trading Commission, (3) highlight the strategies that risk managers use to transfer price exposure onto the Futures & Options markets, and (4) summarize the recent proliferation of *off-exchange* traded Swaps, Hybrids, and other financial futures contracts known as *Derivatives,* as well as the political battle to keep these highly leveraged and powerful instruments virtually unregulated.

I. HEDGING: THE FOUNDATIONAL PURPOSE OF THE FUTURES MARKETS

In theory, Commodity Futures are basically "publicly traded forward contracts.[5] Cash forward contracts still survive today in many commodities. For example, a forward contract (also called a cash contract) would occur when a wheat farmer enters into a pricing contract with a grain merchant or miller. Assume that a farmer had just planted his seed wheat in the fall but his wheat crop will not be ready for harvest until summer. A cash forward contract may be drawn up between the farmer and the grain merchant. Even though the wheat had just been planted and harvest was more than six months away, the contract would provide that the farmer deliver his wheat crop to the grain merchant, specifying a certain number of *bushels*, of a certain *quality*, on a certain *date*, at some specified *price*. Because this contract "locks in" a specific, agreed-to-price, the farmer foregoes any opportunity to participate in higher prices (which benefits the grain merchant) should the wheat market continue to rise into the summer harvest. If, however,

---

[1] Russell Wasendorf, Sr., *Innovation Deserves More than 15 Minutes of Fame*, Stocks, Futures & Options Magazine, 21, 24 (June 2003).

[2] *Proctor & Gamble Co., v. Bankers Trust*, 925 F. Supp. 1270, 1276 (S.D. Ohio 1996).

[3] See Gramm-Leach-Bliley Act, 15 USC, Subchapter 1, § 6801-6890 and § 2A of the Securities Act of 1933.

[4] Commodity Futures Modernization Act of 2000.

[5] Stuart R. Veale, *Stocks, Bonds, Options, Futures* 209 (New York Institute of Finance 2001).

the price of wheat moves lower into harvest, then the farmer would benefit from the cash contract (to the detriment of the grain merchant) since the previously negotiated price was higher. In both scenarios, the farmer brings his wheat to the grain merchant shortly after it is harvested thus "delivering" the quantity of bushels as provided for in the contract.[6]

Basic contract law principles apply as the farmer looks to the grain merchant for performance of the contract (payment for delivering the wheat). Likewise, the grain merchant looks to the farmer to perform in accordance with the terms of the contract (delivering a certain number of bushels, of a certain quality, by a certain date). However, suppose the price of wheat doubles or even triples by harvest time. The farmer may be tempted to default (fails to deliver the wheat to the grain merchant) and just sells the wheat to someone else at the existing market price, thus breaching his contract with the grain merchant in order to get the higher price on the spot market. Now, the grain merchant will still need the wheat after harvest because most likely it will have other contracts to fulfill with flour mills to deliver wheat during that time. Therefore, the grain merchant may be forced to buy wheat on the open market at the higher price to make good on its other contracts and later sue the farmer for damages incurred due to the farmer's breach (failure of the farmer to deliver wheat at the previously agreed price).

This opportunity for breach is referred to as "counter-party risk" which is present when two parties enter into a contract. Likewise, the farmer has counterparty risk because if the price of wheat drops precipitously, then the grain merchant may be the one tempted to breach (especially if they had guessed wrong on the market direction and failed to lay off this risk by offsetting cash contracts with flour mills or other end users of wheat). Law students (in first year Contracts) learn that many breach of the contract cases occur during times of rapid price inflation and deflation in the economy. Large price moves (in either direction) catch many market participants off-guard, which, in turn, causes extreme financial repercussions to the contracting parties. This counter-party risk (i.e. failure of one party to perform) is the most often underestimated risk component of any transaction, especially when the contract involves the price performance of a commodity or futures market.

One of the benefits of using *exchange traded futures contracts* (rather than cash forward contracts or off-exchange Derivatives contracts) is that *the counter-party is now a U.S. Commodity Exchange* as opposed to an individual or corporation. The exchange acts as a buyer for every seller and a seller for every buyer on each transaction.

While the Futures markets originated with grain contracts in the mid-1800's, it wasn't until the 1970's when they first expanded into "perishable" commodities such as cattle and hogs. Each futures contract has a "contract size" that is very important in determining how many contracts will be needed in the transaction. Regardless of the contemplated Futures contract, a hedger should always begin by looking at the contract size to determine how many contracts are needed.[7] Once the hedge has been placed through the broker and the trade executed on the trading floor, the broker should immediately "report

[6] Interview with Steve Smola, president, Beef Group, Inc. (formerly president of Wheeler Brothers Grain) (March 5, 2004).

[7] Interview with Harlan Coit, President, OKC West Livestock Auction Market (February 26, 2004).

the fill" (execution price) to the client. Thereafter, if the futures markets rallies (which means that the futures position is incurring losses), the clearing firm will require the cattleman to post extra margin if he wants to maintain the positions. If the futures position generated a loss, most likely that futures market loss will be offset by his receiving a higher price in the cash market for the commodities.

In the scenario when the hedger guessed right (placing hedges before the market dropped) the hedger is very proud because, had there been no hedges, there would have been no futures profits to offset the losses sustained by the falling cash market. At the conclusion of the hedge, a cattleman waiting to hedge a cash position would still take his cattle to market when they are ready to sell and then simultaneously call his broker to offset the futures hedge. Although the cash and futures transactions mirror one another, they still are separate and distinct transactions (with separate parties) with their own respective obligations. Frequently when a bank is financing the cattle operation, the lender may require under the loan agreement that the cattlemen hedge some percentage of the cattle. While risk management strategies are infinite with varying degrees of risk and reward, this is the foundational premise for most hedging activity regardless of the underlying commodity.

Futures Markets were also designed to allow "commercials" (large grain merchants) to fulfill their hedging needs and purposes. A commercial hedger might employ a "long hedge". This would occur when one would "buy" the futures contract to lock in the price. In all of these transactions, hedgers using the futures have the ability to determine what percentage they want to hedge and they also have the ability to determine how long they want to hold onto the hedge (not exceeding the end date of the contract). However, there is no requirement to hold the hedge all of the way to expiration of the futures contract. In fact, many producers engage in what is called "spec-hedging" which means they are hedging, but if the futures market goes in their favor by an acceptable amount, then they will take their profit and move back to a neutral or "un-hedged position". This is where the term "spec" is used which is short for "speculation".

Livestock producers, grain producers, agricultural commercial firms, energy companies, and other hedgers (remember hedgers are those who own or expect to own the underlying commodity) are not the only one who use Futures. Small and large speculators, commodity funds, floor traders, hedge funds, mutual funds, professional money managers, banks, and other financial institutions also participate in buying and selling Futures contracts depending on their market outlooks, trading objectives, risk management plans, time horizons, and availability of risk capital.

Even though hedging was the initial purpose that led to Futures trading, the market does not know (nor does it care) if the underlying cash commodity is owned by either of the parties in a Futures transaction. The fact that the trader may own the underlying cash commodity is what classifies one as a "hedger".

Unlike the stock market, Futures trading is a "zero-sum game". This means that for every winning Futures position there is a loser and for every losing Futures position there is a winner. In absolute terms, money is not created or destroyed through trading, it is merely *transferred.* Another distinguishing characteristic of the Futures markets is that it is very easy for a trader to initiate a short position ("sell short") when one suspects a market may decline (unlike the stock market, there is no "down-tick rule" in Futures).

Each Futures exchange itself acts as a buyer for every seller and a seller for every buyer. The exchange's clearing house not only clears all of these trades but also collects funds each

and every day (through the process of the initial and maintenance margin call requirements) from the losers to pay to the winners. In Futures, these positions (and subsequent change in account balances) are "marked to the market", which means funds are credited or debited to each account on a daily basis. Therefore, existing profits that have not been realized (by an offsetting transaction) are still available in the account to withdraw or can be used to margin other positions.

In most Futures markets, the trading pits still exist. This method of trading is called "open outcry", where floor traders use a flurry of hand signals coupled with intense screaming and yelling at one another as they execute the trades in the pit. Thousands of contracts trade on a daily basis as the market reacts to a variety of factors on its never ending quest of "price discovery". Price quotations run out into future months.

II. REGULATION OF THE COMMODITY FUTURES INDUSTRY

Regulation of the Futures Industry was under the domain of the states until Congress passed the Grain Futures Act of 1922 which was signed into law by President Warren Harding.[8] The Grain Futures Act (which predates the Securities Act of 33 and the Securities Exchange Act of 34) gave the United States Department of Agriculture (USDA) the power to regulate the Futures market.[9]

In 1936, Congress enacted the Commodity Exchange Act, which was enforced by the United States Department of Agriculture until 1974.[10] In the 1970's, futures contracts began expanding into non-agricultural markets such as metals, petroleum, financials, and currencies market. Therefore, Congress recommended that an all-purpose agency be created to oversee both the traditional and expanding non-agricultural commodities. This new agency was christened, the "Commodity Futures Trading Commission (CFTC)".[11] The CFTC had to refrain from using the word "securities" which would set off alarm bells at the Securities Exchange Commission which was very eager to regulate these emerging financial products.[12]

After the CFTC came into existence in 1974, the issue of its jurisdiction was quickly challenged.[13] Later, the CFTC's jurisdiction was found to extend to interstate commodities transactions and thus the rules of other agencies did not apply.[14] *Trustman v. Merill, Lynch, Pierce, Fenner & Smith* (CD Cal. Jan, 1985).

---

[8] William D. Falloon, *Market Maker: A Sesquicentennial Look at the Chicago Board of Trade* 157-158 (Board of Trade of the City of Chicago 1998)

[9] *Id.*

[10] See www.futuresindustry.org/regulato-2224.aspOct272004.

[11] William D. Falloon, *Market Maker: A Sesquicentennial Look at the Chicago Board of Trade* 246-247 (Board of Trade of the City of Chicago 1998)

[12] *Id.* At 247

[13] *State of Texas v. Monex International Ltd. (Tex.Ct.Civ App. 1975).*

[14] *Trustman v. Merill, Lynch, Pierce, Fenner & Smith* (CD Cal. Jan, 1985).

In 1981, the CFTC gave its approval for the National Futures Association (NFA) to become the self-regulatory organization (SRO) for the futures industry.[15] Unlike the NASD, the National Futures Association is not affiliated with any one marketplace. The NFA performs several regulatory activities such as (1) auditing members to enforce compliance with NFA financial requirements; (2) establishing and enforcing rules and standards for customer protection; (3) conducting arbitration of futures-related disputes; and (4) performing screening to determine fitness to become or remain an NFA member.[16] The NFA is responsible for regulating Futures Commission Merchants (FCMs), Introducing Brokers (IBs), Commodity Trading Advisors (CTAs), and Commodity Pool Operators (CPO's).[17]

In the 1990's, the Chicago Futures Markets challenged the Over-the-Counter (OTC) market in order to prevent them from developing *off-exchange* electronic trading platforms.[18]

III. BASIC RISK MANAGEMENT STRATEGIES FOR HEDGERS[19]

Risk Management has become the new buzz word for "Hedging", yet both these terms are still used interchangeably. Typically a "Hedger" is a person or entity that takes a Futures or Options position that "offsets" a risk in a concurrent "cash" market position. For example, a natural gas producer (who has gas production coming in from wells each month) could take a Futures or Option position (or a combination of both) that would provide price protection should the market decline. In market jargon, we would say that the gas producer is "*long* the cash" and therefore would need to "*short* the futures market" to shift his price risk exposure onto the Futures Market. Notice how the price risk in the *long cash* is offset by the *short futures*, thus a "Short Hedge" occurs. Of course, the Hedger determines when to hedge, the percentage to hedge, the strategy, the timing, and selects from multiple strategies (each with differing levels of risk, reward, and margin requirements).

However, some smaller producers are not offensive in their trading programs but look at risk management from a more "defensive" perspective. In the Futures markets, *fear* drives many of the market participants (including Hedgers) into various trading situations, whether it is a fear of lower prices (thus prematurely *entering* new short positions) or a fear that margin calls will become too excessive to meet (thus *avoiding* the futures completely and just selling the cash product instead). Yet, while many panic during times of extreme market volatility, some of the larger firms are poised to capitalize on these opportunities as they stand ready to provide liquidity to the market during temporary periods of high volatility.[20]

---

[15] National Futures Association Manual, 1003 (January 2003).

[16] *Id.*

[17] *Id.*

[18] *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 923 F.2d 1270 (7th Cir. 1991).

[19] Kurtis Ward, *Cattle Market of 2003-Risk Management Strategies for 2004* (Oklahoma Cowman 2004).

[20] Interview with Aubrey K. McClendon, Chairman and Chief Executive Officer, Chesapeake Energy Corporation (CHK), www.chkenergy.com (April 28, 2004).

An entity that has negative price risk exposure *if the underlying commodity rises*, would be called a "Long" Hedger. To review, an entity that needs to avoid or minimize price *declines*, would be called a "Short Hedger", while one who seeks to avoid or minimize price increases, would be called a "Long Hedger". Even though the combinations of possible strategies are endless, there are several common risk management strategies used by all Hedgers today. This article will discuss several of these basic risk management strategies from the view point of a "Short Hedger" who needs price protection from a declining market.[21]

SPECULATE ON CASH MARKET:

This first strategy is not really a strategy at all (although it could be viewed as the default strategy of doing nothing). Some commodity producers (who refuse to hedge) say that since they are always selling cash production at regular intervals, they will sometimes sell at market highs, sometimes sell at market lows, and sometimes sell in between. Therefore, they argue that the prices they receive throughout the year should average out in the end. Unfortunately, it was the failure of this strategy (letting the market dictate the price received at time of sale) that served as the catalyst for the development of cash forward contracts and subsequently Futures contracts that would allow producers to make pricing decisions well in advance of selling the underlying cash commodity.[22]

CASH FORWARD CONTRACT:

The result of a CASH FORWARD CONTRACT by itself is almost identical to the result of a STRAIGHT HEDGE BY SELLING FUTURES. The difference is that with a Cash Forward Contract, there is usually no initial margin deposit or subsequent margin calls made by the producer. If the market moves higher after the forward contract is in place, the result is the same had margin calls been made anyway because there is no ability to participate in a higher market if prices rise after entering into a cash forward contract. Cash contracts are usually quoted lower than the prevailing Futures Market price because the entity making the cash contract available to a producer needs to receive some profit for "making a market" in the forward pricing of the cash commodity. In a scenario where the market price drops precipitously, one of the major concerns with a cash contract is *CounterParty Risk*. This is a term which defines the *risk of default* if the market drops so much that the other party doesn't show up in the end to fulfill its end of the contract (i.e. receiving the cash commodity in exchange and paying the producer the agreed price). This happened to many producers in the energy industry in their dealings with Enron. Enron had many ventures, one of which was cash forward contracting with oil and gas producers. When Enron collapsed, it defaulted on many of its cash contracts. When one party to a Cash Forward contract defaults, the other party with damages will need to seek legal representation.[23]

---

[21] Kurtis Ward, *Cattle Market of 2003-Risk Management Strategies for 2004* (Oklahoma Cowman 2004).

[22] *Id.*

[23] *Id.*

BUYING CALL OPTIONS WITH CASH FORWARD CONTRACT:

Producers who enter into cash contracts and are willing to take the counterparty default risks should consider simultaneously BUYING CALL OPTIONS in order to participate should the underlying price of the commodity rise. The cash contract itself provides the unlimited downside price protection. If the Call Option is also bought, the hedger will still be able to participate should the market keep moving higher. The hedger will pay a premium for this Call Option, but the loss from the option will be limited to its initial cost. The Call Option will provide unlimited profit potential at the strike price and above (minus the cost of the option).[24]

BUYING PUT OPTIONS:

Buying Put Options is one of the most basic foundational hedging strategies and essential for any risk management program. Buying a Put allows a "floor price" to be set in at the selected strike price while still allowing one to participate if the market moves higher (unlike the Cash Contract or Straight Futures Hedge). Buying a Put is a one-time expense which means the initial cost of the option is the only financial obligation. There will be no further margin calls when an option alone is purchased. There are several strike prices available on each contract month. The closer the strike price is to the underlying futures contract, the more an option will cost. The "floor price" gives the Put buyer unlimited profit potential at the strike price and below, while the maximum loss from the strategy cannot be more than the initial cost of the option. Some Hedgers buy cheap Put Options at their break-even-price to simply "hold their money together". This strategy usually complies with a bank's lending agreement, which requires their borrower to use some form of risk management.[25]

STRAIGHT HEDGE BY SELLING FUTURES CONTRACT:

When Selling the Futures, the Futures Price is locked in. Margin money must be deposited with the broker. This margin money is earnest money (good faith funds) that will be used to offset any losses in the account should the market keep rising. There is *unlimited risk if the market rises* and the position is subject to on-going margin calls that must be immediately met to keep the positions from being liquidated by the brokerage firm. There is also *unlimited profit potential to the downside in a declining market*. If the market drops, money immediately flows into the futures account even before the position is offset. There is virtually no Counter-Party Risk because the exchange is the other party to the transaction, not some person or small corporation like in a cash forward contract. Basically, Futures are really "exchanged traded forward contracts" that have been standardized so that all terms (contract size, grade, delivery, etc) are uniform and disclosed to all market participants. The Futures market gains or losses are then either credited or debited to the concurrent cash market transaction to complete the analysis of this risk management strategy.[26]

THE WINDOW/FENCE: (BUYING PUTS / SELLING CALLS):

This strategy is rather complicated and is not suitable for the first time hedger. Basically, a floor price is set in at the strike price where the Put is bought. This strategy also requires that a "ceiling price" be set in somewhere

---

[24] *Id.*

[25] *Id.*

[26] *Id.*

above the current futures price which is done by Selling a Call. The advantage is the market will pay back some premium for setting in the "ceiling price" and this premium can be used to offset some of the purchase price of the Put. Because there is extra premium obtained from Selling the Call, a higher strike price on the Put might become more affordable when using this strategy. Experienced hedgers use this strategy to set in a higher floor price because the Call that is sold offsets much of the cost of the Put. Because of the "ceiling price" created from Selling the Call, initial margin money is also required (in addition to the cost of the Put). There is now unlimited risk above the Call strike price and additional margin calls will be required if the market moves higher.[27]

COSTLESS COLLARS (another type of WINDOW/FENCE):

The Call Option that is sold is at or near the same price as the Put Option that is bought. Thus, the price of the protection nets out near $0 (zero dollars). Margin money for Selling the Call is also required as well as the potential for additional margin calls. As the name "costless" implies, as long as the Futures Price stays below the strike price of the Call, the protection in the end will cost almost nothing and will still provide unlimited downside protection at the strike price of the Put.[28]

THE BUTTERFLY: (Another type of WINDOW/FENCE with a twist):

The Butterfly starts out as a Window/Fence except that another Put is also sold several strike prices below the first Put Option that was bought. Selling this other Put is the extra twist because it cheapens up the cost of the Window because more premium is received from the additional Put that is sold. Profit potential is no longer unlimited to the downside but is now limited to the difference between the two strike prices of the Put Options (less their net cost). In a steep drop in prices, the profit potential from this risk management strategy is limited.[29]

PUT SPREAD: (BUYING A PUT / SELLING A PUT):

Basically it is the Butterfly above without the Ceiling Price since no Call Option is sold. If the Cash and Futures Market moves higher, there is full participation to the upside and no margin calls. To the downside, the most that can be made is the difference between the strike prices of the two puts (less the net cost). It is a one-time expense and there is no subsequent margin calls. This strategy may be appropriate when volatility levels are such that the options seem too expensive but some protection is still desirable. In a market crash, the profit potential from this strategy is also limited.[30]

SYNTHETIC PUTS: (SELLING FUTURES / BUYING CALLS):

This complex hedging strategy works very similar to the simple strategy of just buying a Put but has much more flexibility. The traditional Put Option allows the buyer to pay a premium for a certain strike price, which provides unlimited protection at the selected strike price. In the Synthetic Put, the Futures are sold (for the downside protection) and a Call option is bought to keep losses from the

---

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] Id.

futures predetermined should the market continue to rally. For advanced hedging programs, this strategy provides some the greatest flexibility because either side of the position could be liquidated in some profitable situations (but doing so will of course change the risk structure of the entire hedge).

One of the drawbacks of Synthetic strategies is that they have the largest requirements for initial margin money since the option that is purchased must be fully paid for and the margin for the entire futures position must be met as well. When the futures position is losing large amounts of money, those margin calls must be met even though the option may be absorbing most of the loss. This anomaly is possible because gains in option value due to market appreciation (unlike futures) cannot be used for margin purposes. Even though the option may be shielding actual losses from the futures position, the gain in value from the option cannot be *realized* until it is liquidated. Experienced risk managers realize that even if they are forced to send in additional margin funds during the time of this synthetic strategy, once the option is liquidated, those extra margin calls will be returned.[31]

SUMMARY OF RISK MANAGEMENT STRATEGIES:

For all commodities, futures, and derivatives, a risk management program is essential for any entity's long-term survival. It does not matter much if the hedging plan is simple, moderately advanced, or extremely complex. For best results, top risk managers combine several of these hedging strategies rather than focusing on just one, realizing these strategies are tools for transferring price risk from the cash market onto the Futures market (each with different levels of risk and reward) all working together to minimize price risk and insure long-term financial viability.[32]

IV. DERIVATIVES, SWAPS, CONTROVERSIES, COURTS & CONGRESS

Commodity cash forward contracts were the predecessors of what became a sophisticated collage of Futures contracts which now trade on Commodity Exchanges around the world. It could be said that Futures and Options were "*derived*" from the underlying cash commodity from which they were created to emulate. Over the past two decades, large market participants (particularly banking institutions) have financially cloned Futures & Options, thereby creating a new class of innovative financial contracts called "Derivatives". These *off-exchange traded* Derivatives primarily exist on the Over-the-Counter Market (OTC).[33] The OTC Market is a non-regulated market consisting of mostly large banks and institutional clients where trades are conducted privately over the phone or through computer networks and not on an Exchange.[34]

It is quite common after an institution books an *off-exchange* Derivative contract with a counterparty for it to simultaneously lay off that same risk in an offsetting transaction on a U.S. Exchange using an *exchange traded* Futures or Options contract. This dual function trading activity is called "arbitrage" whereby market players look for inefficiencies in either market and then take offsetting

[31] Id.

[32] *Id.*

[33] Philip McBride Johnson, *Derivatives* 33 (McGraw-Hill 1999).

[34] *Id.*

trades, pulling out small amounts of profits in the process.[35] Because of the leverage available in Futures and Derivatives contracts, those small profits can become quite substantial because the "notional value" is so large (notional value is the size of the contract agreed upon by the parties).[36] *Notional value* of a Derivatives transaction is synonymous to the *contract size* of an exchange traded Futures contract.

Another arbitrage play (where banks are making enormous profits) occurs where a financial institution enters into a Derivative contract with one of its customers, thereby taking the opposite side of the client's position. The client is allowed to place the Derivative trade without posting any additional margin funds because the financial institution already has a loan with the client (or a sufficient amount of collateral has already been deposited). This seems attractive to the client because (if approved) trades can be executed without posting additional margin funds.

The Over-the-Counter (OTC) market is the virtual exchange used for the trading of securities, futures, options, swaps, and other Derivatives transactions that do not take place on an exchange but rather trade *off exchange* between financial institutions and large institutional clients.[37] There are several types of Derivative contracts but the "Swap" and "Hybrid" are the most common.[38]

According to the Bank for International Settlements, the amount of Outstanding OTC Derivatives around the world was valued at $US 127 trillion as of June 2002.[39] Interest Rates overwhelming represent the bulk of Derivatives transactions (mostly Swaps) and comprise about 70% of that total while Foreign Currency Exchange is a distant second with only 14% of the market share.[40] In comparison, Futures traded on organized exchanges around the world is much smaller ($US 23 trillion).[41] When looking at the Futures/Derivatives Industry as a whole, the contracts traded *off-exchange* represent more than *80%* of the industry while exchange traded contracts represent 20%.[42] Some leaders within the Futures Industry believe the total amount of Futures/Derivatives world-wide has grown to $200 trillion in 2003 but that the exchange traded contracts have recently grown at a more rapid rate and now compose 1/3 or 33% of the total outstanding value.[43]

---

[35] Vinod Kothari, *Credit Derivatives and Synthetic Securitization* 165 (Academy of Financial Serives 2002).

[36] Philip McBride Johnson, *Derivatives* 10 (McGraw-Hill 1999).

[37] Philip McBride Johnson, *Derivatives* 33 (McGraw-Hill 1999).

[38] *Id.*

[39] Desmond MacRae, *Innovations in Disaster*, Stock, Futures & Options, 30, 32 (June 2003).

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] Russell Wasendorf, Sr., *Innovation Deserves More than 15 Minutes of Fame*, Stocks, Futures & Options Magazine, 21, 117 (June 2003).

Swaps are the predominant type of Derivatives contract. A swap is an OTC transaction where two parties agree to exchange payment streams (one person wins the other person loses) based on a specific "notional amount" (similar to contract value) for a specified period.[44] The notional amount of a swap is the underlying principal amount in which some calculation is based depending on whether the underlying contract is an interest rate, foreign currency exchange, stock index, gold, or energy contract.[45] Typically, there is a settlement day on the last day of the contract where the loser must pay the winner based on where the underlying market closed on the last day of the Derivative contract.

Credit Derivatives are one of the more recent innovations that allow one party, the beneficiary, to transfer credit risk of a "reference asset" (which may or may not be owned by the party) to another party who is called the "guarantor".[46] This allows the guarantor to assume the credit risk associated with the asset without directly purchasing it either.[47] Both sides of this transaction are analogous to an Option where a purchaser pays a premium to the seller for price protection on an underlying asset.

Since trading in Derivatives requires large amounts of capital, it is primarily the playing field of large corporations, governments, hedge funds (a hedge fund is really a speculative fund and only *hedges* to the extent as an arbitrager)[48] banks and other financial institutions.

Portfolio managers, who want to be free from most of the regulations imposed by the SEC and the CFTC, organize what is called a *hedge fund*.[49] A Hedge Fund is a trading entity formed as a limited partnership where the limited partners are the investors.[50] These limited partners contribute money to the portfolio and the general partners manage the portfolio. Typically, the hedge fund investor must invest $1 million or have a net worth of $5 million. Since the hedge fund is only made up of "wealthy people", the SEC does not feel they need to monitor them like other mutual funds made up of many small investors (although this view is changing). A hedge fund usually takes large risks. Therefore, Futures, Options, and Derivatives play a big role in their portfolios.[51]

Alan Greenspan and Warren Buffet opposing views on Derivatives contracts

Depending on the market guru, Derivatives are either a "Dr. Jekyl or Mr. Hyde". For example, Federal Reserve Chairman, Alan Greenspan, has been the most influential advocate of Derivatives.

---

[44] Philip McBride Johnson, *Derivatives* 203 (McGraw-Hill 1999).

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] John R. Nofsinger, *Investment Blunders of the Rich and Famous* 198 (Financial Times Prentice Hall 2002).

[49] *Id.*

[50] *Id.*

[51] *Id.*

Derivatives have their famous detractors as well. Warren Buffet paints a picture of an imminent financial Armageddon. In Berkshire Hathaway's annual report for 2002, Mr. Buffet wrote:

> "Derivatives are financial weapons of mass destruction, carrying dangers that while now latent, are potentially lethal..."[52]

The purposes and ideals advocated by Chairman Greenspan suggest that Derivatives do have a place in our financial markets. Yet, Mr. Buffet's cataclysmic warning about Derivatives goes to the heart of their "double-edge sword" characteristic (with high return comes very high risk) as evidenced from the enormous losses suffered by the following institutions in their Derivatives trading programs.

Proctor & Gamble (lost $200 million in 1994).

Derivatives (like Futures) would also face a judicial determination whether they met the definition of a security under the Supreme Court's "Howey test". *Proctor & Gamble Co., v. Bankers Trust*, 925 F. Supp. 1270 (S.D. Ohio 1996). Bankers Trust, a Broker Dealer and Derivatives firm, entered into an Interest Rate and Currency Swap transactions with Proctor & Gamble (P&G), a publicly traded company.[53] These swap agreements were originally negotiated in late 1993 and early 1994.[54] During the preceding year, interest rates in both the United States and Germany moved substantially higher which resulted in huge losses for P&G. The counterparty to the transaction, Bankers Trust, claimed that they were owed over $200 million on the two swaps.[55] P&G claimed that since it was fraudulently induced into these transactions and because the swaps were fraudulently executed, P&G should owe nothing to Bankers Trust.[56] Furthermore, P&G alleged fraud, misrepresentation, breach of fiduciary duty, negligent misrepresentation, negligence, violations of the Securities Acts of 1993 and 1934, the Commodity Exchange Act, Section 10(b) of the Exchange Act of 1934 and Rule 10b-5, as well as several Ohio state laws.[57]

This was a novel case because it involved questions of first impression whether swap agreements would fall within federal securities laws, commodities laws, or Ohio Blue Sky state laws.[58] The court held that the swap agreements *were not securities* as defined by the Securities Acts of 1933 and 1934 and the Ohio Blue Sky laws and that these swap agreements *were exempt* from the Commodity Exchange Act.[59]

---

[52] See Berkshire Hathaway's annual report www.berkshirehathaway.com/2002ar/2002ar.pdf.

[53] *Proctor & Gamble Co., v. Bankers Trust*, 925 F. Supp. 1270, 1276 (S.D. Ohio 1996).

[54] *Id.*

[55] *Id.* at 1277.

[56] *Id.*

[57] *Id.* at 1274.

[58] *Id.*

[59] *Id.*

Bankers Trust argued that swaps were not investment contracts because neither parties to the swap "invested any money", rather they agreed to exchange cash payments at a date in the future.[60] The swaps did not involve an investment in a "common enterprise" which entails pooling funds for the purpose of a business venture.[61] Bankers Trust argued the gains from the swaps were "not profits derived form managerial or entrepreneurial efforts of others" but were payments to be made to either party of the transaction according to future changes in U.S. and German interest rates.[62] While the court stated that swaps may meet some of the elements of the Howey test, the missing element was *"the lack of a common enterprise"* as P&G did not pool its money with that of any company nor did it join together in a common venture with Bankers Trust.[63] The court found that P&G was counterparty with Bankers Trust and therefore they could not be lumped together as a "common enterprise.[64] Since Bankers Trust was not managing P&G's money and the value of the swaps depended on market forces and not Bankers Trust's entrepreneurial efforts, the swaps were not investments contracts.[65] The court went on to hold that neither were the swaps *notes* as they failed to meet all of the prongs of the "Reves Family Resemblance test".[66] Therefore, the swaps would not fall under the purview of the Securities Acts of 1933 and 1934.[67]

The court stated it did not decide the issue *if swaps were futures contracts* because P&G failed to state a claim under this issue. It commented how as of January 1996, the CFTC had not taken a position whether swap agreements were futures contracts even though it had been granted authority under Title V of the Futures Trading Practices Act of 1992 to exempt certain swaps transactions from the Commodity Exchange Act (CEA) coverage under 7 U.S.C. §6(c)(5).[68] Even if the swaps were exempt from other provisions of the CEA, they would still be subject to its anti-fraud provisions.[69]

Orange County, CA (bankrupt after $1.7 billion loss in 1994).

One of the alarm bells that should send investors running for cover is when a portfolio manager tells investors, "*don't worry...these are just paper losses*". Robert Citron was a county treasurer whose Derivatives investments lost $1.7 billion in 1994 and

---

[60] *Id*. at 1278.

[61] *Id*.

[62] *Id*.

[63] *Id*.

[64] *Id*.

[65] *Id*.

[66] *Reves v. Ernst & Young*, 494 U.S. 56, 64-67,110 S. Ct. 945, 108 L. Ed. 2d 47 (1990).

[67] *Proctor & Gamble Co., v. Bankers Trust*, at 1278.

[68] *Id*. at 1284-1285.

[69] *Id*.

caused Orange County to become the largest municipal failure in history.[70] In the 1980's, Robert Citron's return on Orange County's portfolio outperformed other treasurers, including the state fund. How? He did it by investing in riskier securities. The higher returns led many cities, agencies, and school districts to put their money in the Orange County fund. When the fund collapsed, 185 cities and other agencies had contributed a total of $7.6 billion into the pool. By taking money it was borrowing from reverse-repo transactions and buying more Treasury securities, Orange County was able to purchase $20 billion worth of securities for a portfolio that only had $7.6 billion in equity.[71]

In the years that led up to 1994, interest rates continued to decline, which was good news for Orange County's leveraged bond portfolio which outperformed its peers. During 1994, the Fed increased short-term interest rates six times from 3.0% to 5.5%, catching many bond investors by surprise. Higher interest rates caused the value of bonds to fall. The leveraged portfolio only magnified the losses. In September, Citron called the losses just "paper losses", but by December, Orange County publicly announced the loss which had grown to $1.5 billion. Citron was forced to resign; he pleaded guilty to six counts of securities fraud and mismanagement, was fined $100,000 and was sentenced to one year in jail.[72]

Barings Bank (bankrupt after $1.1 billion in trading losses in 1995).

In 1995, it was discovered that arbitrage trader Nickolas Leeson racked up losses in excess of $1 billion, bankrupt the 223-year-old Barings Bank of London.[73] Nick Leeson ran an arbitrage trading desk for the bank. Barings Bank had access to the SIMEX Futures Exchange as well as Derivatives markets in both Singapore and Osaka, Japan.[74] Instead of booking trades for Barings' clients and performing arbitrage activities to lock in small trading profits, on his last day of work, Nick Leeson had ccumulated 61,039 Nikkei Futures Contracts, 26,000 Japanese Bond Futures, and a huge stock option straddle position (all of which were losing millions of dollars).[75] Not only did Nick guess wrong on all three positions (and continue to add to those losing positions), but unfortunately for Barings Bank, he also had access to back office records allowing him to cover up the trading losses for over two years.[76] The total loss was over $1 billion.[77]

Long-Term Capital Management (lost $4.5 billion in 1998 and Federal Reserve led a Wall Street bailout to avert a financial crisis).

---

[70] John R. Nofsinger, *Investment Blunders of the Rich and Famous* 213-241 (Financial Times Prentice Hall 2002).

[71] *Id.*

[72] *Id.* at 227.

[73] *Id.* at 233-241.

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Id.*

John Meriwether, Larry Hilibrand, and two Nobel Prize economists, Merton Miller and Myron Scholes, helped found Long-Term Capital Management (LTCM) in 1993.[78] Initially, $1.25 billion of capital was raised for the fund, but more would come later. Prior to LTCM, Myron Scholes achieved fame for his contribution to the "Black-Scholes Option Pricing Theory", in which mathematical equations were created to value market price behavior.[79] LTCM used this theory to value Derivatives transactions in a variety of markets, especially bonds. As an aggressive Hedge Fund, LTCM became famous as it invested in Derivatives and other highly leveraged speculative strategies with the objective of taking advantage of market irregularities. At its peak, a $1,000 initial investment in LTCM would have grown to $4,000 in just four years. *It took just five weeks for LTCM to lose over $4 billion.*[80]

> **"The fund (LTCM) had entered into thousands of Derivative contracts, which had endlessly intertwined it with every bank on Wall Street. These contracts, essentially side bets on market prices, covered an astronomical sum – more than $1 trillion worth of market exposure".**[81]

In September 1998, the Federal Reserve orchestrated a $3.65 billion bailout of LTCM which included 14 Wall Street banks[82] (most of them were LTCM's counterparties on many of these trades). The Fed was extremely concerned as several large financial institutions had entered into swap contracts with LTCM. Severe market repercussions were expected to follow if LTCM defaulted on its swaps, which some suggested would send shockwaves throughout the entire financial markets.[83]

Enron (Derivatives losses and off-balance-sheet fraud discovered in 2001 leads to a $1.2 billion reduction of equity and ultimate bankruptcy for the largest energy and derivatives trading firm in the world).[84]

Off-balance-sheet assets and Special Purpose Entities (Enron's SPE's were called Raptors) were used to "cook the books" at Enron to disguise transactions and hide losses from shareholders.[85] In response to Enron's fraud, the Sarbanes-Oxley Act of 2002 was overwhelming passed by Congress, setting new requirements for publicly traded companies in the areas of Accounting, Securities, and Corporate Governance. The stated purpose of Sarbanes-Oxley is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes".[86]

---

[78] *Id*. at 194.

[79] *Id*.

[80] *Id*.

[81] *Id*.

[82] *Id*. at 209.

[83] *Id*.

[84] Peter Fusaro & Ross Miller, *What Went Wrong At Enron* 176 (John Wiley & Sons 2002).

[85] *Id*. at 173.

It all began in 1984 when a small energy company called Houston Natural Gas would eventually transform itself into a giant trading company that became known as Enron.[87] Enron became involved in almost every new market that came along, including Derivatives. Not only was Enron a player in energy Derivatives, but it extended its energy trading model to Weather Derivatives and Internet Bandwidth Derivatives.[88] By 1999, Enron's internet trading platform became the world's largest business-to-business platform averaging 6,000 trades per day worth $2.5 billion.[89]

At the heart of Enron's controversy and fraud were its Derivatives transactions, which it entered into with several Raptor's (SPE's), which totaled over $1.5 billion. Basically, Enron booked over $500 million in income from these Derivatives transactions. The Raptor's lacked sufficient credit capacity to pay Enron on its hedges as Sherron Watkins (an Enron accountant) soon discovered. In Watkins' anonymous (but now infamous) memo, she methodically linked Enron's woes to its Derivatives (swaps) transactions. [89]

> **"We (Enron) recognized over $550 million of fair value gains on stocks via our *swaps* with Raptor, much of that stock has declined significantly........The value in the *swaps* won't be there for Raptor, so once again Enron will issue stock to offset these losses.......It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future......the equity holders have no skin in the game, and all the value in the entities comes from the underlying value of the *derivatives*, unfortunately in this case, a big loss.........Looking at the stock we *swapped*, I also don't believe any other company would have entered into the *equity derivative transactions* with us at the same prices or without substantial premiums from Enron. Raptor looks to be a big bet, if the underlying stock did well, then no one would be the wiser. If Enron stock did well, the stock issuance to these entities would decline and the transactions would be less noticeable."**[91]

Enron's bankruptcy was the largest in U.S. history at that time.[92] At its peak, Enron reached over $90 per share in August 2000.[93] By December of 2001, the stock price would be worthless.[94] The Natural Gas and Crude Oil Futures also dropped severely during this

---

[86] *See* Sarbanes-Oxley Act of 2002.

[87] Peter Fusaro & Ross Miller, *What Went Wrong At Enron* 4 (John Wiley & Sons 2002).

[88] *Id*. at 66-67.

[89] Peter Fusaro & Ross Miller, *What Went Wrong At Enron* 171 (John Wiley & Sons 2002).

[90] *Id*. at 185.

[91] *Id*.

[92] *Id*.

[93] *Id*. at 110.

[94] *Id*. at 178.

same time period, which caused oil and gas companies who contracted with Enron (instead of booking their trades through the Exchange) to lose millions of dollars when Enron defaulted on their contracts.

In January of 2002, Swiss-based Wall Street firm UBS Warburg (the last firm to downgrade Enron's stock) purchased Enron's energy trading business by beating out Citigroup.[95] Enron's energy trading business generated about 90% of the company's $101 billion in revenue in 2000.[96] For this business, UBS Warburg paid $0 upfront (that's right, zero dollars) and agreed to pay Enron and its creditors 33% of the pre-tax profits for two years with an option of buying Enron's stake in subsequent years.[97]

CONCLUSION

When the Securities Act of 1933 was enacted just within a few weeks of Franklin D. Roosevelt taking office, it was the first time national securities legislation had ever been passed by Congress.[98] In his inaugural address, Roosevelt announced that "*the money changers have fled from their high seats in the temple of our civilization*"[99] (which was a symbolic reference to Jesus casting out the moneychangers from the temple).[100] Later that spring, the Glass-Steagall Act of 1933 (also called the Banking Act) would radically alter the face of banking by creating deposit insurance and separating investment and commercial banking.[101] However, some sixty years later, the Gramm-Leach-Bliley Act would repeal many restrictions contained in the Glass-Steagall Act, which left some wondering if the moneychangers had indeed returned to Wall Street's temple. Derivatives (as we know them today) were not in existence in the 1930's. Nevertheless, the fact that Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act of 2000 inserted exemptions for Swap Agreements directly into the Securities Act of 1933 suggests how influential the banking lobby had become.[102]

Even though Derivatives received favorable treatment in *Proctor & Gamble v. Bankers Trust*, as well as special exemptions from the CFTC, the Gramm-Leach-Bliley Act, and the Commodity Futures Modernization Act of 2000, it is probable that Derivatives litigation will increase in the future due to the enormous financial losses associated with these colossal-sized transactions. To some it may appear (because of the large dollar amounts involved), that Derivatives losses are outrageous and should be banned altogether. However, it should be noted that in the cases of fraud, financial losses are always

---

[95] Houston Chronicle, *Swiss Bank to Pay Nothing Up Front for Enron's Trading Business*, (January 15, 2002).

[96] *Id.*

[97] *Id.*

[98] Charles R. Geist, *Wall Street-A History* 228-229 (Oxford University Press 1997).

[99] *Id.*

[100] John 2:15 (King James).

[101] Charles R. Geist, *Wall Street: A History* 230 (Oxford University Press 1997).

[102] §2(A) Securities Act of 1933.

outrageous when illegal activity by one party causes monetary damages to another. The question is, do we really want federal regulators to limit a market participant's right to freedom of contract because one party "might guess wrong" and lose millions of dollars in a transaction? If both parties can financially assume the underlying inherent risks associated with Derivatives contracts (assuming they are made in compliance with full and fair disclosures), should we preclude their trading in the United States only to watch this business move overseas?[103]

These two issues (freedom of contract and overseas competition) may explain why Congress and the federal financial regulators have sought to keep OTC Derivatives exempt from scrutiny provided they remain the domain of institutions and not accessible to the investing public. The systemic risks that could potentially harm the world's financial system cannot be overlooked either. Perhaps the abuse of leverage is where regulators should focus their regulatory oversight by requiring some form of institutional margining of funds similar to the initial margin requirement system used by all Futures Exchanges. Yet, some would argue that this would simply turn OTC Derivatives back into exchange traded Futures contracts. Others point to a world organization already in place which is working to bring financial institutions together to insure uniformity and stability to the OTC Derivatives markets. That organization is called the International Swaps & Derivatives Association (ISDA).[104]

The ISDA was founded in 1985 and has more than 600 members of which 202 are primary members representing the largest OTC Derivatives dealers.[105] According to the ISDA, less than one percent of all outstanding OTC Derivatives ($127.6 trillion) are collateralized[106] Since 1992, the ISDA requires transactions to be documented (in a "Master Agreement") between parties of different jurisdictions around the world and when transactions occur in different currencies.[107] This Master Agreement also standardizes damages provisions, close out provisions, force majeure termination events, interest, and compensation provisions between the parties and it is widely accepted by most Derivatives dealers around the world.[108]

While the court seemed unsympathetic to Proctor & Gamble's $200 million dollar Derivatives loss, perhaps prospective entities who are harmed by these contracts might be able to prevail under other legal theories.[109] One phenomenon that has occurred after the passage of the Commodity Futures Modernization Act of 2000 is the number of new dealers entering into the OTC Derivatives markets. Mid-size Banks are likewise joining the Wall Street Banks and are jumping head first into Derivatives trading as a means to generate additional fees and create new profit centers by executing Derivatives transactions with their existing clients. Since the financial

---

[103] Wall Street Journal, *Derivatives Growth has Helped Banks*, (October 8, 2002).

[104] See http://www.isda.org/

[105] Desmond MacRae, *Innovations in Disaster*, Stock, Futures & Options, 30, 33, (June 2003).

[106] *Id.*

[107] *Id.*

[108] *Id.*

[109] *Proctor & Gamble Co., v. Bankers Trust*, at 1278.

institution already has the customer's loan or investment banking business, it is a rather easy task to persuade (or demand) their client to use their new "in-house trading services". One inducement for the client (which is different from exchange traded products) is that margin funds do not have to be directly posted for Derivatives trades with the bank (although market fluctuations of the Derivatives will be assessed internally against lines of credit). Regardless of the marketing spin, *there is no free lunch.*

Since in many cases the bank already has a loan with the client, it can easily evaluate counterparty risk of the client by using credit information already in its possession (from a prior fiduciary purpose). If the client enters into Derivatives trades with the bank, the client's available collateral and equity will be closely monitored at all times, especially when the market moves against the client. Here lies the quandary. At what point does the financial institution breach fiduciary duties owed to the client when it switches roles from a fiduciary to a counterparty? What will the ramifications be after the client loses large amounts of capital through Derivatives losses (paid from the client directly to the bank) if the bank uses its existing relationship without a good faith and fair disclosure to the client (or uses undue influence) of all the important details of this new trading relationship (i.e. transaction fees, hidden costs, wider bid/ask spreads, increased interest costs, leverage risks, conflicts of interests, etc.)?

Banks and other financial institutions may become over confident if they rely too much on the *Proctor & Gamble* decision and recent legislation. They may be surprised to discover how their behavior was found to be culpable after all (based on other legal theories) and thus held financially responsible for the OTC Derivatives losses of their clients even though they alleged these were just "arms-length transactions".

The client not only runs the risk of its fiduciary becoming an adversarial counterparty but the client may be unknowingly booking *off-exchange* trades with the next LTCM or Enron. Finally, if Warren Buffet is right, unconstrained Derivatives trading might be the catalyst which causes the entire economic system to collapse in a financial holocaust. This warning reverberates in the closing words of a former Federal Reserve member who voices his consternation in his book about the impropriety of Securities & Derivatives Regulation. Martin Mayer writes, *"The tragedy for all of us would be if the Fed, the Treasury, and Congress's reverence for people who make a lot of money left us unprotected against some sudden revelation of the truth that becomes obvious only in hindsight, that a lot of them don't know what they're doing".*[110]

[110] Martin Mayer, *The*

Theories Of Involuntary Fiduciary Liability

Angela H. Magary

Ms. Magary is an associate with the firm of Brickley, Sears & Sorett, in Boston, Massachusetts and dedicates much of her practice to the representation of investors in securities disputes. *She wishes to express her gratitude to Prof. Charles E. Rounds, Jr. of Suffolk University Law School for his insights and assistance with this article.*

Establishing that a broker-dealer or its representatives owe a customer a fiduciary duty is a matter that is generally governed by application of a state-specific body of law. Some states take a strict, limited view that a broker acting in connection with a customer has a limited fiduciary duty only to act as agent for its customer/principal in effecting transactions accurately. *See, e.g., Saboundjian v. Bank Audi*, 157 A.D.2d 278, 283, 556 N.Y.S.2d 258, 261 (1990). Other states find that the relationship between a stockbroker and his or her customer is automatically a fiduciary one, that requires the broker to act "in the highest good faith toward the customer." *See Duffy v. Cavalier*, 215 Cal. App.3d 1517, 1534 Cal. Rptr. 740, 752 (1989). Yet others rely upon an analysis of the facts of each case, rather than establishing hard and fast rules. *See, e.g., Patsos v. First Albany*, 433 Mass. 323, 334, 741 N.E.2d 841, 851 (2001) (enumerating factors for consideration in determining the existence of a general fiduciary duty owed by a broker to a customer). Under certain circumstances, however, a broker may assume a broad, general fiduciary duty as an involuntary trustee. A broker may become a trustee *de son tort*, even in states where stock brokers do not necessarily owe customers a broad, general fiduciary duty, due to intermeddling with the trust.[1] A broker may also become liable to the beneficiaries as an aider and abettor in a duly appointed fiduciary's breach of duty. Finally, a broker, and not a trustee, may be fully liable for all investment related damages incurred when the broker acts as an investment agent for the trustee if the trustee satisfies the requirements set forth under the Prudent Investor Act.

---

[1] The majority of states recognize, either explicitly or implicitly, use of the term "trustee *de son tort*," including Alabama, *see Johnston v. Johnston*, 256 Ala. 485, 55 So.2d 838 (1951); Arkansas, *see Graves v. Pinchback*, 47 Ark. 470, 1 S.W. 682 (1886); California, *see England v. Winslow*, 196 Cal. 260, 237 P. 542 (1925); Colorado, *see Underhill v. Whitney*, 88 Colo. 688, 299 P. 12 (1931); Florida, *see Hamilton v. Flowers*, 134 Fla. 328, 183 So. 811 (1938); Hawaii, *see Long v. Holt*, 18 Haw. 290 (1907); Illinois, *see Pease v. Kendall*, 391 Ill. 193, 63 N.E.2d 2 (1945); Indiana, *see Ervin v. State*, 150 Ind. 332, 48 N.E. 249 (1897); Kentucky, *Meredith v. Ingram*, 495 S.W.2d 171 (1973); Maine, *see Tarbox v. Tarbox*, 11 Me. 374, 89 A. 194 (1914); Maryland, *see Ins. Co. of N. Am. v. Genstar Stone Prods. Co.*, 338 Md. 161, 656 A.2d 1232 (1995); Massachusetts, *see Milbank v. J.C. Littlefield, Inc.*, 310 Mass. 55, 36 N.E.2d 833 (1941); Michigan, *see Reeg v. Burnham*, 55 Mich. 39, 20 N.W. 708 (1884); Minnesota, *see McGhie v. First & American Nat'l Bank*, 217 Minn. 325, 14 N.W.2d 436 (1944); Mississippi, *see Yandell v. Wilson*, 182 Miss. 867, 183 So. 382 (1938); Missouri, Riggs v. Moise, 344 Mo. 177, 128 S.W.2d 632 (1939); Montana, *see State v. District Court*, 73 Mont. 84, 235 P. 751 (1925); Nebraska, *State v. Columbus State Bank*, 124 Neb. 231, 246 N.W. 235 (1933); Nevada, *see Beck v. Thompson*, 22 Nev. 109, 36 P. 562 (1894); New Mexico, *see Flanagan v. Benvie*, 58 N.M. 525, 273 P.2d 381 (1954); New York, *see Katzman v. Aetna Life Ins. Co.*, 309 N.Y. 197, 128 N.E.2d 307 (1955); North Carolina, *see Strickland v. Bingham*, 227 N.C. 221, 41 S.E.2d 756 (1947); North Dakota, *see Ward County v. Warren*, 32 N.D. 79, 155 N.W. 658 (1915); Ohio, *see Charpiot v. State*, 119 Ohio St.

TRUSTEE DE SON TORT

What is a trustee *de son tort*? The term "*de son tort*" is a French phrase that means literally "of his own wrong." *See* BLACK'S LAW DICTIONARY 485 (Rev'd 4th Ed.). It is akin to an executor *de son tort*, which "is defined in Black's Law Dictionary 403 (5th Ed.) as a 'person who assumes to act as executor of an estate without any lawful authority, but who, by his intermeddling, makes himself liable as an executor to a certain extent. . . . 'The power of the court to treat a wrongdoer as a trustee *de son tort* or trustee ex maleficio is beyond question.'" *In re Estate of Sakow*, 160 Misc.2d 703, 706-07 (1994) (citations omitted). A trustee *de son tort* may also be viewed as one "who of his own authority enters into the possession, or assumes the management, of property which belongs beneficially to another; and he is subject to the same rules and remedies as other constructive trustees." *Lee v. Randolph*, 12 Va. 12 (1807). A broker may knowingly intermeddle with a trust to such an extent that he becomes a trustee, and thereby assumes all the liability of a trustee as if he were himself a court-appointed fiduciary. Trustee *de son tort* liability arises only when there is no duly appointed trustee.

Liability as a trustee *de son tort* is most likely to arise in the context of a testamentary trust where no trustee has been duly appointed by the court, or in a situation where a duly appointed trustee has died or otherwise relinquished his or her office.[2] Generally, one who is designated or appointed as trustee must accept the office in order to serve. *See* LORING, at § 3.4.2. Establishing trustee *de son tort* liability appears to be a fact-driven process. It requires that a party take affirmative steps that evidence or manifest management of the trust property where there is no actual trustee.

AIDER AND ABETTOR LIABILITY

Another basis for imposing fiduciary liability lies in a concept somewhat similar to *de son tort* liability. That is the liability imposed upon one who aids and abets a breach of trust, as one who knowingly assists in the breach of trust of a fiduciary becomes liable to third parties for that fiduciary's breach. *See Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1015 (S.D.N.Y. 1984) ("A person may be liable, as an aider and abettor, for the tortious conduct of another if the person knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself."); *see also* Restatement 2d of Trusts, §326 ("A third person who, although not a transferee of trust property, has notice that the trustee is committing a breach of trust and participates therein is liable to the beneficiary for any loss caused by the breach of trust.") "[A] plaintiff must demonstrate three elements in order to impose aider and abettor liability: (1) a breach of fiduciary duty by the defendant; (2) defendant's knowledge of this wrongdoing; and (3) substantial assistance or

---

66, 162 N.E. 277 (1928); Oklahoma, *see Sandpiper North Apts., Ltd. v. American Nat'l Bank & Trust Co.*, 1984 OK 13, 680 P.2d 983 (1984); Oregon, *Stephan v. Equitable Sav. & Loan Assoc.*, 268 Ore. 544, 522 P.2d 478 (1974); Pennsylvania, *see Ramsey v. Ramsey*, 351 Pa. 413, 41 A.2d 559 (1945); South Carolina, *see Leaphart v. Nat'l Surety Co.*, 167 S.C. 327, 166 S.E. 415 (1932); Tennessee, *see Fidelity & Deposit Co. v. Long*, 138 Tenn. 43, 195 S.W. 766 (1917); Texas, *see Settegast v. Second Nat'l Bank*, 126 Tex. 330, 87 S.W.2d 1070 (1935); Vermont, *see First Nat'l Bank v. Bamforth*, 90 Vt. 75, 96 A. 600 (1916); Virginia, *see First Nat'l Bank v. Johnson*, 183 Va. 227, 31 S.E.2d 581 (1944); Washington, *see Longview v. Longview Co.*, 21 Wn.2d 248, 150 P.2d 395 (1944); West Virginia, *see Morris v. Joseph*, 1 W.Va. 256 (1866); Wisconsin, *see Cazier v. Hart*, 158 Wis. 362, 148 N.W. 860 (1914).

[2] "The appointment of the trustee under a declaration of trust (i.e., when the settlor and trustee are one and the same) requires no action by the court and no act of property transfer." Charles E. Rounds, Jr., LORING A TRUSTEE'S HANDBOOK, §3.4.1 (5th Ed.) [hereinafter "LORING"].

encouragement provided by the defendant." *Id.*; *see also American Surety Co. Of New York v. First Nat1 Bank in West Union, W. Va*, 141 F.2d 411, 413 (4th Cir. 1944) ("'If a trustee commits a breach of trust in depositing trust funds in a bank and the bank when it receives the funds has notice of the breach of trust, the bank is liable for participation in the breach of trust, and is chargeable as a constructive trustee of the funds.'" (quoting Restatement of the Law of Trusts, § 324, Comment b)). Aider and abettor liability would arise only when there exists a duly appointed trustee, since the liability of the aider and abettor rests upon his or her knowing assistance of the breach by the actual trustee. Imposing liability under this theory, too, will depend upon the facts of any particular case.

LIABILITY AS AGENT OF A TRUSTEE

Brokers may assume liability as agents of a duly appointed trustee where the trustee "exercises reasonable care, skill, and caution in selecting the agents, establishes the scope and terms of their responsibilities, and periodically monitors their activities." LORING, § 3.2.6. This concept derives from the Uniform Prudent Investor Act and contradicts the prior common law rule that a trustee could not delegate investment and management functions. *See id.* If a trustee so follows the requirements of the Prudent Investor Act and exercises the appropriate care, establishes the scope of the agent's responsibility, and monitors the investment activities of the agent, the trustee is entirely absolved of liability. *See id.*; *see also* MASS. GEN. L. Ch. 203C § 10(c) ("A trustee who [exercises reasonable care, skill and caution] shall not be liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.") The repercussions of the delegation of liability for this very important responsibility is of extreme significance, as often a broker raises as a defense in a claim brought by a beneficiary that the trustee bore responsibility for the investment functions of the trust. A trustee who acts properly pursuant to the Prudent Investor Act therefore has a solid defense to any third-party claim or counterclaim raised by a broker in a claim brought against the broker. The Prudent Investor Act, or legislation substantially similar thereto, has been adopted in a majority of jurisdictions.[3]

The Uniform Prudent Investor Act, as adopted in Massachusetts, sets forth specific standards for investment and management decisions. The Prudent Investor Act (PIA) requires that a trustee:

(a) Invest and manage trust assets as a prudent investor would, considering the purposes, terms, and other circumstances of the trust, including those set forth in subsection (c). In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

---

[3] The jurisdictions include: Alaska, AS §§ 13.36.200-.275; Arizona, A.R.S. §§ 14-760 - 7611; Arkansas, A.C.A. §§ 24-2-610 - 619; California, West's Ann. Cal Probate Code, §§ 16045 - 16054; Colorado, West's C.R.S.A. §§ 15-1.1-101 - 115; Connecticut, C.G.S.A. §§ 45a-541 - 541/; District of Columbia, D.C. Official Code, 2001 Ed. §§ 28-4701 - 4712; Florida, West's F.S.A. §§ 518.11, 518.112; Hawaii, H.R.S. §§ 554C-1 - C12; Idaho, I.C. §§ 68-501 - 514, Indiana, West's A.I.C. §§ 30-4-3.5-1 - 3.5-13; Iowa, I.C.A. §§ 633.4301 - 4310; Kansas, K.S.A. 58-24a01 - 24a19; Maine, 18-A M.R.S.A. §§ 7-302 - 7-302 note; Massachusetts, Mass. Gen. L. Ch. 203C §§ 1 - 11; Michigan, M.C.L.A. §§ 700.1501 - 1512; Minnesota, M.S.A. §§ 501B.151 - .152; Missouri, V.A.M.S. §§ 456.900 - .913; Nebraska, R.R.S.1943, §§ 8-2201 - 2213; New Jersey, N.J.S.A. 3B:20-11.1 - 11.12; New Mexico, NMSA 1978, §§ 45-7-601 - 612; New York, McKinney's EPTL 11-2.3; North Carolina, G.S. §§ 36A-161 - 173; North Dakota, NDCC 59-02-08.1 - .11; Ohio, R.C. §§ 1339.52 - .61; Oklahoma, 60 Okl.St.Ann. §§ 175.60 - .72; Oregon, ORS 128.192 - .218; Pennsylvania, 20 Pa. C.S.A. §§ 7201 - 7214; Rhode Island, Gen Laws 1956, §§ 18-15-1 - 13; Tennessee, T.C.A. §§ 35-14-101 - 114; Utah, U.C.A. 1953, 75-7-302; Vermont, 9 V.S.A. §§ 4651 - 4662; Virginia, Code 1950, §§ 26-45.3 - .14; Washington, West's RCWA 11.100.010 - .140; West Virginia, Code, 44-6C-1 - 6C-15; and Wyoming, Wyo. Stat. Ann. §§ 4-9-1-1 - 113.

(b) A trustee's investment and management decisions respecting individual assets shall be considered in the context of the trust portfolio as a part of an overall investment strategy reasonably suited to the trust.
(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;
(2) the possible effect of inflation or deflation;
(3) the expected tax consequences of investment decisions or strategies;
(4) the role that each investment or course of action plays within the overall trust portfolio;
(5) the expected total return from income and the appreciation of capital;
(6) other resources of the beneficiaries;
(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.
(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this chapter.
(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has such special skills or expertise, shall have a duty to use such special skills or expertise.

The duties of a trustee with respect to investment and management decisions are therefore quite specific and detailed in the PIA. It is understandable that all trustees may not have the necessary knowledge or skill to carry out the mandated investment functions and would wish to delegate that duty to another person or entity that has the requisite knowledge and skill.

ILLUSTRATIVE EXAMPLES

As an illustrative example, in a particular case, a broker-dealer was put on notice that an estate executor had in his possession, in an account in the name of the executor held at the broker-dealer, assets that were to be placed into trust. The trust was a testamentary trust that named four trustees, two of whom declined to serve. After the estate business was concluded and the estate wrapped up, the executor of the estate attempted to open a trust account. The broker-dealer reviewed the will of the decedent, including the trust provision. After apparently determining that all four trustees must assent to the opening of the trust account, the broker-dealer refused to open an account for the trust without all four signatures. The attorney for the estate informed the broker that two of the trustees had declined to serve and therefore, there would be no signatures from them. When the broker for the estate account again attempted to open a trust account, the trust department of the broker-dealer again refused to open the account, informing the lawyer for the estate that he would have to go to court to get documents reflecting the change in trustees. The lawyer for the estate refused and requested that the broker-dealer simply return the assets to the estate account. The trust assets then sat in the estate account for a period of over six years. During that six-year period, the executor of the estate, who was one of the named trustees, made distributions to himself out of the trust assets, contrary to the terms of the trust.[4] The executor, who was an income beneficiary of the trust, also

[4] Under the trust, no trustee could make distributions to him or herself.

permitted the trust corpus to be invested in assets that greatly favored the income beneficiaries over the remainder beneficiaries. The executor thereby committed three separate breaches of trust: 1) failing to deliver the estate assets into the trust; 2) making unauthorized distributions to himself; and 3) failing to diversify the investments to satisfy the needs of both the income and remainder beneficiaries.

Under the circumstances, the broker-dealer should be charged with liability as a trustee *de son tort*, and with aider and abettor liability. The reason for imposition of liability as a trustee *de son tort* is that the broker-dealer had notice that the assets were to be turned over to the trust, yet it continued to retain possession of the assets in the name of the executor only for a period of several years. In this case, the broker-dealer's failure to take any further action constitutes "intermeddling" sufficient to bestow it with trustee *de son tort* status. During the time period where the broker-dealer permitted, without question or complaint, the assets in the name of the executor, its employees also continued to recommend investments for the account and to effect transactions, including withdrawals, in the account. This conduct, too, in the face of the broker-dealer's knowledge concerning the trust causes it to become a trustee *de son tort*. Finally, the broker-dealer's direct contact with the estate's attorney to determine that the attorney did not wish to go to court and wanted to have the assets returned to the estate account also constitute intermeddling with the trust. All of these factors weigh in favor of imposing liability as a trustee *de son tort*.

The broker-dealer is also liable as an aider and abettor because it had notice, based upon its review of the trust instrument, that the executor of the estate was committing breaches of duty. The broker-dealer's admitted review of the trust document indicates that it knew that the estate assets were intended for the testamentary trust and the fact that the executor attempted to open a trust account indicates that the estate business had been sufficiently concluded to permit the segregation of assets into the trust. The broker-dealer nonetheless permitted and assisted the executor's breaches of duty by allowing the trust assets to sit in the estate account for several years, issuing checks to the executor, even though the broker-dealer knew that the assets should have been placed into a trust that limited the executor's authority to make distributions to himself, and by effecting transactions that did not satisfy the needs of both the income and residual beneficiaries.

AVOIDING INVOLUNTARY TRUSTEE LIABILITY

What should a broker do if caught in such a situation? There are multiple options available that should protect the broker from the imposition of liability. First, the broker may direct the account holder to go to court to obtain the documents necessary to open the trust account. Any such direction should be clear, concise, and in writing to provide the desired protection from liability. Second, the broker could go into court on his or her own as a stakeholder and seek instruction from the probate court for what to do with the assets. This may be deemed by some as an extraordinary measure, but this action would provide the broker with a very secure basis to support whatever action he or she actually takes, assuming he or she follows the instruction given by the court. Third, the broker could resign possession and control of the assets, having them placed in the name of the executor, and thereby removing the assets from his or her custody. The broker should notify all interested parties of such action to provide optimal protection from liability to ensure that those parties (namely the beneficiaries and any co-trustees) may be aware of the situation and take appropriate action on their own.

SIGNIFICANCE OF ESTABLISHING THE EXISTENCE OF A FIDUCIARY DUTY

In the fact pattern outlined above, the broker-dealer failed to take any of these steps, and

therefore, after passage of a reasonable time, assumed the duties as a trustee *de son tort*, due to the absence of a duly appointed trustee. The broker-dealer also took affirmative steps in assisting the executor of the estate in committing breaches of duty. A beneficiary of a trust in such a situation would wish to establish the existence of a fiduciary duty on the broker-dealer because there are a number of duties that a fiduciary must satisfy. In addition to any governmental reporting obligations, a trustee has a duty to: take active control of, segregate, earmark, and protect trust property; make trust property productive; apply the "prudent man rule"; maintain confidentiality with respect to trust affairs; separate income from principal and the right to income; act impartially; defend the trust from attack and not to attack the trust; use special skills or expertise; administer the trust promptly and efficiently; and keep precise, complete, and accurate records. *See generally* LORING, Chapter 6. The effect of establishing the existence of the full fiduciary responsibility of a trustee will be to make it easier for a wronged party to establish a breach of duty.

In the context of a claim against a broker-dealer, the most significant fiduciary obligations are typically the duty to make the trust property productive and the duty to apply the "prudent man rule." Both of these concepts require the trustee to diversify the assets to serve the beneficiaries of the trust, both current and remainder. *See* LORING, at § 6.2.2.1. Although a broker-dealer always has an obligation to recommend only investments that are appropriate for the customer,[5] once the broker assumes the full obligations of a trustee, it has the duty actually to *make* the appropriate investments consistent with its fiduciary obligation. The often-raised defense that a particular customer rejected a recommendation or requested that the broker purchase securities that were not appropriate for the customer would thereby be defeated because as a trustee, the broker-dealer would be the party responsible for making investment decisions and either be solely liable as a trustee *de son tort*, as a co-trustee under the aider and abettor reasoning, or as agent of the trustee where the trustee has properly delegated investment authority to the agent.

It may be possible for a trustee client, or estate beneficiary, to establish trustee liability of a broker-dealer under the theories detailed above in any case where the broker-dealer has reviewed a trust agreement. Once the broker-dealer is imputed with the knowledge contained in the trust agreement (which it undoubtedly had to review prior to opening a trust account), it must then not permit or assist the trustee customer to act in a manner inconsistent with the trustee's fiduciary duty.

Once a trustee is found to have breached his or her duty, he, she, or it is then liable for all damages caused by that breach. In the context of a failure to diversify, the well-managed account theory may serve as the best measure of damages. *See e.g.*, *Dasler v. E.F. Hutton*, 694 F.Supp. 624 (6th Cir. 1998); *Medical Associates v. Advest, Inc.*, 1989 Lexis 11253 (W.D.N.Y. 1989); *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773-74 (9th Cir. 1984); and *In re Drexel Burnham Lambert Group, Inc.*, 161 B.R. 902 (S.D.N.Y. 1993). That is to say that the wronged beneficiaries may recover for the loss measured by the diminution in value of the portfolio due to the failure to diversify and allocate assets in a manner consistent with the needs of the income and residual beneficiaries and are entitled to put in a position that they would have been had the account been properly allocated. *See Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (1981).

CONCLUSION

There are alternative theories of imposing the liability as a fiduciary upon a broker under the right circumstances. Basic common law that limits the scope of a broker's fiduciary duty to a customer may give way under the right fact pattern to a broad general fiduciary duty.

[5] *See* NASD Rule 2310: NYSE Rule 405.

Customers, brokerage firms, and investment professionals should be aware of the implications of a broader fiduciary duty and take appropriate steps to protect their interests. Dealing with trusts, trust accounts, and trustees in a careful, attentive way should ensure that all parties' interests are best protected.

Expert's Corner: The Roles And Responsibilities Of The Branch Office Manager

By Frank A. Sullivan

INTRODUCTION:

The NYSE Rule 342, (b) paragraphs (1) and (2) calls upon the general partners or directors to provide "supervision and control" by delegating to qualified principals authority and responsibility for supervision of each office, along with procedures of supervision and control. It also requires a separate follow-up system and review to determine if the delegated authority and responsibility is properly exercised. The NASD Rule 3010 states the same but with specific reference to supervision of the registered representatives. It states the need to have qualified supervisory personnel by virtue of training and experience.

BACKGROUND:

The Branch Office Manager of a securities firm has four essential drivers. These are: sales and marketing, operations/administration, personnel and compliance. The people who are customarily chosen to be Branch Office Managers (BOM) are usually from the sales side of the business with a proven track record of revenue enhancement and a "clean book of business." The reasons they choose to become managers differ, but all have one fundamental theme: leverage their own business by participating in the profits of the office. This is true of managers who keep their book of business and those who are full time managers.

Since compliance is viewed as a "boring" area, most managers try to delegate as much as they can in order to focus on driving the business or revenues for the profit center of the branch. They do not get a bonus for compliance. They may get disciplined or fired for failure to supervise but generally they spend only the minimum time required on compliance matters. As a result, ninety percent or more of the daily activity is spent away from compliance matters. Add this to the general lack of any formal compliance training and it is often the case that the BOM finds the job is not only unfulfilling but also dangerous to his career in the securities industry.

The NYSE Rule342 Supplementary 13, regarding the acceptability of supervisors, states that a candidate should have a creditable record as a registered representative or equivalent experience and should pass the BOM exam. The NASD states that reasonable efforts should be made to determine if the candidate is qualified by experience or training to carry out the responsibilities of a BOM. (NASD Rule 3010 (a) paragraph 6). The background of the requirements of experience, proven sales record, passing an

Frank A. Sullivan of Avon, Connecticut is an expert witness and a member of Expert Witness Securities Roundtable. He provides dispute resolution services as an NASD and NYSE Arbitrator. Additionally, he is a Professor at the college level in Business and Finance. He may be contacted at 860-675-4219/5394, 860-604-7702.or at Fsulli1702@aol.com.

exam and some training are essential requirements of a BOM. The realities of the qualifications place the BOM squarely in the role of a sales/marketing manager who is presumed to be the compliance manager while supervision operations, administration and personnel matters.

CRITICAL FEW OR CRITICAL MANY:

There are nearly 50 items for which the BOM is responsible for in his supervisory role. They vary in importance and in intervals. Signing the new account form is a daily responsibility and the annual compliance audit takes place in that interval. In the interim, the responsibility ranges from the simple: approving or not approving a mutual fund switch from one fund to another; to the complex: reviewing the daily trade blotter to check for excessive trading in an account, suitability, size of transactions, account number changes, trading the same stock, option trades and ensuring the broker is licensed in the state where the client resides.

The usual "red flag" areas for the BOM are: option accounts, which have to be monitored in line with the objectives and the resources of the client; customer complaints about a broker using unauthorized discretion as to time, price and sale of a security; the "exception report" which shows that a client has generated high commissions in a short period (usually three to five thousand dollars); and a significant loss in a clients account due to a concentrated position or excessive trading. A decline of $10,000.00 year to date or a continuous monthly decline of ten per cent will usually cause the account to come up for review by the broker, manager and client. Two more items would be the sudden change of trading not in line with the client objectives stated the new account form and the need for extensions to make payment for a transaction or repeated margin calls in an account.

It is usually a "red flag" when confirmations of trades are mailed to PO boxes. In one instance, the broker would pick up the confirms in collusion with a client who was a foreign national and meet with him once per year to give him the confirms and statements. The client then died and the broker kept trading, waiting for the client to come on his annual visit to collect the documents. Then the account lost significant value in this time period. The widow and her children discovered the account in the deceased man's papers and sued the firm for discretion in Federal Court and won.

Several years ago a client handcuffed himself to the door of the branch office after calling the national evening news for a nationwide appearance, complaining that his order was not executed and the gaming stock he wanted ran up without his order being filled. The BOM called the proper authorities, negotiated a settlement with the client and invited him to take his business elsewhere. The broker was correct in entering the limit order but the client felt entitled to his limit order, which it was determined to be wrong, as there was stock ahead.

All correspondence from the office must to be approved before it is mailed to the client to ensure that fair dealing and correct representations are made to the public. This is especially true with regard to prospectus items or an IPO, which must stand-alone without comment by the broker.

In one case, a broker stapled a sales solicitation to a copy of the front page of a prospectus of a Bank Floating Rate Note: "Interested in getting 10% from a Bank? Call this number..." He placed it under the windshield wipers of cars at a mall parking lot. The BOM discovered it and promptly reported it to his superiors who notified the SEC. The NYSE banned the broker from the industry for life, the firm was banned from the offering the security and the BOM was able to keep his job with out disciplinary action.

An area that has become a focus for the BOM has been the use of brokerage firms as a vehicle for money laundering. No cash is taken in at the window and any funds wired in from foreign entities must be monitored carefully under NYSE Rule 405 the "know your customer" rule. Any transaction over $10,000 is usually reviewed by the operations manager and reviewed with the broker as to the identity of the client and source of funds. A brokerage firm recently accepted a series of third party checks from a corporation to meet margin calls in an individual's option account. It was discovered the client was signing the checks in his corporate capacity for his personal use. The manager was a producing manager who told the margin department that it was the client's company. The manager is no longer in the securities business and the client pleaded guilty to a felony offense and took up residence at a Federal penitentiary to serve out his sentence. The firm sued the brokerage firm in Federal Court, as it was a foreign corporation.

ALL THINGS TO ALL PEOPLE:

Beginning in the 1970's brokerage firms shifted from a transaction business to a marketing business offering a whole series of investment products. Options began in the commodity pits in Chicago and became a hot new product. This required registration with the CBOE for the brokers and a Registered Options Principal exam for the BOM. Since, then options have been a major source of customer complaints because they are basically futures trading with stocks/bonds/currencies as the derivative vehicle. They have been a compliance challenge for the BOM basically in the area of suitability. Since the commission payouts are higher and the amount of money required to invest in options can be small, the brokers find ways to get clients involved in trading options. Entering trading options in margin accounts causes the risk exposure increases at a double the rate of risk in a cash account.

The basic mistakes made by brokers and BOM's is that they allow allocation of liquid assets to be too high (15% is the usual amount recommended), and allow clients to get into spreads and combinations that the client does not understand.

In one case a client had huge profits in naked puts but would not close his positions because he wanted a certain profit gain. He then let the options expire and become worthless. The BOM called, asked to meet with the client, showed him his losses and counseled him to lower his risk. The client refused. The BOM instructed both the broker and the client that there would be no new positions allowed and that the margin debit must be paid off. The client opted to go elsewhere. The BOM prevented the client from committing financial suicide while under his supervision.

In another case, an executive used the stock option-financing program of a major firm to pledge his restricted stock to borrow millions of dollars with a customized collar. He gave the broker Power of Attorney (POA) to trade options. In a two-year period the client paid $2 million in commissions and lost $7million. The BOM "left no finger prints" during this process. He never met the client or his wife, it was a JT/WROS. The POA was not appropriate because it was simply a way to avoid a discretionary account, which requires duplicate statement to a principal of the firm and heightened supervision and approval of every trade. The operations manager was initialing the order tickets. The broker traded on the same ticket with the client instead of following the FIFO practice when it comes to trading securities the same a client's. Aside from a few "feel good" letters, after three years of losses the BOM was not supervising the broker or the account. The firm's margin department and option department did nothing to supervise the account.

The BOM did not monitor the type, size, amount, frequency, profit/loss or suitability of the trading in the account. The BOM never spoke to the client or the wife, who was owner of the account with the husband. The BOM never updated the option documents. In the same case the broker lost over one and one half million dollars selling bullish straddles in an up market for three years. The strategy was flawed and yet the broker continued to tell the "gambling" client to keep doing it using a POA for discretionary trading. An NASD panel found that the broker has no business catering to and enabling the blindly bullish and flawed options strategy.

Failure to supervise by the manager was testimony given by the home office compliance director who said the BOM had the duty: a. to call a. to call the client; b. to have the trades ratified: c. assure that the client was comfortable with the strategy: d. that the strategy made sense. In short the home office placed the responsibility on the BOM.
See: "The Failure to Recommend Hedge Strategies as a Basis for Stockbroker Liability."
PIABA Bar Journal. Vol.9. No.1. (Spring 2002).

Since the introduction of listed options in 1973, the securities industry has offered: tax shelters of all kinds from oil drilling to wind farms, retirement accounts, unit investment trusts, annuities and whole life insurance, mortgages, business loans, stock option financing with the use of customized collars, cash management accounts, professional money managers, who are registered investment advisors Series 65 licensed, and various forms of index and derivative based closed- end funds. Finally, most recently, firms have become "financial planners." The new era of fee based accounts from B share mutual funds, 12 B 1 fees, fee based trading accounts and "outside money managers" has added another layer of supervision.

The fees are silent revenue streams for the firms and are aimed at asset allocation models for clients. The money managed accounts for instance charge a fixed fee 1.5% to3% regardless of performance. In some instances clients have complained that they were paying a fee when the account was 40% in cash! In other cases brokers have been asked why they have not traded in an account when the client was paying a fee in lieu of commissions. These issues are open have not been resolved by the industry.

To put this in perspective, the term "registered representative" has been translated into "account executive" and most recently, " financial consultant," "wealth manager," or "specialists" in retirement plans and the other products mentioned above. The broker and managers have had to become insurance licensed, Series 65 licensed as money managers and in some cases, licensed in real estate.

The BOM is faced with having these products coming into his office by way of various marketing specialists. These specialists are compensated on marketing their particular product. Few of them have ever been brokers, managers or are licensed in the securities industry. The BOM then has the job of supervising the products sold in the office without the authority to supervise the specialists who report to their home office department heads. Few of the department heads have ever been in the branch or are licensed in the securities industry. This situation makes the reporting and monitoring of what is best for the client a steep challenge for the BOM.

A clear example of this is the current customer complaints about tax-deferred annuities, which have been sold in the billions to clients. The BOM often does not even see the contract that it is signed by the client and approved by the insurance specialist. Yet he is responsible for the sale in the office. On occasion, specialists will recommend a 1035 exchange from one annuity to the one offered

by the firm they represent. The BOM must sign off on these though they are usually a high cost to the client with little real benefit or need.

Clients are attracted to the tax-deferred annuity by such terms as, "guaranteed principal," "fixed rate for the first 3-5 years or market appreciation, whichever is higher," "free of state and federal taxes" and other marketing buzz words. The cost of the contract, the mutual fund fees, and the high redemption fees in the first 3-6 years are lost in the presentation. The fact that the principal is "guaranteed" (you must die to collect) makes it attractive to put into IRA accounts for some clients. This opens up a series of compliance violations from the "Fair Dealing with Clients and Suitability" rule.

Recently, a woman who was in a terrible auto accident survived a three month coma and took a partial settlement in cash from the insurance account. With no job and two teenaged children, an insurance specialist proceeded to have her invest $500,000 in a tax-deferred annuity. Inside the annuity were four speculative mutual funds. The client lost $250,000. A paraplegic who has a learning disability, she retained counsel.
The insurance company refused to talk settlement. They sent five attorneys to defend the broker before the Arbitration Panel. The BOM "left no finger prints" and was not at the hearing. The decisions was in favor of the claimant. The point is that the BOM could have intervened or the insurance company should never have offered the contract with speculative mutual funds, which the claimant did not understand.

Examples abound in the cases of retirees rolling over their pensions into tax-deferred annuities. One major firm fired six managers where the abuses of this product occurred. See: Variable Annuities: What You Should Know, US SECURITIES & EXCHANGE COMMSISSION. http://www.sec.org/investor/pubs/warranty.htm. NASD Takes Disciplinary Actions for Variable Annuity Abuses and Investor Alert on Variable Products, 1991 NASD Lexis 57 1991. Notice to Members 40 (May 27,2003).

FEAR OF LOSING THE 'BIG HITTER":

Securities firms recruit and cater to larger "producers." The BOM has the job of recruiting and supervising these brokers, as well as his own homegrown talent.
Often the big producer will resist compliance rules as he views these rules to be annoying and most of the time not applicable to him. The big producer will not review accounts requiring an activity review, will get involved with outside interests and not report them on the outside interest annual questionnaire or be allowed to do so without investigating a conflict of interest, and he will make demands for special treatment on IPO's, mortgage approvals and building positions in highly speculative stocks on margin. A recent quarterly report by a major firm showed a loss of $40 million in bad loans to key clients. The reason stated for approving the risky loans was the pressure from big producers. Thus the BOM fears losing the large producer or is afraid of the big producer calling the company president in order to get the BOM off his back or get loans or trades approved. The BOM is then called on the carpet for not being broker-friendly and in some cases removed as manager. In other words, firms may not back up their BOM, so he maintains a low compliance profile with big producers, which eventually results in a customer complaint and a failure to supervise on the part of the BOM.

WE ARE WITH YOU WIN OR TIE!

The home office compliance departments usually have the first objective to defend the firm. A BOM is resembles a professional coach who is expendable in the heat of a financial battle. As was mentioned in the case above in "All Things to All People," the home office legal and compliance department will back the manager when he follows protocol, but is hard pressed to give any support to the

BOM other than to put forth an argument that in effect says he has no responsibility to supervise.

In a recent NYSE case a major firm stated:

> "When a non-discretionary securities account is involved, the broker's duty is limited to executing the order properly."
> "Moreover, a broker does not have any responsibility to his customer after the transaction is complete."
> "A broker has no continuing duty to keep abreast of financial information that may affect his customers' portfolio, or to inform his customers of developments that could influence their investments."

The panel found this argument to be wrong and awarded a six-figure sum, damages and legal expenses to the claimant. The net result is that the CRD of the BOM shows the finding on his permanent record. This "de minimis" approach did not give the BOM a chance to defend himself.

It should be noted that "Feel Good Letters" or form letters to active accounts are letters from the home office and signed by the BOM. Rarely does the client call the BOM but relays any issues the broker, who advises his client to ignore the letter as a public relations matter. The letters are generic but recently have required the BOM to put in the letter the total commission dollars and a profit and loss picture year to date. Brokers usually see this as trying to "start trouble" with a good client. In those cases, the BOM will often invite the broker to be on the call with the client to ease his concerns. This puts the client in the difficult position of complaining to the manager in front of his broker. The procedure does have merit, however, as it gives the BOM some proof that he did contact the client and take the necessary action such as a personal meeting or reviewing the risk profile of the client. Again, this is not an area that the BOM finds comfortable and will try to speak with the broker alone as a substitute to personal client contact. Again, the burden of supervising rests on the shoulders of the BOM.

RECRUIT OR DIE:

In the late 1970's and early 1980's the "gentlemen's club" of Wall Street took a bounce when Mr. George Ball left E.F.Hutton to become the head of Prudential Securities. He revolutionized the industry with his huge up-from bonus checks to attract brokers from the competition. The rationale was that the cost of training was higher and the attrition rates in the industry demanded a new approach: an upfront bonus based on a percentage of the brokers trailing twelve-month gross production. The bonus took the form of an upfront, annual forgivable loan over a three-year period. For a million dollar producer the deal is structured as 75% cash of the trailing twelve-month's production, 10% in deferred compensation five to ten years out and a 15% "look back" bonus over a twelve to fifteen month period at the new firm. The broker pays back one third of his cash bonus each year and gets a check (less taxes) in return as a bonus. The bonus also may have a higher percentage payout in the first few months and a back end bonus for assets and production targets. The point is that the recruiting process can become a distraction from watching the compliance posture of his office. He also must recruit and beware of the possibility of losing his best brokers to the competition.

The results have been an unmitigated disaster for Wall Street with brokers hopping from deal to deal and leaving a trail of unsecured debts and compliance complaints. The New York Times featured such a debacle in its issue of Sunday, January 16, 2005.
In the late 1990's the SEC under Arthur Levitt established the Tully Commission to stop the job-hopping by brokers with a list of complaints and to stop the extravagant payouts to brokers. This has met with limited success. Examples are that customers and recruiting firms now can view the brokers CRD on the NASD Website and firms must

now promptly report customer settlements and complaints or face substantial fines.

The BOM now spends considerable time using the services of recruiters who get five to six per cent on the bonus paid and doing his own recruiting efforts. In some cases a competitor raided entire offices including the BOM. The NASD ruled that taking the majority of the office revenues by another firm or firms as illegal and subject to substantial fines.

The BOM has had to deal with the downdraft in the market since March 10, 2000. With new brokers in his office his firms has had to extend the terms of the "loans" to five years. The intention was to give the broker time to build his business in a difficult market condition and ensure that he will not jump and leave the firm with the unsecured loan.

Recently, two high level managers at a major firm were fined six figures by the president for allowing a team of brokers to violate late trading rules in mutual funds. The BOM was praised for recruiting such a high-powered team without realizing that a large percentage of their business was in violation of mutual fund trading rules.

The job of recruiting often leads the BOM to compromise in the area of compliance. The broker may have questionable hedge- fund clients, he may do speculative business, he may be concentrated on a very narrow account base, and he may have a very short term trading mentality and comes to a large firm simply to get new issues for his clients. In other words, the BOM is placed in the position of having to recruit or sit and watch his office be attacked. He may have to compromise compliance for his own big producers in order to keep them at the firm.

The recruiting game has heated up with the recovery in the market, but many firms are now trying to collect training fees from young brokers who jump and from larger produces that simply walk out the door to another firm. The panels of the NASD and NYSE have generally rule in favor of the firms in these contract disputes.

It is safe to say that the new era of recruiting has lined the pockets of brokers and recruiters. The clients have not benefited to any great extent and the brokerage firms are in a continual battle to buy business from other firms. The BOM is caught in the middle. He must spend time away from his normal duties of sales, compliance and administration to recruit and hand hold the big producers. He is also at risk to the profit and loss of the his office bottom line when a big producer leaves and a new bonus broker is slow to get his business growing to pay off the loan, or in some cases never do enough to cover the cost of the upfront loan.

THE TOUGHEST JOB ON WALL STREET

The BOM job is not an easy one. It has been called the "toughest job on Wall Street." There are BOMs who have established an office culture of compliance that is acceptable to the brokers and the firm. When asked what it is that these BOMs do there are key components of their supervision.

1. Hires only employees with a solid ethical background as new hires or recruits from the competition. Solid background checks.
2. Delegates but does not abdicate responsibility on: new account forms and risk profiles, option new account forms, account activity reviews, margin agreements, outgoing correspondence, customer complaint log, daily trade activity review, client contact with accounts generating large commissions, updated license/registration files and communication of compliance updates to the office staff especially regarding money laundering and requests for verification of accounts on firm letterhead. Reviews mutual fund

swapping to enhance commissions by the broker.

3. Makes preparations for operations and compliance audits.
4. Finally, when the BOM develops such a culture he gets support from the firm.

There are other factors that the BOM of professional offices use to stay compliance friendly. In the main, to fail to execute any of the above duties is an invitation to violation of NYSE and NASD rules and regulations and exposure to complaints and arbitration.

CONCLUSION:

In October of 2004 the NASD sent out guidance on supervisory controls to take effect on January 31, 2005. The topics cover the following:

1. Account Name/Designation Changes.
2. CEO Certification and establishment of policies and procedures for compliance.
3. IM –3110 Holding Customer Mail.
4. Rule 2510 Customer Account Information.
5. Rule 3010 Customer Discretionary Accounts.
6. Rule 3010 Supervision.
7. Rule 3012 Supervisory Control Systems
8. Rule 3013 Annual Certification of Compliance and Supervisory Procedures.
9. Rule 3110 Books and Records.
10. Supervision.
11. Supervisory Control Procedures.
12. Time and Price Discretion.

The SEC on June 17, 2004 approved the amendments to the above rules and on September 30, 2004 granted accelerated approval to the proposed rule changes to conform to the NYSE's internal control amendments.

Particular attention is given to small offices with a producing manager. The need for heightened supervision for these "satellite" offices becomes very clear from the new supervisory controls.

The effect on the BOM is heightened supervision of his office by the home office and gives him the added responsibility to carry out the changes and to supervise any producing managers under his jurisdiction.

Recent Arbitration Awards

By Jason Doss

Veronica Nicholas v. Fox & Company Investments and Sean Melroe
NASD Case No. 03-07996

Claimant alleged that Respondent improperly recommended that Claimant purchase securities in Becton Dickinson & Company, Liberate Technologies, Palomer Enterprises, Inc. Energy River Corp, Future Carz and Regency Investment Group, Inc.

Claimant asserted the following causes of action: fraud, misrepresentations, unauthorized trading, unsuitable securities recommendations, breach of fiduciary duty, failure to supervise, and violations of the rules of the NASD. Claimant requested 290,666.15 in compensatory damages, $1,000,000 in punitive damages, prejudgment interest, and costs including attorney's fees. Claimant also requested an NASD investigation into the sales practices and day-to-day operations of Respondent Fox & Company Investments, Inc.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various affirmative defenses.

1. The Panel found Respondent Fox & Company liable for $240,000.00 in compensatory damages.

2. The Panel also found Respondent Fox & Company liable for $5,000.00 in discovery sanctions for failure to comply with the Chair's discovery orders.

3. The Panel also required Respondent Fox & Company to pay Claimant $500.00 for reimbursement of the initial claim filing fee.

The award is significant because the Panel issued sanctions against Respondent Fox & Company for failing to comply with discovery orders.

Claimant's Counsel- Paul W. Thomas, Esq. of the Law Office of Paul Thomas & Associates, Carlsbad California.

Respondents' Counsel- Peter E. Garnell, Esq. of Liner Yankelevitz Sunshine & Regenstreif LLP, Los Angeles, California.

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.

Joseph M. Salerno, Beverly T. Salerno, Joseph Salerno and Beverly T. Salerno v. Citigroup Global Markets, Inc. f/k/a Salomon Smith Barney, Inc. and Jack Grubman
NASD Case No. 04-04920

Claimants claimed that they invested nearly $1.12 million in WorldCom stock from 1998 to 2000 based on Jack Grubman's enthusiastic recommendations of the telecommunications company. Claimants held on to it as the stock price declined, because Grubman's research notes continued to urge optimism about the Company's future. Claimants alleged that Respondents disseminated the optimistic research to the investing public even though it did not believe it to be true.

Claimants asserted the following causes of action: omission to state a material fact and conflicts of interest in violation of §17(A) of the Securities Act of 1933, Chapter 110A, §101 of the Massachusetts Uniform Securities Act and NASD Rule 2210(d)(1), breach of fiduciary duty and *respondeat superior*. Claimant requested rescissionary damages in the amount of $1,115,269.60, punitive damages, pre-judgment and post-judgment interest, costs, attorney's fees, and such other damage as the Panel deems appropriate.

Respondents requested that the Panel dismiss the Statement of Claim in its entirety with prejudice and with attorney's fees and costs assessed against Claimants.

1. The Panel found Respondents liable for compensatory damages in the amount of $913,000.00.

2. The Panel also found Respondents liable for punitive damages in the amount of $1,500,000.00 pursuant to MGL-A-CH 110A §410 (h) and NASD Rules 95-85 and 95-16.

3. The Panel also awarded Claimants interest on the award at the rate of 6% per annum from September 15, 2005 until the award is paid in full.

The award is significant because this case is a holder action based on Respondents' fraudulent research. In addition, the award is significant because the Panel awarded punitive damages. Finally, the award is significant because Claimants introduced a damaging SSB internal memo, which said that using stricter rating standards for stocks could threaten the brokerage firm's investment banking business.

Claimant's Counsel- Robert Weiss, Esq. of Hooper & Weiss, LLC, Orlando Florida and Stephen David Murakami, Esq. of Hooper & Weiss LLC, Jericho, New Jersey.

Respondents' Counsel- John A. Sten, Esq. of Greenburg Traurig, LLP, Boston Massachusetts.

Cases & Materials

By Charles W. Austin, Jr.

COURT DECISIONS

FEDERAL COURTS

Second Circuit

Lentell v. Merrill Lynch & Co. Inc.
396 F.3d 161 (2d Cir. 2005)

Second Circuit reversed the trial court's holding that news articles describing analyst conflict of interest were sufficient, standing alone, to constitute "inquiry notice" that would trigger the running of the statutes of limitations.

Bear, Stearns & Co. v. 1109580 Ontario, Inc., 409 F.3d 87 (2d Cir. 2005)

An arbitration decision may effect collateral estoppel in a later litigation or arbitration if the proponent can show "with clarity and certainty" that the same issues were resolved. Collateral estoppel is permissible as to a given issue if "(1) the identical issue was raised in a previous proceeding; (2) the issue was actually litigated and decided in the previous proceeding; (3) the party had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits." These four factors are required but not sufficient. In addition, a court must satisfy itself that application of the doctrine is fair.

In this case, the Second Circuit affirmed the trial court's finding that, in light of earlier arbitration awards favorable to Bear Stearns involving its role as A.R. Baron's clearing firm and the subjectivity accorded the arbitrators in applying the requisite "fairness" standard when deciding whether "offensive" collateral estoppel should be applied, it could not be said that the arbitrators "manifestly disregarded the law" in refusing Ontario's attempts to invoke collateral estoppel against Bear Stearns.

Schaad v. Susquehanna Capital Group
No. 03 Civ. 9902 (SDNY March 3, 2005)

Petition filed by member firms to vacate an arbitration award of attorneys' fees in favor of a former employee, including fees incurred in connection with related state court litigation.

The court refused to vacate the award of attorneys' fees, holding that the arbitrators had properly invoked NASD CAP Rules 10215 and 10324 to make the award of attorneys' fees.

Charles W. (Chuck) Austin, Jr., Richmond, Virginia, is a director of PIABA and a member of its executive committee. His practice is dedicated exclusively to the representation of investors in disputes with the securities industry.

Benson v. Lehman Brothers,
04 Civ. 7323, 2005 U.S. Dist. LEXIS 8542 (SDNY May 9, 2005)

An attempt to avoid arbitration on the grounds of "substantive unconscionability" is denied.

Defendant employer moved to compel plaintiff former employee to arbitrate her claims against the employer in an employment discrimination case pursuant to an arbitration clause in the employee's employment contract. The employee argued that the arbitration provision was unconscionable

The arbitration agreement stated that the employee agreed that any controversy arising out of or in connection with her compensation, employment, or termination of employment with the employer or any of its affiliated companies, would be submitted to arbitration before the NASD, the NYSE or the ASE and be resolved in accordance with the rules, then in effect, of such entities. The employee contended that the NASD, NYSE, and ASE were not neutral third parties, but rather were owned in part by the employer, and that the provision was therefore structurally biased, inequitable and procedurally and substantively unconscionable. The court rejected the employee's contention that the contract was substantively unconscionable, noting that the argument was at odds with settled federal case law regarding the fairness and neutrality of arbitrations conducted under the auspices of regulatory organizations such as the NYSE and NASD. The court further ruled that, because the employee's argument substantive unconscionability failed, it was unnecessary to reach her arguments about procedural unconscionability.

Fraternity Fund Ltd, *et al* v. Beacon Hill Asset Management,
376 F. Supp. 2d 385 (SDNY, July 5, 2005)

Court recognized that the New York Court of Appeals has held that there is no implied private right of action under the Martin Act and that other New York courts have determined that sustaining a cause of action for breach of fiduciary duty in the context of securities fraud would effectively permit a private action under the Martin Act, which would be inconsistent with the Attorney General's exclusive enforcement powers thereunder.

Court also noted that the 2nd Circuit agreed with this rule, citing principles of federalism and respect for state courts' interpretation of their own laws.

Nonetheless, the SDNY held in this decision that the Martin Act does not preempt common law claims where securities at issue were not sold "within or from" New York.

Barkan v. Lehman Bros.
No. 04Civ07431 (SDNY August 2, 2005)

Customer brought arbitration claim against Lehman and individual broker alleging negligence by Lehman in its failure to divise a plan to diversify his concentrated holdings and failure to execute sell orders and received a large award against Lehman, but all claims against the individual broker were denied. Customer moved to confirm award and Lehman moved to vacate on "manifest disregard of the law" grounds.

Lehman first argued that, as the customer's account was non-discretionary, the arbitrators manifestly disregarded the law pertaining to the duty arising out of a non-discretionary account as set forth in *De Kwiatkowski v. Bear, Stearns*, 306 F.3d 1293 (2d. Cir. 2002)(broker owes no duty to give ongoing advice to the holder of a non-discretionary account). The court found that, regardless of *De Kwiatkowski*, the evidence adduced in the arbitration of Lehman's failure to execute sell orders given by customer was "sufficient evidence of a breach of the non-discretionary duty owed to [the customer]" to provide a ground for the arbitrator's decision of liability, "which is all that is required to withstand the standard of manifest disregard of the law."

Lehman next argued that, based on the size of the award, the arbitrators manifestly disregarded the law of mitigation and ratification. In addressing this argument, the court first noted that, under the law of the Second Circuit, "manifest disregard of the law" requires that "the arbitrator must appreciate the existence of a clearly governing legal principle but decide to ignore it or pay no attention to it." However, the record in the arbitration revealed that, while mitigation and ratification were pled as affirmative defenses in Lehman's answer in the arbitration, "they were not further advanced before the arbitrators at any point during the hearing," so it could not be said that these defenses were "disregarded," as required. "An arbitrator, even one who is a lawyer, is ordinarily assumed to be a blank slate unless educated in the law by the parties."

Finally, Lehman argued that the arbitrators manifestly disregarded the law of *respondeat superior* because, by dismissing all claims against the broker, the arbitrators "removed any possible legal basis for holding Lehman liable for negligence." The court also rejected this argument, holding that, under both New York and Second Circuit case law, "an arbitration panel may hold a brokerage house liable for negligence while absolving the particular broker from liability. For example, negligent supervision can provide an independent basis for liability, even where the individual broker is not similarly held liable by the arbitrator. Moreover, a brokerage firm may be liable for negligence even absent a finding of negligence by any one particular broker. Here, petitioner dealt with various Lehman employees. His contact was not limited to the individual broker alone, and evidence of such interactions was before the arbitrators. Moreover, The arbitrators may have found that [the brokerage house's] culpability for its negligence was so much greater than [the broker's] culpability that the [brokerage house] should be held solely liable for [petitioner's] losses. Holding respondent liable for negligence without also holding the individual broker liable is not repugnant, and therefore does not demonstrate a manifest disregard of the law."

Vaughn, *et al* v. Leeds, Morelli & Brown and Prudential Securities,
04 Civ. 8391, 2005 U.S. Dist. LEXIS 16792 (SDNY, August 12, 2005)

Former Prudential employee had earlier settled an employment discrimination claim with Prudential in which former employee was represented by Leeds. The settlement agreement in the underlying dispute, to which Leeds was not a signatory, contained a mandatory arbitration provision. Former employee subsequently brought class action against Prudential and Leeds alleging that the settlement agreement that resolved his dispute with Prudential was a product of secret collusion between Prudential and Leeds and further alleging, on behalf of himself and all others similarly situated, that Leeds had established "an employment discrimination dispute resolution system that would enable Prudential to cap damages paid to various plaintiffs and settle numerous claims with plaintiffs represented by Leeds at one time with a lump sum payment while providing direct payment of attorney's fees to Leeds.

Leeds and Prudential both moved to compel arbitration under the terms of the settlement agreement. Former employee opposed the motion: (1) On the grounds that SRO arbitration rules did not allow for class actions; and, (2) As to Leeds, on the grounds that Leeds was not a signatory to the settlement agreement which contained the mandatory arbitration clause at issue.

The court granted the motions to compel arbitration as to both Prudential and Leeds, holding that: (a) Whether or not SRO arbitration would allow for the claim to proceed as a class action in arbitration was a question for the arbitrators, not the Court; and, (b) That Leeds had the right to compel arbitration under the agreement to which it was not a signatory because the claims against Leeds were so intertwined with and

dependent upon the claims against Prudential. "Under principles of estoppel, a non-signatory to an arbitration agreement may compel a signatory to that agreement to arbitrate a dispute where a careful review of the relationship among the parties, the contracts they signed, and the issues that had arisen among them discloses that the issues the nonsignatory is seeking to resolve in arbitration are intertwined with the agreement that the estopped party has signed."

Third Circuit

Black Box Corporation v. Markham,
127 Fed.Appx. 22,
2005 U.S. App. LEXIS 3968
(3d Cir. March 9, 2005)

Appellant Black Box moved to vacate an arbitration award against it under the Arizona Securities Act on the grounds that the arbitrators exceeded their authority by making an award under the Act because the parties' agreement provided for the application of Pennsylvania substantive law.

The district court held that appellant had waived its right to contest the arbitrability of the claim under the Act by not raising the issue with the arbitrators and thereby voluntarily submitting adjudication of the claim to arbitration. The Third Circuit affirmed.

National Clearing Corp. (fka J.B. Oxford), *et al* v. Treff, No. 04-CV-4765,
2005 U.S. Dist. LEXIS 415
(ED Pa., January 10, 2005)

The investor/defendant brought an arbitration action against NCC alleging breach of contract, fraud, breach of fiduciary duty, failure to supervise, and failure to handle the account in the manner required under NASD rules and regulations and in a manner suitable to the investor's financial condition and expressed desires. An arbitration panel held hearings, and NCC presented evidence that the investor was not who he represented himself to be, had been convicted of grand theft, and had been using other people's social security numbers. Despite this evidence, the arbitration panel entered an award in favor of the investor. NCC filed a motion to vacate the award on the grounds that "the arbitrators imperfectly executed their powers, because the award does not meet the test of fundamental rationality and because it compels violation of the law and is therefore contrary to public policy."

The court found that while the investor's identity and use of numerous social security numbers was indeed suspect, the court simply could not, on the basis of the record before it, find that the award violated any well-defined and dominant public policy, that it escaped the bounds of rationality or that the arbitrators imperfectly executed their powers in issuing it. "It was within the arbitrators' province to accept or reject and to weigh the evidence concerning the investor's identity and credibility."

NCC's motion to vacate was denied, and the investor's motion to confirm was granted.

Fourth Circuit

Discover Bank v. Vaden,
396 F.3d 366 (4th Cir. 2005)

Non-securities case.

Rejecting the *Westmoreland doctrine* adopted by the Second, Fifth and Ninth circuits, the Fourth Circuit decides that when a party comes to federal court seeking to compel arbitration, the presence of a federal question in the underlying dispute is sufficient to support subject matter jurisdiction.

Fifth Circuit

Joel J. Safer, *et al* v. Nelson Financial Group, *et al*, 422 F.3d 289 (5th Cir. 2005)

Plaintiff individuals sued defendant financial advisors alleging inappropriate investments, misrepresentation, breach of fiduciary duty, violation of federal securities laws, and negligence. The U.S. District Court for the Middle District of Louisiana denied defendants' motion to stay the action pending arbitration and to compel arbitration. Defendants appealed the judgment.

The appellate court rejected the individuals' contention that their claims arose solely under an advisory agreement, which did not include an arbitration clause, because the forms signed with the broker-dealer through whom the trades were executed contained an arbitration clause and were signed at the same time as the advisory agreement. The court noted that the customers' complaints arose out of the implementation of the allegedly bad advice through the broker dealer, with whom the customers did have an arbitration agreement. Thus, both agreements were designed to give effect to the parties' relationship. To the extent the individuals' claims fell under the terms of the advisory agreement, the plain language of the arbitration clause in the broker-dealer forms specifically covered those claims.

The judgment was reversed and the case was remanded for entry of an order staying the litigation and requiring the parties to submit their dispute to arbitration.

Pacific Life Insurance Co. v. Heath,
370 F. Supp. 2d 539
(S.D. Miss., May 5, 2005)

Plaintiff insurance company filed an action against defendant purchaser to compel arbitration of the purchaser's claims asserted against the insurance company and others in an underlying litigation in state court arising out of "flipping" annuities.
The purchaser had executed an agreement with the broker-dealer that contained provisions for arbitration. The court found that the arbitration clause in the broker-dealer agreement applied to the claims against the insurance company, even though the insurance company was not a signatory to the agreement, because the insurance company's claims were intertwined with the claims arising out of the purchase agreement. The court rejected the purchaser's assertion that the arbitration agreement was invalid because it was allegedly procured by fraud. The agent represented to the purchaser that she was signing a new account agreement, and that representation was not false. Based upon the broad language of the arbitration provision, the underlying lawsuit needed to be submitted to arbitration.

The court granted summary judgment in favor of the insurance company, compelled the claims against the insurance company to arbitration and stayed the state court proceedings.

Sixth Circuit

Glazer v. Lehman Bros. & SG Cowen,
Nos. 03-4312/4415,
2005 U.S. App. LEXIS 468
(6th Cir., January 12, 2005)

A "Gruttadaria" case.

Investor filed suit in federal district court, which Lehman and Cowen moved to compel to arbitration on the basis 4 different agreements customer signed which contained arbitration provisions. In connection with Lehman's and Cowen's motions to compel, the investor testified that, prior to signing the subject agreements, Gruttadaria had advised the investor that the arbitration clauses "would not be enforced." On the basis of that testimony, the trial court denied the motions to compel arbitration on the grounds that the arbitration agreements had been fraudulently induced.

The Court of Appeals reversed on the grounds that, because the basis of the trial court's decision rested on inadmissible "parol evidence" (the testimony that Gruttadaria had assured the investor that the arbitration provisions would not be enforced), there was otherwise no evidentiary basis for the trial court's refusal to grant the motions to compel arbitration.

Liberte Capital Group, LLC, *et al* v. Capwill, *et al* -- UNPUBLISHED
Case No. 03-4040,
2005 U.S. App. LEXIS 18324
(6th Cir. August 24, 2005)

Appellant securities dealer sought review of an order of the U.S. District Court for the Northern District of Ohio, which granted appellee investors' motion to compel arbitration of their dispute with the dealer regarding the purchase and sale of certain viatical insurance investments.

The dealer marketed viaticals. The dealer sued two escrow agents and their owner for misappropriating investment funds. The investors, who purchased the dealer's investments, became members of a class that intervened in this lawsuit. Thereafter, the investors filed an arbitration claim under Rule 10301(d)(2) against the dealer. The district court granted the investors' motion to compel arbitration of this claim, finding it was not encompassed by the class litigation, but was based on the conduct of the dealer's sales employees, who were not part of the class suit.

On appeal, the court affirmed. The arbitration raised different issues and sought different damages than the class litigation. Further, the dealer was not a party defendant in the class action, and its liability for the misconduct of its agents was not related to the limited purposes of the class litigation. Further, the arbitration was not precluded under the plain meaning of Rule 10301(d)(2) because it did not seek the same claims as the class litigation.

Henson v. Morgan Stanley DW, Inc,
No. 3:04-0963,
2005 U.S. Dist. LEXIS 15371
(M.D. Tenn., June 7, 2005)

Arbitrators awarded attorneys' fees and costs under the state securities statute and cited to the statute in the body of the award as support for its award of attorneys' fees. The same panel, however, failed to award full compensatory damages under the state statute. On the customers' motion to vacate, the court found that the record in the arbitration, including the arbitrators' citation to the state securities act in the body of the award, evidenced manifest disregard of the statutorily mandated compensatory damages and vacated and modified the Award, raising the compensatory damages award by over 3 times to the statutorily mandated level.

Seventh Circuit

Olson v. Wexford Clearing Services Corp.,
397 F.3d 488 (7th Cir. 2005)

A lengthy opinion worth reading because of its discussion of important procedural issues raised and the impact of those rules on the timeliness of post-award challenges. The overriding lesson is, in the Court's own words, that "[a] party who is uncertain about the finality or appealability of an arbitration award should err on the side of compliance with FAA § 12, which is not onerous."

Investor filed arbitration against clearing firm, which clearing firm moved to dismiss. Solely on the basis of the parties' written submissions, the arbitration panel Chairman issued a two page order dismissing the Statement of Claim.

Investor petitioned the entire arbitration panel to reconsider the Chairman's dismissal of his claim on the grounds that the Chairman alone was not empowered under NASD arbitration rules to issue such a summary dispositive ruling. In response, the entire arbitration panel heard arguments on Wexford's motion to dismiss. On April 15, 2002, at the conclusion of Olson's and Wexford's arguments, the panel again found in favor of Wexford and issued a "Prehearing Conference Order" stating that Wexford "is hereby dismissed from this arbitration." This order was signed by the chair on behalf of the panel. At the bottom of the "Prehearing Conference Order" appeared a statement to the effect that "this Order shall remain in effect unless amended by the Panel."

A little over two months passed before Olson filed a "Motion for Consent to File Second Amended Statement of Claim," which Wexford opposed. On July 29, 2002, the arbitration panel issued a letter to Olson, stating that after "careful review, " it was denying his request to amend his Statement of Claim for the second time.

Olson then turned to the federal court. On October 24, 2002, Olson filed his action to vacate the arbitral decision dismissing Wexford from the case. Olson was aware that the FAA has a three-month limitations period within which challenges to arbitration awards must be filed. In his view, however, the clock began to tick on July 29, 2002, the date on which the panel denied his request to file a second amended Statement of Claim, which - if accepted by the court - would mean that his petition to vacate was timely.

Wexford countered that the relevant date for purposes of the limitations analysis was April 15, 2002, when the panel dismissed it as a party to the arbitration proceedings. Under Wexford's theory, Olson was too late because more than three months had passed since the panel made its final decision on April 15. The district court agreed with Wexford's analysis and dismissed Olson's petition as untimely. Olson appealed to the Seventh Circuit.

The Seventh Circuit's starting point in its analysis was NASD Rule 10330, which requires that an arbitration award include "a summary of the issues, . . .the damages and other relief requested, the damages and other relief awarded, [and] a statement of any other issues resolved" and that the award is to be in writing and "signed by a majority of the arbitrators or in such manner as is required by applicable law."

Olson argued that the April 15 dismissal of Wexford did not meet the NASD criteria for finality, because the following sentence appeared at the bottom of the Prehearing Conference Order: "This Order shall remain in effect unless amended by the Panel." Olson asserted that this language, supported the inference that the arbitrators did not consider the dismissal of Wexford to be their final award.

The Seventh Circuit found that the sentence on which Olson is relied must be viewed in context, and noted that it was preceded by a section entitled "other rulings," which was addressed to the other parties remaining in the arbitration, consistent with CAP Rule 10330(e) (explicitly permitting an award to include "a statement of any other issues resolved"). On that basis, the Seventh Circuit concluded that, taken as a whole, the sentence upon which Olson rested his argument was merely one addressed to the parts of the case that were still alive. The Court concluded that the April 15th dismissal complied with the basic requirements under NASD CAP Rule 10330 to constitute an "award." "Since the panel's handling of this matter complied with the general requirements of NASD Rule 10330(e), we conclude that the April 15 dismissal of Wexford was a final NASD award."

Interestingly, the Court noted that "[i]t is not clear whether the presence of claims against other parties to the arbitration affects the finality of Wexford's dismissal, but Olson has not relied on that theory to reject the April 15 date (not surprisingly, because it would also doom his attempt to characterize the July 29

order as 'final'). Under the circumstances, he has forfeited that potential argument, which we reserve for another day."

The investor next argued that, even if the April 15 award was sufficiently final to end the case, it had another flaw serious enough to affect the limitations period. NASD Rule 10330(a) requires all awards to be "signed by a majority of the arbitrators." Thus, according to Olson, the April 15 award could not have been a proper award under NASD rules because it was signed by the chair on behalf of the panel. While conceding that "'superficial technicalities' should not control whether a decision in arbitration is final or not," Olson argued that the signature requirement is substantively important.

In response, the 7th Circuit noted that the finality of an arbitration agreement "should be judged by substance and effect, not by superficial technicalities," and that the arguable violation of an NASD rule should not have the drastic consequence of rendering the April 15 decision a nullity, particularly since the NASD rules do not prohibit the chair from signing an order on behalf of the panel.

Finally, the Court rejected the investor's argument that the June 29 denial of his motion to amend started the three-month limitations clock for purposes of the FAA § 12. "The FAA speaks in terms of 'awards,' and we have found no authority suggesting that a letter denying one party's motion to amend is properly characterized as an award. "The purpose of the short periods prescribed in the federal and state arbitration statutes for moving courts to vacate an award is to accord the arbitration award finality in a timely fashion. This purpose would be severely undermined if the limitations period prescribed in the FAA § 12 were tolled every time a losing party filed the functional equivalent of a motion for reconsideration.

Mary Lou Baird & Betty Ann Barnes v. RBC Dain Rauscher
Case No. 03 C 5157,
2005 U.S. Dist. LEXIS 7197
(ND Ill. March 30, 2005)

Plaintiffs brought action under Wisconsin securities and common law against RBC Dain Rauscher, Inc. requesting, among other things, rescissionary damages under the Wisconsin Securities Act. Defendant moved to dismiss those allegations in plaintiffs' complaint which set forth plaintiffs' "selective rescission" theory of damages.

After noting that the issue was one of first impression, the Court stopped short of ruling that rescissionary damages were available under the Act, ruling instead that the issue was fact dependent. As such, Defendant's motion was deemed premature and was denied.

Eighth Circuit

Biscanin v. Merrill Lynch & Co., Inc.,
407 F.3d 905 (8th Cir. May 6, 2005)

Assuming without deciding that a claim of "manifest disregard of federal law vested the trial court with "federal question jurisdiction," the Eighth Circuit nonetheless found that the trial court did not have jurisdiction over a customer's motion to vacate an arbitration award because the allegations of "manifest disregard of federal law" were "so untenable as to be patently meritless." "A court does not obtain subject-matter jurisdiction just because a plaintiff raises a federal question in his or her complaint. If the asserted basis of federal jurisdiction is patently meritless, then dismissal for lack of jurisdiction is appropriate."

Ninth Circuit

Credit Suisse First Boston v. Grunwald,
400 F.3d 1119 (9th Cir. 2005)

First "nail in the coffin" of the attempt to apply the California "arbitrator disclosure standards" to SRO arbitration (*see* the *Jevne* decision from the California Supreme Court discussed below). The Ninth Circuit held that, while the California legislature intended the standards to apply to SRO arbitration, the Securities Exchange Act of 1934 preempts application of California's ethics standards to NASD arbitrations and that, as such, NASD rules approved by the SEC have preemptive force over conflicting state law.

Tenth Circuit

Ansari v. Qwest Communications,
414 F.3d 1214 (10th Cir. 2005)

Non-securities matter. Case of first impression in the Tenth Circuit.

Ansari filed suit against Qwest in federal court in Colorado. Qwest moved to compel arbitration based on an agreement between the parties requiring arbitration in Washington, D.C.. The trial court denied the petition to compel arbitration, ordered that any arguments regarding arbitrability of plaintiffs' claims be decided by the district court in the District of Columbia (if Qwest chose to file a petition to compel arbitration there) and stayed the action pending a determination by the District of Columbia district court on the arbitrability of the claims and the outcome of any arbitration proceeding. The Tenth Circuit affirmed, finding that: (1) The trial court could not compel arbitration in Colorado because of the parties' arbitration agreement requiring arbitration in Washington, D.C.; and, (2) The trial court had no right to compel arbitration in a district other than its own.

Eleventh Circuit

SII Investments v. Jenks,
370 F. Supp. 2d 1213 (M.D. Fla. 2005)

Because recommendation was made at Firm A, Firm A can be compelled to arbitrate claim even though investment was not purchased until broker had moved to Firm B.

STATE COURTS

Alabama

Edward D. Jones & Co., *et al* v. Ventura
907 So. 2d 1035 (Ala. Feb. 25, 2005)

The trial court denied a motion to compel appellee beneficiary to arbitrate his claims in two actions against two separate brokerage firms and their respective agents (firms), in an action alleging a breach of fiduciary duty, as a trustee in invitum, and fraud and/or suppression in their handling of the beneficiary's trust estate with the conservator. The trial court held that the firms failed to establish that the conservator had the authority to bind the beneficiary to the investment agreements, no binding contract was established, and no preference in favor of arbitration existed.

On appeal, the beneficiary argued that his conservator lacked the authority to enter into arbitration agreements with the firms on his behalf. The appeals court first held that under Ala. Code § 26-2A-152, the conservator was granted the same powers of investment as those granted a trustee. Thus, the conservator had the authority to enter into the investment agreements on the beneficiary's behalf. Because the beneficiary's claims arose out of the investment agreements for purposes of the motions to compel arbitration, and the language of said provisions was broad enough to encompass said claims, he had to rely on or refer to the investment agreements to establish his allegations. That was true despite his status as a non-signatory to the arbitration provision. Finally, because the beneficiary was subject to the arbitration

provision, his cause of action under the theory of trustee in invitum was an issue for the arbitrator to resolve.

The judgments in both cases were reversed, and the cases were remanded.

Arizona

Morgan v. Carillon Investments
109 P.3d 82 (Ariz. April 1, 2005)(*en banc*)

There is no limitations period under the Arizona Securities Act for filing a motion to vacate an arbitration award. "A prevailing party has the ability to preclude the spectre of an unlimited limitations period for filing a motion to vacate an arbitration award by filing a motion to confirm the award pursuant to A.R.S. § 12-1511 (2003), thereby triggering the twenty-day limitation in which to file an opposition."

California

Provencio, *et al* v. WMA Securities
125 Cal.App.4th 1028
(Cal. App. Dist.2, Feb. 14, 2005)

NASD CAP Rule 10301 prevented defunct brokerage firm from compelling arbitration of customer claim without the customer's express written consent.

Banc of America Investment Services v. Plycraft Industries - UNPUBLISHED
Case No. B168627, 2005 Cal. App. Unpub. LEXIS 3469 (Cal. Ct. App., April 20, 2005)

Based on the doctrine of *res judicata*, the trial court enjoined a party from litigating a spoliation of evidence claim in a subsequent arbitration proceeding. The Court of Appeals concluded *res judicata* bars the claim because the issue of spoliation was litigated in the first arbitration proceeding and that *res judicata* similarly barred the assertion of the claim against a non-party to the first proceeding. The court further ruled that, even if an independent cause of action for spoliation of evidence were recognized by Florida law, the spoliation claim would be barred by *res judicata*. Finally, the spoliation claim was waived by the failure to assert it as a basis for vacating the arbitration award or opposing the petition to confirm the award.

Jevne v. Superior Court of Los Angeles
35 Cal. 4th 935; 28 Cal. Rptr. 3d 685
(Cal. May 23, 2005)

The second and final "nail in the coffin" of the attempt to apply the California "arbitrator disclosure standards" to SRO arbitration (*see* discussion of *CSFB v. Grunwald* in "Federal Cases").

The court held that Cal. Code Civ. Proc. §1281.85(a) authorized the California Judicial Council to adopt ethics standards for arbitrators appointed by arbitration providers, but it also held that the Securities Exchange Act of 1934 preempted the California Standards in the context of arbitrations administered by NASD Dispute Resolution. In determining that the NASD Code should preempt the California Standards, the Court found that, in approving the NASD Code,the SEC acted within its authority, and its determination was neither arbitrary nor unreasonable. A delay in arbitrator selection and appointment, resulting from uncertainty regarding the applicability of the California Standards, did not relieve the investors of their duty to arbitrate.

Florida

Citigroup, Inc., *et al* v. Amodio
894 So. 2d 296
(Fla. Dist. Ct. App., Feb. 23, 2005)

A retired former employee of WorldCom decided to place his WorldCom stock shares in what he says was a "retirement" account with Citicorp Investment Services. He had acquired the shares during his years of employment with WorldCom (or its predecessor). He signed an account agreement which included an agreement to arbitrate "all controversies which may arise concerning any order or transaction, or the

construction, performance or breach of this Agreement." None of his WorldCom stock was thereafter bought or sold through this account. The account agreement did not give Citicorp Investment any discretion to manage the WorldCom shares; the retiree was responsible for making any decisions to trade these shares.

Some time later, he sought advice from representatives of CitiGroup as to the wisdom of having nearly his entire holdings in WorldCom stock alone, fearing that if something happened his retirement savings would be gone. He was referred to Salomon Smith Barney (SSB), a subsidiary of CitiGroup and one of its analysts. The SSB analyst assured him that he had analyzed WorldCom and recommended holding onto it because "it would break triple digits by the end of the year." Needless to say, something bad happened to WorldCom. The retiree lost all value from his WorldCom portfolio.

The retired employee sued CitiGroup, Citicorp Investment Services, and the CitiGroup subsidiary that is the successor to SSB, for fraud and negligent misrepresentation, Florida Blue Sky law violations, breach of an oral contract and emotional distress. Defendants all moved to compel arbitration on the basis of the foregoing arbitration provision. In denying the motion, the trial judge found that none of plaintiff's claims involved an "order or transaction" and that none of the claims involved "construction, performance or breach" of the Citicorp Investment account agreement. All defendants appealed the trial court's order.

The appeals court affirmed the trial court's denial of the motion to compel arbitration, noting that, the mere fact that the dispute would not have arisen but for the existence of the contract and consequent relationship between the parties is insufficient by itself to transform a dispute into one 'arising out of or relating to' the agreement. "If the contract places the parties in a unique relationship that creates new duties not otherwise imposed by law, then a dispute regarding a breach of a contractually-imposed duty is one that arises from the contract. Analogously, such a claim would be one arising from the contract terms and therefore subject to arbitration where the contract required it. If, on the other hand, the duty alleged to be breached is one imposed by law in recognition of public policy and is generally owed to others besides the contracting parties, then a dispute regarding such a breach is not one arising from the contract, but sounds in tort. Therefore, a contractually-imposed arbitration requirement would not apply to such a claim."

The appeals court concluded that all of the investor's claims alleged breaches of law imposed generally to enforce public policy creating duties owed to the public at large, and therefore did not fall within the narrow arbitration intent expressed by the parties in their agreement. The court also noted that plaintiff had no prior agreement whatever with CitiGroup. The written agreement was with only Citicorp Investment and the predecessor to CitiGroup Global Markets, and accordingly there was no arguable basis to require arbitration between plaintiff and CitiGroup.

Raymond James v. Saldukas
896 So.2d 707 (Fla. Feb. 24, 2005)

There is no requirement that "prejudice" be demonstrated to find that a party has waived its right to arbitrate under Florida arbitration law.

Citigroup, Inc. v. Boles
No. 4D04-3480
(Fla. Dist. Ct. App., Sept. 28, 2005)

Appeal by Citigroup of trial court's refusal to compel "Worldcom claim" to arbitration.

Investors acquired Worldcom stock between 1998-2001 allegedly on the basis of Jack Grubman's research reports. In 2003, investors opened an account with Citigroup as a repository for their Worldcom stock and signed a typically broad arbitration agreement. Subsequently, investors filed suit against Citigroup and others alleging fraud,

negligence, and Florida Blue Sky law violations on the part of Citigroup and others arising from Grubman's allegedly flawed stock analyses. Citigroup moved to compel arbitration of the claim based on the agreement signed by the customers in 2003. The trial court denied the motion.

In affirming the trial court's decision, the appeals court observed that "the complaint does not involve or refer to the agreement, and the agreement is not related in any way to the allegedly tortious investment advice. Furthermore, the alleged misrepresentations made by Grubman were made long before the account was opened, and the stock was nearly worthless before it was placed in the [investors'] account. The [investors'] claims unquestionably sound in tort and as violations of ... the Florida Securities Investors Protection Act, and do not concern the agreement or any transaction or relationship of any kind between [them] and SSB.. . . Not only is it unlikely that the Boleses intended to sign their rights away by opening the account, there is no reason to accept that SSB contemplated claims like those of the [investors] when drafting the account application form that imposed no obligations on SSB."

Maine

Barrett v. McDonald Investments
870 A.2d 146 (Me. March 29, 2005)

Appeal of trial court's refusal to compel arbitration under a written agreement.

Customers executed an agreement under which customers would deposit money with McDonald to invest in options selected by customer and upon customer's instruction and direction. The Agreement disclaimed any fiduciary relationship and did not in any way describe McDonald or its representative as having any advisory roles. The Agreement provided: "The Custodian (McDonald) and the Depositor (Customer) agree that by the Custodian opening and carrying an account for the Depositor, all controversies which may arise between us concerning any transaction or the construction, performance or breach of this or any other agreement between us pertaining to securities and any other property, whether entered into prior, on or subsequent to the date hereof, shall be determined by arbitration."

Contrary to the terms of the agreement, McDonald's representative advised the customers to invest all of their money into a variable annuity. After losing approximately half of their savings, the customers filed suit against McDonald in court alleging various tort claims. McDonald moved to compel on the basis of the arbitration agreement. The trial court denied McDonald's motion and McDonald appealed.

"The issue before us presents a clear conflict between two established principles of contract interpretation. On one hand, Maine has a broad presumption in favor of arbitration. On the other, we have long recognized that ambiguities in a contract are to be interpreted against the drafter. The tension between these doctrines is heightened when, as in this case, the parties to the contract are in unequal bargaining positions."

Following this analysis, the Maine Supreme Court found that the contract was ambiguous insofar as the arbitration agreement was concerned. "In the context of this Agreement, where the parties expected McDonald to act in a purely custodial capacity, it is unclear whether the giving of investment advice constitutes a 'transaction' within the meaning of the arbitration clause. It is also unclear from the Agreement whether the giving of investment advice constitutes 'any other agreement' between the parties. These uncertainties create ambiguities in determining the reach of the agreement to arbitrate.

We must determine whether to follow our long-held principle that an ambiguity in a contract be construed against the drafter or to apply the principle that doubts should be

resolved in favor of arbitrability. In this context, where an individual with little leverage is entering into an agreement with a larger entity that offers its services on a 'take it or leave it' basis, we conclude that the balance tips in favor of applying the equitable rule favoring the construction of the contract against the drafter."

The trial court's denial of McDonald's motion to compel arbitration was affirmed.

Montana

Willems v U.S. Bancorp Piper Jaffray, *et al*,
107 P.3d 465 (Mont. Feb. 22, 2005)

The trial court concluded that the parties' contract created a fiduciary duty and that the broker breached its fiduciary duty when it failed to explain the consequences of the arbitration provision prior to the formation of the contract. In affirming, the Montana Supreme Court observed that Mont. Code Ann. § 30-10-301(1) created an implied code of conduct for brokers, violations of which could constitute a breach of the duty that a broker owed to a customer. A fiduciary relationship was created whenever a broker had discretion to buy and sell in a client's account. The court determined that the parties' contract, which gave the broker discretion to buy and sell in the investor's account whenever the broker deemed it necessary for the broker's protection, gave rise to a fiduciary relationship. The obligation arose prior to the actual signing of the agreement. The district court did not improperly apply different legal standards to arbitration provisions and did not violate either the Federal Arbitration Act or Mont. Code Ann. § 27-5-114(2) when it determined that a fiduciary relationship existed. The arbitration provision was thus unenforceable.

The district court's denial of the broker's motion to compel arbitration was affirmed.

New Jersey

Wilde v. O'Leary
866 A.2d 205
(N.J.Super.App.Div. Feb. 4, 2005)

The court vacated an arbitration award where there was a finding for the Respondent brokerage firm. Although the Claimant had submitted her expert's *Curriculum Vitae* well prior to the hearing, Respondents did not move to preclude the expert's testimony prior to the hearing, but rather, waited until the Claimant's expert was scheduled to testify to object to his qualifications. The arbitrators precluded the expert's testimony and gave the Claimant only until that afternoon to get another expert. Claimant could not do so, and the panel ruled in favor of Respondents. The lower court granted Respondents' motion to confirm and denied Claimant's motion to vacate. The appellate court reversed.

Under N.J.S.A. 2A:24-8 (c) an award can be vacated if the arbitrators were guilty of misconduct in refusing to postpone the hearing upon sufficient cause bring shown. In the Court's view, "the 'misconduct' arose when the arbitrators refused to grant plaintiff an extension of time to retain a new expert after defendants strategically waited until the expert was presented before making their motion to preclude. When a party is required to arbitrate before an industry-controlled arbitration panel in accordance with rules propagated by the industry, it is incumbent upon the arbitrators to provide a fair forum and to respect fundamental due process rights." The court cites with approval Bordonaro v. Merrill Lynch, 805 N.E.2d 1138 (Ohio App. 2004).

New York

CSFB v. Pitofsky, *et al*
824 N.E.2d 929 (N.Y. 02/10/2005)

CSFB appealed a New York Supreme Court, Appellate Division, reversal of an order, granting the bank a stay of arbitration that former CSFB employees had commenced

before the NYSE. CSFB argued that an arbitration clause in its employee handbook superseded arbitration provisions in the employees' agreement with the NYSE.

Although the employees' registration agreement with the NYSE provided that disputes with their employers would be arbitrated before the exchange, the bank's arbitration clause specified other bodies as arbitration forums. The court held, first, that the intermediate court had erred in holding that the registration agreement's arbitration clause could not, as a matter of law, be superseded, but that nonetheless, the outcome it had ordered was correct. New York case law was generally highly respectful of parties' rights to contract, and so the clause in the handbook superseded the one in the exchange registration agreement. Nonetheless, the employer's clause contained an exception for matters that were legally required to be arbitrated in another manner, and it was clear from a stock exchange rule that disputes over payment between broker-dealers and their employers were absolutely required to be arbitrated by the exchange. Although it was not dispositive, the court also noted that the employer had admitted that its arbitration clause had been primarily directed at discrimination claims in any event, which were not implicated in the case before it.

The court affirmed the order of reversal.

Fellus v. A.B. Watley, Inc.
2005 NY Slip Op 50622U;
2005 N.Y. Misc. LEXIS 821
(Sup. Ct. NY Co., April 15, 2005)

Motion by ex-employee to confirm arbitration award in his favor and cross-motion by broker-dealer to vacate the award on the grounds of "manifest disregard of the law."

The court noted that it had earlier ruled that "manifest disregard" is not an available basis under New York law to vacate an award. However, if the FAA applies to the contract under which the arbitration was held, the New York courts have no choice but to apply the "manifest disregard" standard to review arbitration awards. The court found that, in this case, since the contract involved a broker-dealer which was involved in interstate commerce, the court must recognize the "manifest disregard" standard. Nonetheless, after a lengthy discussion of the "manifest disregard" standard as enunciated by the Second Circuit, the court found that the broker-dealer could not prevail in its motion to vacate on that basis.

North Carolina

First Union Securities v. Lorelli
607 S.E.2d 674 (N.C. App. Feb. 1, 2005)

FUSI filed a petition seeking to vacate or modify an attorneys' fee award granted by an arbitration panel in favor of former employee. Former employee filed a petition to confirm. The Mecklenburg County North Carolina trial court confirmed the award. FUSI appealed.

FUSI argued that the trial court erred in confirming the award because the arbitration panel lacked the authority to award attorneys' fees. The trial court specifically found that NYSE Rule 629 allowed arbitrators to award attorneys' fees and that both parties submitted the issue of attorneys' fees to the panel. The appellate court held that these two grounds were sufficient to uphold the award of fees. The submission agreement signed by both parties and under which the parties agreed to arbitrate the dispute under the constitution and rules of the NYSE, was a valid and binding contract which modified the arbitration agreement. Thus, the scope of the arbitrators' jurisdiction was defined by both the contract containing the arbitration clause and the submission agreement. Attorneys' fees were properly awarded pursuant to NYSE Rule 629(c). The agreement to arbitrate contained no state law provision, and in any event, a state choice of law clause in an arbitration agreement was not construed to limit the authority of arbitrators.

The judgment was affirmed.

North Dakota

Strand v. U.S. Bank
693 N.W.2d 918 (N.D. March 31, 2005)

Non-securities case.

A "no class action" provision in an arbitration agreement is found to be procedurally unconscionable but not substantive unconscionable under North Dakota law. A showing of both procedural and substantive unconscionability was required to declare a contractual provision unconscionable and unenforceable. "Although the unavailability of a class action or class arbitration could make recovery of damages less convenient for the purported class as a whole, under the facts in the case the arbitration provision created a chance that the customer could be made whole through individual arbitration."

Texas

In re Prudential Securities & Lamonte,
2005 Tex. App. LEXIS 2404
(Tex. Ct. App. March 30, 2005)

During the course of marriage, Husband maintained account with Prudential Securities through its registered representative, Lamonte, which was subject to a broad arbitration agreement. During the divorce proceeding, Wife learned Husband was an aggressive commodities trader and lost over $ 2,000,000 in commodities trading over the course of their marriage. After the divorce, Wife brought court action against Prudential and Lamonte for fraud, breach of fiduciary duty, negligence and gross negligence, alleging they participated with Husband in a fraud on the community property. Prudential and Lamonte filed a motion to compel arbitration of wife's claims citing the arbitration agreement executed by Husband during marriage. Wife responded that her claims were not subject to arbitration because she had not signed the agreement, and her claims did not fall within the scope of the arbitration agreement. The trial court agreed with Wife, and denied the motion to compel. Prudential and Lamonte filed a petition for writ of mandamus with the Texas Court of Appeals, which was also denied.

Subsequent to the appeals court's denial of the mandamus request, Wife amended her claim to include claims formerly belonging to Husband which were assigned to her in divorce proceeding and which Wife conceded were subject to the arbitration agreement executed by the Husband during the marriage. Prudential and Lamonte filed another motion to compel arbitration, which the trial court denied. Prudential and Lamonte filed another Petition for Writ of Mandamus with the appeals court.

While conceding that the claims assigned to her in the divorce proceedings fell within the scope of the arbitration clause, Wife contended that, once the appeals court had denied the first mandamus petition, that denial became "the law of the case." The court rejected that argument, noting that it had not specified the grounds for denial of the first mandamus petition and that, regardless, Wife had added new claims subsequent to the denial of the first mandamus petition. The Appeals Court then went on to examine the facts underlying the original claims and the new claims, rather than the causes of action asserted, and found that the original claims (which were not subject to the arbitration agreement) were so intertwined with the new claims (which were concededly covered by the arbitration agreement), that all of the claims must be arbitrated. Prudential's and Lamonte's second petition for writ of mandamus was granted.

Virginia

Bates v. McQueen
613 S.E. 2d 566 (Va. June 9, 2005)

An arbitration ordered to be conducted in accordance with Virginia's version of the Uniform Arbitration Act requires a hearing. As there was no hearing conducted in the underlying arbitration, the Virginia Supreme Court vacated the award.

Wisconsin

<u>**Richards v. First Union Securities**</u>
702 N.W.2d 45
(Wis. Ct. App. June 1, 2005)

Appeal by broker-dealer of default judgment entered in favor of investor.

A FUSI employee accepted service of process in an action by investor to recover investment losses. When FUSI failed to answer, the investor filed a motion for a default judgment. The judgment was granted, and FUSI sought to reopen the default judgment after garnishment proceedings were instituted. The circuit court found that personal service was waived, and FUSI sought review.

In reversing, the Wisconsin Court of Appeals determined that the circuit court had no personal jurisdiction if service of process was insufficient. Such a defense was waived only if it was omitted from Wis. Stat. §802.06 motions or the responsive pleadings. Since this was not the case, there was no evidence of a waiver. Next, the court considered whether service on FUSI's employee complied with Wis. Stat. §§180.0504(1), 801.11(5)(a). The personal service delivery option was not met because the employee was not an officer, director, or managing agent of the bank. Nor was the alternative service option met because the location where service was made was not the office of a managing agent. Because service of process was not valid, the default judgment was void, and the trial court's ruling was reversed.

AROUND the SROs

NASD

Notices to Members

NTM 05-04: SEC Approves Amendments to NASD Rule 2830(k) to Strengthen Prohibitions on Investment Company Directed Brokerage Arrangements; Effective Date: February 14, 2005

On December 20, 2004, the Securities and Exchange Commission approved amendments to NASD Rule 2830(k), which governs NASD members' execution of investment company portfolio transactions. The amended rule augments existing proscriptions on directed brokerage practices by prohibiting a member from selling the shares of, or acting as an underwriter for, any investment company if the member knows or has reason to know that the investment company or its investment adviser or underwriter have directed brokerage arrangements in place that are intended to promote the sale of investment company securities. The amendments also eliminate an existing provision in the rule that permits a member, subject to certain conditions, to sell or underwrite the shares of an investment company that follows a policy of considering fund sales in determining whether to send portfolio transactions to a broker-dealer. The effective date of this rule change was February 14, 2005.

NTM 05-08: Guidance Regarding the Application of the Supervisory Control Amendments to Members' Securities Activities, Including Members' Institutional Securities Activities

On September 30, 2004, the Securities and Exchange Commission approved the Supervisory Control Amendments in their final form. Previously, on June 17, 2004, the SEC approved similar rule changes proposed by the New York Stock Exchange (NYSE) to enhance its members' supervisory and supervisory control systems (Internal Control

Amendments). NASD's Supervisory Control Amendments and the NYSE's Internal Control Amendments become effective on January 31, 2005. Although NASD and the NYSE (the SROs) have previously provided their respective members with general guidance regarding the application of the new rule changes, additional questions have been raised. Accordingly, the SROs are issuing this joint memorandum to address those issues.

NTM 05-09: NASD Amends Rule Governing Predispute Arbitration Agreements with Customers; Effective Date: May 1, 2005

The Securities and Exchange Commission has approved amendments to NASD Rule 3110(f) that require firms to modify their predispute arbitration agreements with customers to provide enhanced disclosure about the arbitration process. The amendments also: require members to provide copies of predispute arbitration agreements and relevant arbitration forum rules to customers upon request; clarify the use of certain limiting provisions; and require firms seeking to compel arbitration of claims initiated in court to arbitrate all of the claims contained in the complaint if the customer so requests.

The effective date of this rule change is May 1, 2005. Predispute arbitration agreements will be governed by the version of Rule 3110(f) in effect at the time the agreement was executed, except that Rule 3110(f)(3) as amended applies to all new and existing agreements.

NTM 05-10: NASD Amends Rule Governing Time Limits for Submission of Arbitration Claims; Effective Date: May 1, 2005

The Securities and Exchange Commission has approved amendments to Rule 10304 of the NASD Code of Arbitration Procedure relating to time limits on the submission of claims in arbitration. The amendments clarify that arbitrators, and not courts, will 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.

The effective date of this rule change is May 1, 2005, for all claims filed with NASD on or after that date.

NTM 05-32: SEC Approves Amendments to NASD Rule Governing Predispute Arbitration Agreements with Customers

NASD Rule 3110(f) governs a member's use of predispute arbitration agreements with customers. The Securities and Exchange Commission has approved changes to NASD Rule 3110(f) to conform the NASD delivery requirement for predispute arbitration agreements with the SEC's recordkeeping rules. The rule change also extends the date by which firms must begin using the disclosure required by the recent changes to NASD Rule 3110(f)(1) from May 1,2005 until June 1, 2005.

NTM 05-35: SEC Approves Amendments to IM-10104 and Rule 10315 to Permit Arbitrations in Foreign Hearing Locations; Effective June 6, 2005

The Securities and Exchange Commission has approved amendments to IM-10104 and Rule 10315 of the NASD Code of Arbitration Procedure to permit parties to have their hearings in a foreign hearing location, and to allow the director of arbitration to authorize a higher or additional honorarium for the use of a foreign hearing location. The amendments will be effective on June 6, 2005, and will

apply to any arbitration claims filed on or after June 6, 2005.

NTM 05-36: SEC Approves New Interpretive Material to Rule 10308 Regarding Arbitrators Who Also Serve as Mediators; Effective Date: May 6, 2005

The Securities and Exchange Commission has approved a new Interpretive Material (IM) to Rule 10308 of the NASD Code of Arbitration Procedure relating to mediators who also serve as arbitrators. The amendments clarify that (1) fees for service as a mediator are not included in determining whether an attorney, accountant, or other professional derives 10 percent of his or her annual revenue from industry-related parties; and (2) service as a mediator is not included in determining whether an attorney, accountant, or other professional devotes 20 percent or more of his or her professional work to securities industry clients. The effective date of this rule change is May 6, 2005, for arbitrator applications received or arbitrator disclosures reviewed on or after that date.

NTM 05-50: Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities

This Notice to Members addresses the responsibility of firms to supervise the sale by their associated persons of equity-indexed annuities (EIAs) that are not registered under the federal securities laws.

NTM 05-55: SEC Approves Amendments to IM-10104 to Provide Payment to Arbitrators for Deciding Discovery-Related Motions; Effective Date: September 26, 2005

The Securities and Exchange Commission has approved an amendment to Interpretive Material (IM) 10104 of the NASD Code of Arbitration Procedure (Code) to provide payment to arbitrators for deciding discovery-related motions without a hearing session. The amendment became effective on September 26, 2005, and will apply to any arbitrator order issued on or after September 26, 2005, that decides a discovery-related motion.

NTM 05-67: SEC Approves Uniform Branch Office Definition and Related Interpretive Material; Effective Date: May 1, 2006

On September 9, 2005, the Securities and Exchange Commission approved (1) amendments to Rule 3010(g)(2) to revise the definition of "branch office" (Uniform Definition); and (2) adoption of IM-3010-1 to provide guidelines on factors to be considered by a member in conducting internal inspections of offices. The SEC simultaneously approved amendments to the New York Stock Exchange, Inc.'s (NYSE) Rule 342 (Offices-Approval, Supervision and Control) to provide a new, uniform industry definition of the term "branch office."

In addition, there has been a coordinated effort by regulators to develop a new centralized branch office registration system through the Central Registration Depository (CRD) to provide a more efficient, standardized method for members to register branch office locations as required by the rules and regulations of states and self-regulatory organizations (SROs), including NASD. To facilitate the development of this system, NASD filed a rule proposal with the SEC to adopt new Form BR, which will replace Schedule E of the Form BD, the current NYSE Branch Office Application Form, and certain state branch office forms. The SEC approved such rule filing on September 30, 2005. Form BR will enable firms to register or report branch offices electronically with NASD, the NYSE and states that require branch registration or reporting, via a single filing through the CRD system.

Disciplinary Actions

Legg Mason Wood Walker, Inc. (CRD #6555, Baltimore, Maryland) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $10,000, and required to pay $453.53, plus interest, in restitution to public customers. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of
findings that in transactions for or with a public customer, the firm failed to use reasonable diligence to ascertain the best interdealer market and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. The findings also stated that the firm failed to execute customer market orders fully and promptly. (NASD Case #CMS040183)

Raymond James Financial Services, Inc. (CRD #6694, St. Petersburg, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to enforce a supervisory system and written supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and NASD rules regarding the formation and maintenance of a partnership with a public customer of the firm. (NASD Case #C8A040107)

Castle Securities Corp. (CRD #16077, Freeport, New York) and Michael Thomas Studer (CRD #707394, Registered Principal, Amityville, New York)

The firm was expelled from NASD membership and Studer was barred from NASD membership in any capacity. The firm was fined $98,300, solely, and fined $37,500, jointly and severally with Studer. The Securities and Exchange Commission affirmed the National Adjudicatory Council (NAC) decision imposing sanctions following appeal of an Office of Hearing Officers (OHO) decision. The sanctions were based on findings that the firm churned he account of a public customer, and that Studer and the firm failed to reasonably supervise trading in the account of a public customer by ignoring "red flags" that indicated potential problems with the account. The findings also stated that the firm and Studer induced a public customer to execute margin guarantees that benefitted the firm and exposed the customer to significant risk. (NASD Case #C3A010036)

American Express Financial Advisors, Inc. (CRD #6363, Minneapolis, Minnesota) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $20,000, and required to demonstrate the adequacy and effectiveness of the supervisory tools the firm devised to detect and prevent mishandling of public customer accounts by registered representatives and to improve the accuracy of firm Redemption/Purchase Reports. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that the firm failed to supervise a general securities representative with respect to his handling of public customer accounts. The findings also stated hat the firm assigned four consecutive supervisors to the representative who failed to take corrective action when the accounts of the representative's customers appeared on numerous Redemption/Purchase Reports, disclosing unsuitable trading through redemptions and subsequent purchases of different share funds of different mutual fund families within a 30-day period. NASD also found that the Redemption/ Purchase Reports that the firm prepared for the supervisory review of significant activity in customer accounts contained inaccuracies and were difficult to decipher, severely limiting heir usefulness as a supervisory tool. (NASD Case #C8A040126)

CIBC World Markets Corp. (CRD #630, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $75,500, and—if the firm begins marketing or selling hedge funds—required to file all advertising materials relating to hedge funds with NASD's Advertising Department at least 10 business days prior to use for three years from the date of acceptance of this AWC. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it used various types of sales literature in the marketing of hedge funds and funds of hedge funds that contained inadequate risk disclosure and improper comparisons. NASD determined that many of the materials contained generalized risk disclosure but failed to address the specific risk attributed to the investments offered. The findings also stated that the advertising materials failed to contain a fair and balanced presentation of the risks as well as the benefits of a particular investment or strategy being promoted. NASD also found that sales presentations made improper comparisons that failed to include any material differences between the subjects of comparison. In addition, NASD found that the firm failed to maintain evidence of approval by a registered principal for pieces of sales material for three years. (NASD Case #CAF040114)

NFB Investment Services Corp. (CRD #25658, Melville, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $20,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to amend Forms U4 and Forms U5 to disclose customer complaints in a timely manner. NASD found hat the firm's failure to file amendments to Forms U4 and U5 in a timely manner may have impeded the investing public's ability to assess the background of certain brokers through NASD's public disclosure program (NASD BrokerCheck), may have potentially denied member firms access to relevant information in making hiring determinations, may have enabled some brokers to transfer firms without having their application reviewed by the appropriate state securities regulator, and may have hindered NASD from promptly investigating certain disclosure items. (NASD Case #CLI040036)

Wells Fargo Brokerage Services, L.L.C. (CRD #16100, Minneapolis, Minnesota) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $150,000. Without admitting or denying the allegations, he firm consented to the described sanctions and to the entry of findings that it issued account statements to public customers regarding certificates of deposit (CDs) that were misleading in that the language was not adequate to fully disclose the potential price differential between the par value and market value. NASD also found that the firm published advertisements and provided sales literature to public customers related to brokered certificates of deposit that failed o provide a sound basis for evaluation of the service offered, omitted facts or qualifications that caused the communications to be misleading, and contained misleading statement of material fact. (NASD Case #C05040087)

UBS Financial Services, Inc. (CRD #8174, Weehawken, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $175,000, and required to pay restitution to public customers. Without admitting or denying the allegations, the firm consented to he described sanctions and to the entry of findings that it sold securities to public customers for whom the investment was unsuitable. The findings also stated that the firm failed to maintain records disclosing the basis upon which its suitability determinations were made in its recommendations and sales o public customers of certain securities. The findings further stated that the firm included advertisements on its Web site hat failed to adequately disclose and describe the risks of investing in managed futures products. (NASD Case #CE3050009).

Morgan Keegan & Company, Inc. (CRD #4161, Memphis, Tennessee), George Earl Bagwell, III (CRD #10078, Registered Principal, Montgomery, Alabama), and Woodley Hannon Bagwell (CRD #10084, Registered Principal, Montgomery, Alabama) submitted a Letter of Acceptance, Waiver, and Consent in which they were fined $30,000, jointly and severally. George Bagwell and Woodley Bagwell each were suspended from association with any NASD member in any principal capacity for six months. Without admitting or denying to allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Woodley and George Bagwell, failed to supervise the activities of registered representatives.

George Bagwell's suspension began July 5, 2005, and will conclude at the close of business January 4, 2006. Woodley Bagwell's suspension began July 5, 2005, and will conclude at the close of business January 4, 2006. (NASD Case #C05050029)

Raymond James & Associates, Inc. (CRD #705, St. Petersburg, Florida) and Angelo Masut, Jr. (CRD #1245245, Registered Representative, Homasassa, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $10,000. Masut was fined $10,000, including disgorgement of $1,960.36 in commissions received, and suspended from association with any NASD member in any capacity for 10 business days. In addition, the firm and Masut are required to pay $3,924 in restitution to public customers. Without admitting or denying the allegations, the firm and Masut consented to the described sanctions and to the entry of findings that Masut recommended and effected transactions in the accounts of public customers without having reasonable rounds for believing that the recommendations and resultant transactions were suitable for the customers based on their financial situation and needs. The findings also stated that the firm failed to maintain and enforce its written supervisory procedures to supervise the activities of Masut and to achieve compliance with NASD Conduct Rule 2310. Masut's suspension began June 6, 2005, and concluded at the close of business June 17, 2005. (NASD Case #C05050020).

American Express Financial Advisors Inc., (CRD #6363, Minneapolis, Minnesota) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $25,000, and required within 30 days to provide NASD staff with a report attesting to, and setting forth the details of, its implementation of procedures correcting supervisory deficiencies. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to have adequate procedures in place to monitor whether the managing principal representative (MPR) performed certain supervisory reviews of the office of supervisory jurisdiction (OSJ), or to identify and review transactions by individual registered representatives under he MPR's supervision. NASD also found that the firm failed o reasonably ensure that the OSJ forwarded copies of letters regarding mutual fund switches to the home office on a consistent basis, as required by its written supervisory procedures. (NASD Case #C05050021)

UVEST Financial Services Group, Inc., (CRD #13787, Charlotte, North Carolina) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $80,000. Without admitting or denying he allegations, the firm consented to the described sanctions and to the entry of findings that it violated recordkeeping requirements in that the firm failed to preserve for three years certain electronic mail communications received by its employees that related to its business as a broker, dealer, or member of an exchange. NASD also found that the firm failed to have a systematic means to retain electronic communications related to its business that were reasonably designed to achieve compliance with SEC and NASD rules. (NASD Case #CE4050005)

Securian Financial Services, Inc. (CRD #15296, Saint Paul, Minnesota) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to supervise adequately and properly a registered representative with respect to his recommendations to public customers. (NASD Case #C8A050068)

Merrill Lynch, Pierce, Fenner & Smith Inc. (CRD #7691, New York, New York) submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined $50,000 and required to certify to NASD that it has reviewed and established systems and procedures reasonably designed to achieve compliance with applicable securities laws, regulations and NASD rules regarding the Mortgage 100 program.

Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it offered information regarding a mortgage program of an affiliate on its public Web site that constituted advertising material, and included statements and representations hat were misleading or unbalanced and failed to disclose material information about the program. NASD found that the firm failed to establish any guidelines or written supervisory procedures reasonably designed to achieve compliance with he firm's activities relating to the mortgage program. In addition, NASD determined that the firm did not use any exception reports or other documents or procedures that might assist managers, compliance personnel or other staff in reviewing accounts that used the mortgage program. (NASD Case #EAF0300610002)

NYLIFE Securities Inc. (CRD #5167, New York, New York) submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined $200,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to adequately supervise the activities of a registered representative who violated the firm's policy involving unapproved advertising and sales material and outside business activities. NASD found hat the firm failed to conduct adequate inspections of activities in a branch office. The findings also stated that the firm's review and approval of variable annuity and mutual fund transactions was deficient in that the firm failed to aggregate transactions and consider all customer holdings when reviewing individual transactions, thereby allowing a registered representative to circumvent the financial tests established by he firm. (NASD Case #E052004010401)

Edward Jones to Pay $75 Million to Settle Revenue Sharing Charges

The SEC, NASD and the New York Stock Exchange announced settled enforcement proceedings against Edward D.Jones & Co., L.P., a registered broker-dealer headquartered in St.Louis, Missouri, related to allegations that Edward Jones failed to adequately disclose revenue sharing payments that it received from a select group of mutual fund families that Edward Jones recommended to its customers.

As part of the settlement of all three proceedings, Edward Jones will pay $75 million in disgorgement and civil penalties. All of hat money will be placed in a Fair Fund for distribution to Edward Jones customers. Edward Jones also agreed to disclose on its public Web site information regarding revenue sharing payments and hire an independent consultant to review and make recommendations about the adequacy of Edward Jones' disclosures.
According to an Order issued by the SEC, Edward Jones entered into revenue sharing arrangements with seven mutual fund families, which Edward Jones designated as "Preferred Mutual Fund Families." Edward Jones told the public and its clients that it was promoting the sale of the Preferred Families' mutual funds because of the funds' long-term investment objectives and performance. At

the same time, Edward Jones failed to disclose hat it received tens of millions of dollars from the Preferred Families each year, on top of commissions and other fees, for selling their mutual funds. Edward Jones also failed to disclose hat such payments were a material factor, among others, in becoming and remaining an Edward Jones Preferred Family. Edward Jones provided the Preferred Families with certain benefits not otherwise available to non-preferred families including, among other things, exclusive shelf space for the sale and marketing of their funds and exclusive access to Edward Jones' investment representatives (IRs) and customer base.

Edward Jones also exclusively promoted the 529 college savings plans offered by its Preferred Families over all other 529 plans hat it had available to sell.

Linda Chatman Thomsen, Deputy Director of the SEC's Division of Enforcement, said, "Edward Jones' undisclosed receipt of revenue sharing payments from a select group of mutual fund families created a conflict of interest. When customers purchase mutual funds, they should be told about the full nature and extent of any conflict of interest that may affect the transaction. Edward Jones failed to do that." Merri Jo Gillette, Regional Director of the SEC's Midwest Regional Office, added, "Edward Jones made affirmative representations to investors regarding its purported reasons for recommending the mutual funds offered by the seven Preferred Families, but failed to inform investors of one important factor: that it was being paid undisclosed compensation by those fund families. By not telling investors the whole story, Edward Jones violated the federal securities laws." "Beyond its disclosure failures, Edward Jones engaged in other activities that violate NASD rules aimed at precluding conflicts of interest–including accepting directed brokerage payments and staging a sales contest to promote the Preferred Funds," said Barry Goldsmith, NASD Executive Vice President and Head of Enforcement. "These kinds of activities increase the potential for investors to be steered into investments that serve the financial interests of the firm and its representatives instead of the best interest of the customers." "Firms have a responsibility to supervise all their business activities," said Susan Light, Vice President of Enforcement, NYSE Regulation. "Edward Jones's supervisory lapses are especially troubling in this case because of the direct conflict between the firm and its customers." According to the Commission's Order, Edward Jones had entered into selling agreements with approximately 240 mutual fund families, but only the seven Preferred Families made these payments to Edward Jones. Edward Jones, its general and limited partners, and its IRs received financial benefits from the Preferred Families' payments. Edward Jones exclusively promoted the Preferred Families' funds over all other mutual funds. Historically, over 95 percent of Edward Jones' sales of mutual fund shares have been sales of the seven Preferred Families.

In NASD's separate settlement, in addition to the receipt of direct revenue sharing payments, NASD found that the firm gave preferential treatment to the Preferred Funds in exchange for millions of dollars in directed brokerage from three of the Preferred Fund families. This violates NASD's "Anti-Reciprocal Rule," Conduct Rule 2830(k), which prohibits regulated firms from favoring the distribution of shares of particular mutual funds on the basis of brokerage commissions to be paid by the fund companies.
NASD also charged Edward Jones with holding an unlawful sales contest in the fall of 2002. Winning brokers could choose a trip from among a list of 35 "world class" vacation destinations, such as Singapore, St. Martin, Davos, Biarritz and Tortola. These sales contests, which were held every six months, rewarded the winners with airfare, five-star accommodations, and treats attendees to activities such as skiing, golfing, fine dining, and ours. During October 2002, Edward Jones changed the contest rules and only credited sales of funds that were on the

Preferred Funds list. This violates NASD rules that prohibit product-specific sales contests that credit the sale of certain, but not all, fund sales. Indeed, some brokers complained that "doing the right thing for the client" (by recommending non-preferred funds and variable annuities) penalized their chance to earn a sales contest rip.

NASD also found that the firm failed to retain e-mails, failed to supervise the late trading of mutual funds, and failed to supervise the activities relating to the Preferred Funds and revenue sharing, directed brokerage, and sales contests.
NYSE Regulation found that Edward D. Jones & Co.'s conduct was inconsistent with just and equitable principles of trade and failed to adhere to good business practices in violation of NYSE Rules 476 and 401. In violation of Rule 342, the firm failed to supervise its business with respect to revenue sharing agreements, late trading of mutual funds and email retention.
In addition to the $75 million payment, Edward Jones has agreed to be censured and to cease and desist from committing or causing violations of Section 17(a)(2) of the Securities Act of
1933, Section 15B(c)(1) of the Securities Exchange Act of 1934 and Rule 10b-10 promulgated thereunder and Municipal Securities Rulemaking Board Rule G-15. The SEC's Order further requires Edward Jones to comply with certain undertakings, including hiring an independent consultant to review and make recommendations about the adequacy of Edward Jones' disclosures. Edward Jones has consented to the issuance of the SEC's Order, without admitting or denying the findings contained therein.

First Command to Pay Restitution, Fund Investor Education Program for Military Community

NASD censured and fined First Command Financial Planning Inc., a Fort Worth, TX broker-dealer, $12 million for making misleading statements and omitting important information when selling mutual fund investments with up-front sales charges of up to 50 percent through a monthly installment method known as a "Systematic Investment Plan." From that $12 million, First Command is ordered to pay restitution to thousands of customers who purchased a Systematic Investment Plan between Jan.1, 1999 and the present who terminated the plan and paid an effective sales charge greater than 5 percent. All money remaining will be payable to he NASD Investor Education Foundation, to be used for the investor education needs of members of the military and their families. The Foundation will use the funds to support educational programs, materials and research to help equip members of the military community with the knowledge and skills necessary to make informed investment decisions. It is anticipated that the Foundation will receive approximately $8 million.

First Command also settled NASD charges of inappropriately confronting a customer who complained, failing to maintain e-mail, failing to maintain adequate supervisory systems and procedures, and filing an inaccurate Form U-5 regulatory report. In a related action, NASD fined a First Command supervisor $25,000 and suspended him from acting in any supervisory capacity for 30 days.

The SEC instituted settled enforcement proceedings against First Command based on similar allegations relating to the firm's sales of systematic investment plans.

"Using misleading sales scripts, inappropriate comparisons, and omissions of important information, First Command sold hundreds of thousands of complicated and often enormously expensive plans to young members of our armed services, who are frequently inexperienced investors," said NASD Vice Chairman Mary L. Schapiro. "These investors, like all others, are entitled to balanced and honest information about investment alternatives. And it is inexcusable that a First Command sales supervisor would try to stifle an airman's complaint by

suggesting, among other things, that sending his complaint violated Air Force regulations." Under Systematic Investment Plans, an investor makes monthly payments for a fixed term, typically 15 years, which are invested in underlying mutual funds. The purchaser is charged a 50 percent sales load on the first 12 monthly payments. Payments over the remainder of the term are not subject to sales charges so that the effective sales charge decreases so long as the purchaser continues to make additional investments. However, if he investor does not terminate within 18 months, and then fails to complete the term, he or she will pay a sales charge of up to 50 percent of the amount invested. At the conclusion of NASD's investigation of this case, First Command informed NASD that it is eliminating the sale of new Systematic Investment Plans.

NASD found that First Command primarily sold the plans to commissioned and non-commissioned officers. The firm's customer base includes over 297,000 current and former military families. Forty percent of current active duty general officers, one-third of commissioned officers and 16 percent of noncommissioned officers are First Command clients. First Command's sales force consists primarily of former military personnel. Its executive officers, supervisors, managers and its Board of Advisors are primarily retired or separated military personnel.

NASD found that the firm sold the plans through the use of a three-step scripted sales process that contained misleading statements and omissions. For example:

• First Command emphasized in its sales that the 50 percent sales load would decrease to 3.3 percent upon completion of the term and that the high up-front sales charges increased the likelihood that an investor would complete he plan. However, the Firm's own data showed that historically, only 43 percent of its customers completed the 15-year term.

• First Command told its clients that a benefit of the high first-year sales charge was to "instill discipline." However, First Command failed to inform its customers of the lost earnings potential as a result of the sales charges deducted from the customer's first 12 months' investments. For example, an investor who made monthly payments of $100, totaling $1,200 in the first year, would be left with an investment in the funds of only $600 for that year.

• First Command also made misleading statements when comparing their plan with other mutual fund investments, telling investors that no-load mutual funds were primarily for speculators and that no-load funds frequently have some of the highest long-term costs. In fact, the long-term costs of owning no-load funds are, on average, lower than owning load funds.

• First Command, in a training manual, cautioned its representatives when looking for prospects:

• "Don't ask or suggest to a 'termite' [a person who purchases term insurance, and invests the remainder in mutual funds] or 'no *loader' [an individual who advocates he purchase of no-load mutual funds] who refuses to accept our philosophy that he talk with referrals. This is like voluntarily spreading a cancer in your market." NASD also found that First Command violated NASD rules when* a First Command supervisor inappropriately confronted a former customer—an Air Force officer—who complained in an e-mail to an online publication that he had suffered losses and recommended that others not invest with First Command. The email was in response to a negative article about First Command's sales practices.

First Command District Supervisor James Provo contacted the customer, suggested that he might need an attorney, told him hat the highest level of Air Force commanders were being contacted regarding the e-mail and told him his previously approved change

in assignment might be delayed until the matter was resolved. NASD also found that Provo arranged a meeting with the Air Force's legal assistance office, questioning whether the customer had violated Air Force regulations by using e-mail to send his message criticizing First Command.

Provo also contacted the customer's squadron commander and informed her that First Command might have a grievance against a member of her squadron. First Command eventually wrote a letter of apology to the former client, but otherwise took no steps to discipline Provo.

NASD Fines Sigma Financial for Suing Customers in Violation of NASD's Arbitration Code

NASD censured and fined Sigma Financial Corporation of Ann Arbor, MI and its president, Jerome Rydell, $135,000 for violating NASD's Code of Arbitration Procedure—by frivolously pursuing legal action against an elderly couple who had won an arbitration award against the firm.

In addition, Rydell was suspended for 10 business days in all supervisory capacities. Sigma has reimbursed the elderly couple for the $110,000 in attorney fees and costs they incurred in defending themselves for three years. NASD also ordered Sigma o certify annually, for a period of two years, that it has fully complied with the NASD Code of Arbitration Procedure in connection with any customer disputes. Sigma must also notify NASD prior to taking any legal action against customers in federal or state court.

The settlement resolves an NASD complaint filed against Sigma and Rydell in December 2003.

"This firm used the courts to carry out a campaign of harassment against two elderly customers because of an arbitration award it did not like—in clear violation of NASD rules and the firm's own agreement with its customers," said NASD Vice Chairman Mary L. Schapiro. "This kind of conduct will not be tolerated. " As described in detail in an NASD News Release earlier this year, he couple filed an arbitration claim in July 1999 after losing money in investments they had made through the firm. In April 2001, following seven days of hearings, an NASD arbitration panel awarded the customers $318,096, including attorney fees and costs. Unhappy with that result, Sigma, acting through Rydell, filed two lawsuits against the customers in Michigan Circuit Court later that same month.

The first lawsuit was an attempt to vacate the arbitration award. In the second lawsuit, Sigma claimed, for the first time, that it was entitled to damages as a third-party beneficiary to agreements the customers had signed with the issuer of the investments they had purchased through Sigma. Sigma did not seek to arbitrate this claim, despite NASD rules and its own agreement to arbitrate any controversy and waive its right to seek remedies in court.

The Michigan Circuit Court confirmed the arbitration award, dismissed Sigma's second lawsuit and sanctioned the firm $500 for filing a frivolous claim. Nevertheless, Sigma continued to litigate against the elderly customers. On February 19, 2004, the Michigan Court of Appeals upheld the Circuit Court's confirmation of the arbitration award, dismissal of the third-party beneficiary lawsuit, and imposition of monetary sanctions.

Still not satisfied, Sigma, through Rydell, then filed an appeal with the Michigan Supreme Court. Sigma took this action more than three months after NASD had instituted these enforcement proceedings against Sigma and Rydell, and nearly three years after the customers had received their Award. The firm withdrew the appeal to the Supreme Court in connection with his settlement.

In settling these charges, Sigma and Rydell neither admitted nor denied the charges.

NASD Fines Scottrade, Inc. $250,000 for Improperly Extending Credit to Cash Account Customers

NASD fined Scottrade, Inc., of St. Louis, MO, $250,000 for improperly extending credit to customers in violation of federal securities laws and banking regulations.

NASD determined that Scottrade permitted cash account customers to purchase and sell securities in a series of trades without requiring full cash payment for each purchase, in violation of Federal Reserve Regulation T. Regulation T requires hat customers trading in cash accounts make full cash payment for each separate purchase without regard to unsettled proceeds of any securities sold.

"The sanctions in this case reflect NASD's continuing concerns about securities firms improperly extending credit to cash account customers," said NASD Vice Chairman Mary L. Schapiro. "In addition to complying with federal securities laws and NASD rules, firms must adhere to banking requirements, including Regulation T." NASD found that from January 1, 2001, to September 28, 2001, Scottrade allowed its cash account customers to purchase and sell securities with the proceeds due from unsettled trades. The firm permitted this trading to occur in over 27,500 transactions in more than 1,400 cash accounts.

Regulation T, however, requires full cash payment for the purchase of any security in a cash account without relying upon the anticipated proceeds of any unsettled trade in the account. The Federal Reserve Board staff issued guidance on his issue in January 2000, one year before Scottrade's misconduct commenced. Scottrade, nevertheless, permitted its customers to execute numerous purchase and sell transactions, on the same day, with unsettled funds well into September 2001.

In settling this matter, Scottrade neither admitted nor denied he charges, but consented to the entry of NASD's findings.

NASD Fines Quick & Reilly, Piper Jaffray $845,000 for Directed Brokerage Violations

NASD fined Quick & Reilly, Inc. (now part of Banc of America Investment Services, Inc.) $570,000 and Piper Jaffray & Co. $275,000 for directed brokerage violations. In imposing sanctions against Piper Jaffray, NASD took into account the fact that the firm self-reported its violative conduct after conducting its own internal review. The two cases are the latest enforcement actions in NASD's ongoing effort to crack down on directed brokerage abuses.

NASD found that both firms operated "preferred partner" or "shelf space" programs, giving favorable treatment to funds offered by certain mutual fund companies in return for brokerage commissions and other payments. That special treatment included higher visibility on the firms' internal websites, increased access to the firms' sales forces, participation in "top producer" or training meetings, and promotion of their funds on a broader basis than was available for other funds. That conduct violated NASD's "Anti-Reciprocal Rule" which prohibits firms from favoring he sale of shares of particular mutual funds on the basis of brokerage commissions.

"The purpose of the rule is to help eliminate conflicts of interest in the sale of mutual funds," said Mary L. Schapiro, NASD Vice Chairman. "These sorts of arrangements encourage the inappropriate use of mutual fund commission dollars and have the potential to improperly influence a firm's judgment when making recommendations to their clients." Both firms offered a preferred partner program to a relatively small number of mutual fund families. Piper Jaffray, which operated its preferred partner program from 1998 to 2003, included only 12 to 15 fund complexes in the program, but sold funds offered by more than 100 fund complexes. Quick & Reilly maintained its program from 2001 to 2003 and included only 16 to 20 fund complexes, while it sold funds offered by about 300 fund complexes.

The participating mutual fund companies paid the firms extra fees in addition to regular sales fees. Piper Jaffray negotiated hose extra payments with mutual fund companies each year, asking for minimum payments of $100,000 to $125,000. Some fund complexes paid a flat fee; others paid amounts based on a percentage of gross fund sales and the average daily assets under management for the fund complex. Quick & Reilly charged participating fund complexes 10 basis points on he gross amount of sales and five basis points on the average daily assets under management, subject to a minimum annual payment of $75,000.

Several of the funds participating in the preferred partner programs paid part or all of the extra fees by directing the funds' brokerage business to the firms. The commissions were generated by the funds through portfolio transactions which he funds executed either through the firm, in the case of Piper Jaffray, or through an affiliate or third party, in the case of Quick and Reilly.

Piper Jaffray, on its own initiative, conducted an internal review of the general subject matter involved in the case and self-reported its findings to NASD staff. "This type of self examination and self-reporting by a registered firm benefits NASD's enforcement program and investors by allowing for cost-effective enforcement and timely remedial action, and

NASD Fines Citigroup Global Markets, American Express, and Chase Investment Services More Than $21 Million for Improper Sales of Class B and C Shares of Mutual Funds

NASD censured and fined Citigroup Global Markets, Inc., American Express Financial Advisors, and Chase Investment Services a total of $21.25 million for suitability and supervisory violations relating to mutual fund sales practices between January 2002 and July 2003. These cases are part of a larger, ongoing investigation into mutual fund sales practices.

The cases against Citigroup and Chase involve their recommendations and sales of Class B and Class C shares of mutual funds, while the action involving American Express relates only to Class B shares. In all three cases, the firms made recommendations and sales of mutual funds to their customers without considering or adequately disclosing, on a consistent basis, that an equal investment in Class A shares would generally have been more economically advantageous for their customers by providing a higher overall rate of return.

The firms also had inadequate supervisory and compliance policies and procedures relating to these mutual fund sales.

In particular, NASD found that the firms did not consistently consider that large investments in Class A shares of mutual funds entitle customers to breakpoint discounts on sales charges, generally beginning at the $50,000 investment level, which are not available for investments in other share classes.

Investors may be entitled to breakpoints based on the amount of a single mutual fund purchase; the total amount of multiple purchases in the same family of funds; and/or the total amount of mutual fund investments held, at the time of the new purchase, by members of the customer's "household"—typically, accounts of close family members.

In resolving these actions, the firms have agreed to a remediation plan that includes over 50,000 households and more than 275,000 transactions in Class B shares, and, to a lesser extent, Class C shares. The plan generally covers investors who, between January 1, 2002 and March 22, 2005, purchased Class B shares aggregating to $50,000 or more, depending upon the particular fund's pricing structure. A limited number of investors who purchased Class C shares during the same time frame (generally those who purchased $500,000) will also be included in the remediation plan. A number of exclusions also apply.

NASD's settlement with Citigroup includes more than 18,000 households, involving more than 90,000 Class B and Class C share transactions. NASD fined Citigroup $6.25 million, which takes into consideration the $20 million fine and other sanctions the Securities and Exchange Commission is imposing on Citigroup to settle a related enforcement action involving sales of Class B shares, among other things.

NASD's settlement with American Express includes more than 30,000 households and 182,000 Class B share transactions. NASD fined American Express $13 million. NASD's settlement with Chase involves more than 2,000 households and 4,000 Class B and C share transactions. NASD fined Chase $2 million. The amount of the fines was based on the estimated additional commissions each firm received in connection with affected Class B share transactions.

Jefferson Pilot to Pay over $500,000 in First VUL Market Timing Action; NASD Also Fines Affiliate $125,000 for E-Mail Retention Violations

NASD fined Jefferson Pilot Variable Corporation, a Concord, NH broker-dealer, $325,000 for failing to have an adequate supervisory system in place to prevent market timing and excessive trading in the sub-accounts of its Ensemble series of variable universal life insurance policies (VULs). Jefferson Pilot is the exclusive distributor of Ensemble VULs, which are issued by a Jefferson Pilot insurance affiliate. In addition, the firm must pay $238,697 in restitution to the affected funds.

Separately, NASD fined another affiliate, Jefferson Pilot Securities Corp. (JPSC), also of Concord, $125,000 for failing o retain all e-mail communications of its registered persons.

This is the first NASD enforcement action to date involving market timing in VUL sub-accounts. Last June, NASD settled a case involving market timing in the sub-accounts of variable annuities. VULs offer a fixed premium schedule and a minimum death benefit. They differ from traditional whole life insurance in that cash values are allocated to various subaccounts, each reflecting investments in particular mutual funds that are separate from the general assets of the insurance company.

"Market timing and excessive trading by a few can hurt other fund shareholders by diluting share value and raising transaction costs," said NASD Vice Chairman Mary L. Schapiro. "Jefferson Pilot's failure to conduct a meaningful review of its supervisory systems resulted in the impermissible market timing and excessive trading, which in turn resulted in harm to other policy holders with assets in these subaccounts." NASD found that, despite having an electronic system ostensibly designed to recognize and block sub-account transfers in excess of policy limits, Jefferson Pilot failed to determine whether the system was functional. Given the firm's exclusive reliance on this system to monitor sub-account transfers, such follow-up and review was essential. As a result of this failure, 292 Ensemble series VUL policyholders were permitted to exceed the 20-transfers-per-policy-year limit described in the prospectus.

NASD found that in 2003, Jefferson Pilot failed to prevent two VUL policyholders, through the purchase and sale of subaccount units, from engaging in market timing in the shares of three different funds. The two market timers exceeded the prospectus limits by 116 transfers, realizing additional profits of $238,697. From January 1, 2001 through December 31,
2003, at least 290 other VUL policyholders had been following an investment strategy that required periodic rebalancing of heir sub-account portfolio. Although not market timers, those policyholders still exceeded the VUL prospectus transfer limitations.

Of the $238,697 in restitution, Jefferson Pilot previously paid $119,024 to the JPVF International Equity Portfolio. The remainder—an additional $119,673—will be

paid to the following funds: American Century Variable Products, Inc., VP International Fund ($66,191) and Franklin Templeton Variable Insurance Products Trust Templeton Foreign Securities Fund ($53,482).

NASD also found that the Jefferson Pilot securities affiliate, JPSC, failed to maintain and preserve all internal e-mail communications for 217 registered persons who were also employed by their affiliated life insurance company. From at least January 1, 2001 through December 31, 2003, JPSC's email system purged the e-mail communications of those 217 registered persons after 60 days. NASD rules require that email communications be retained for no less than three years.

In addition to fining and censuring both firms, NASD required Jefferson Pilot to certify that it has disclosed all instances of transfers within VUL sub-accounts that contravened the limitations set forth in the applicable prospectus and that it has implemented appropriate supervisory controls to enforce prospectus transfer limits; and JPSC was required to certify hat has reviewed its procedures relating to preservation of electronic mail communications and that it has established reasonable supervisory controls to ensure e-mail retention.
In settling this matter, neither firm admitted nor denied the charges, but they consented to the entry of NASD's findings.

NASD Charges 15 Firms with Directed Brokerage Violations, Imposes Fines Totaling More Than $34 Million

NASD imposed fines totaling more than $34 million on 15 broker-dealers in connection with the receipt of directed brokerage in exchange for preferential treatment for certain mutual fund companies.

These cases, part of NASD's efforts to eliminate conflicts of interest in the sale of mutual funds, focus on brokerage firms involved in selling mutual funds to retail investors, as well as one mutual fund distributor. All of the cases involve violations of NASD's Anti-Reciprocal Rule, which prohibits firms from favoring the sale of shares of particular mutual funds on the basis of brokerage commissions received by the firm. Among other things, a firm may not recommend specific funds to sales personnel or establish preferred lists of funds in exchange for directed brokerage.

NASD found that the 14 retail firms, most of which sold funds offered by hundreds of different mutual fund complexes, operated "preferred partner" or "shelf space" programs that provided certain benefits to a relatively small number of mutual fund complexes in return for directed brokerage. The benefits to mutual fund complexes of these quid pro quo arrangements included, in various cases, higher visibility on the firms' internal Web sites, increased access to the firms' sales forces, participation in "top producer" or training meetings, and promotion of their funds on a broader basis than was available for other funds.

"When recommending mutual fund investments, firms must act on the basis of the merits of the funds and the investment objectives of the customers and not because of other benefits he brokerage firm will receive," said NASD Vice Chairman Mary L. Schapiro. "NASD's prohibition on the receipt of directed brokerage is designed to eliminate these conflicts of interest." The mutual fund complexes that participated in these programs paid extra fees for enhanced visibility. The additional fees were typically based on a combination of sales and/or assets under management by the brokerage firm. Some of the complexes participating in the preferred partner programs paid part or all of the revenue sharing fees by the use of directed brokerage–that is, by directing a portion of the trades in the portfolios they managed to the trading desks of the firms participating in the program.

For firms that did not have the capacity to provide trade execution, trades were sent to designated third parties, which hen remitted a

portion of the trading commissions to the retail firms, although they provided no services in connection with the trade. These commissions were sufficiently large to pay for the benefits received by the funds as well as the costs of trade execution.

The retail firms generally monitored the amount of directed brokerage received to ensure that the fund complexes were satisfying their revenue-sharing obligations. The use of directed brokerage allowed the fund complexes to use assets of the mutual funds instead of their own money to meet their revenue sharing obligations.

NASD also censured and fined one mutual fund distributor, Alliance Bernstein Investment Research and Management, Inc. Alliance Bernstein paid for some of its shelf space obligations by having its affiliated investment adviser direct portfolio transactions to or for the benefit of firms to which the distributor owed revenue sharing fees.

The 15 firms and their respective fines are as follows (firms noted with asterisks are wholly owned subsidiaries of AIG Advisor Group, Inc.):

Royal Alliance Associates, Inc.*
H.D. Vest Investment Services
Alliance Bernstein Investment Research and Management, Inc.
Linsco/Private Ledger Corp.
Wells Fargo Investments, LLC
SunAmerica Securities, Inc.*
FSC Securities Corp.*
Securities America, Inc.
RBC Dain Rauscher, Inc.
McDonald Investments Inc.
AXA Advisors, LLC Sentra Securities Corporation* and Spelman & Co., Inc.* (joint fine)
Advantage Capital Corp.*
Advest, Inc.

NASD Orders Morgan Stanley to Pay over $6.1 Million for Fee-Based Account Violations

NASD fined Morgan Stanley DW, Inc., $1.5 million and has ordered the firm to pay more than $4.6 million in restitution for failing to adequately supervise its fee-based brokerage business. More than 3,500 Morgan Stanley customers will be receiving restitution.

"Fee-based accounts can be appropriate for a wide range of customers," said NASD Vice Chairman Mary L. Schapiro. "But firms have an obligation to their customers to periodically reassess whether a fee-based account, like that offered by Morgan Stanley, remains appropriate. Firms must have systems and procedures in place that adequately evaluate the continued appropriateness of these accounts for their customers." The Securities and Exchange Commission issued a report (commonly known as the "Tully Report") in 1995, noting that fee-based accounts are appropriate for investors who are building assets in their accounts, and may be appropriate for investors with moderate trading activity. But it also noted that because of the imposed annual fee, small and low-trading activity accounts would pay higher costs as a fee-based account than as a commission-based account.

The following year, Morgan Stanley began offering its customers a fee-based brokerage account program, called "Choice." NASD found that Morgan Stanley recognized and instructed its brokers, consistent with the Tully Report, that Choice accounts were not appropriate for certain categories of investors, including buy-and-hold customers and certain accounts that fall below $50,000. The firm typically required a minimum of $50,000 in eligible assets to open a Choice account and charged an annual fee based on the total amount and type of eligible assets held in the account.

NASD found that between 2001 and 2003, all Choice accounts, regardless of size, paid a minimum annual fee of $1,000. By the end of

2001, the firm had 129,630 Choice accounts, holding $19.8 billion in assets. By the end of 2002, here were 157,143 Choice accounts, holding over $21.2 billion in assets. Morgan Stanley had 176,274 Choice accounts holding $30.6 billion in assets by the end of 2003.

NASD's investigation showed that from January 2001 through December 2003, Morgan Stanley failed to establish and maintain a supervisory system reasonably designed to review and monitor its fee-based brokerage business to determine whether Choice accounts remained appropriate for its Choice customers. As a result of the firm's deficient system and procedures, Morgan Stanley allowed 3,549 of its customers to continue using Choice accounts without adequately reassessing whether the accounts remained appropriate for hem. These customers, who either conducted no trades in heir Choice accounts for at least two consecutive years or had Choice accounts whose assets averaged below $25,000 for at least one full year, or both, will be receiving restitution under he settlement announced today.

NASD found that Morgan Stanley's written procedures did not prescribe a system for ongoing supervisory review of the appropriateness of Choice accounts until June 2003. Beginning in December 2003, the firm's branch managers began receiving monthly exception reports based on a suppressed-commission-to-fee ratio for all Choice accounts with an anniversary date within that month. At that time, Morgan Stanley provided the branch managers with specific guidance on the review to be conducted and the specific actions to be taken with respect to accounts that appeared on he exception report. Although the firm improved its system and procedures, Morgan Stanley's system and procedures still were fundamentally flawed, in that the exception reports failed to capture any accounts that fell below $50,000 in assets.

NASD also found that between January 2001 and December 2003, there were 1,818 Choice customers whose billable asset level averaged below $25,000 for at least one full year. Morgan Stanley's supervisory system failed to capture these accounts, so the firm failed to conduct an adequate supervisory review to determine whether the accounts should remain in the Choice program. All of these customers paid at least the minimum annual fee of $1,000 applicable at the time, which represented at least four percent of the assets in heir Choice accounts-well in excess of Morgan Stanley's stated maximum rate of 2.25 percent. Those customers paid a total of $2.7 million in Choice fees.

In addition, NASD found that 2,062 customers conducted no trades in at least two consecutive Choice years. Although many of these customers had traded previously in their Choice accounts, after these customers went an entire Choice year without trading, the firm's system and procedures failed to determine whether these accounts remained appropriate for Choice. Consequently, without an adequate supervisory review of their particular circumstances, these 2,062 customers remained in Choice for at least an additional year, in which hey incurred an additional $2.8 million in fees without conducting any trades.

In sanctioning Morgan Stanley, NASD took into account the firm's demonstrable steps, undertaken shortly after NASD's inquiry began, to enhance its system and procedures and which led to the firm's identification and removal of large numbers of accounts for which the Choice program was not appropriate.

In settling these matters, the firm neither admitted nor denied he charges, but consented to the entry of NASD's findings.

NASD Fines Hornor, Townsend & Kent, Inc., $325,000 for Improper Sales Contests, Email and Supervision Violations

NASD fined Hornor, Townsend & Kent, Inc. (HTK), of Horsham, PA, $325,000 for conducting prohibited sales contests for its brokers and managers, as well as for email and supervision violations. The contests violated NASD rules by awarding exclusive or greater weight to the sales of proprietary variable life and variable annuity products over non-proprietary products, thereby creating improper incentives for brokers to sell those products instead of focusing on the investment's merits and the customer's financial interests. In resolving this matter, HTK agreed to prohibit any sales contests promoting he sale of variable life or annuity products for the next three years.

NASD also found that HTK failed to retain the email communications of approximately 83 employees. Those employees included HTK's president and two other senior managers, who approved at least some of the violative national sales contests. NASD rules require that email communications be retained for at least three years.

"By favoring the sale of some variable life and annuity products over others, these contests created conflicts of interest that could undermine the broker's obligation to recommend suitable investments based on the needs of the customer," said NASD Vice Chairman Mary L. Schapiro. "NASD rules are designed to prevent such conflicts between he broker's self-interest and the customer's." Between 2001 and 2003, HTK conducted six national and numerous branch office sales contests to promote the sale of variable life and variable annuity products. When a firm stages a sales contest for a particular product line, NASD rules require hat it cover all products the firm offers within that line, and hat equal weight be given to the sales of all products within that line.

NASD found that several of the national sales contests were based only on the sale of variable products offered by Penn Mutual Life Insurance Company, HTK's parent company. In determining the winners for some of the national contests, sales of Penn Mutual variable life products were given exclusive or greater weight than sales of Penn Mutual variable annuity products.

HTK offered or awarded substantial rewards for the national contest winners, including weekend trips to New York City, New Orleans, and Las Vegas; vouchers worth $400 or $800 hat could be used for personal entertainment or education; and gift cards that could be used to purchase items from a number of brand-name merchants. The total value of the national sales contest awards exceeded $200,000.

Between 2001 and 2003, HTK's branch offices conducted additional sales contests. Nine were based solely on the sale of proprietary Penn Mutual variable products. In another four, sales of proprietary products were given greater weight than sales of non-proprietary products. Prizes for the branch contests included such items as golf trips, tickets to sporting events and other entertainment events, dinners, high definition television sets, and other expensive electronic goods.

NASD found that the non-cash compensation that HTK provided to its sales force was substantial enough to provide he improper incentives that the non-cash compensation rules were designed to prevent.

NASD also found that HTK did not have in place an adequate supervisory system and procedures with respect to the noncash compensation rules.
In settling this matter, the firm neither admitted nor denied he charges, but consented to the entry of NASD's findings.

NASD Charges Eight Firms with Directed Brokerage Violations, Imposes Fines Totaling More than $7.75 Million

NASD has fined eight broker-dealers - including seven retail firms and one mutual fund distributor - more than $7.75 million for directed brokerage violations. The sanctions are the latest actions resulting from an NASD enforcement sweep focusing on the receipt or payment of directed brokerage in exchange for preferential treatment for certain mutual fund companies.

All of the cases involve violations of NASD's Anti-Reciprocal Rule, which prohibits firms from favoring the sale of shares of mutual funds on the basis of brokerage commissions received by the firm. Among other things, the rule prohibits a firm from recommending funds or establishing preferred lists of funds in exchange for receipt of directed brokerage.

"We continue to pursue conduct which puts the interests of firms ahead of the interests of customers," said Barry Goldsmith, NASD Executive Vice President and Head of Enforcement. "NASD's prohibition on the receipt of directed brokerage is designed to eliminate these conflicts of interest in the sale of mutual funds, whose costs are paid not by the mutual fund company, but by the funds' shareholders." NASD found that the seven retail firms operated "preferred partner" or "shelf space" programs that provided benefits o specific mutual fund complexes in return for directed brokerage. The benefits to the mutual fund complexes included, in various cases, higher visibility on firms' internal Web sites, including inclusion on internal lists identifying the funds as participants in the programs; increased access to firms' sales forces; participation in "top producer" or training meetings; and promotion of the preferred funds on a broader basis than was available for other funds.

The mutual fund complexes that participated in these programs paid extra fees for the preferential treatment they received. The additional fees were usually based on a combination of sales and/or assets under management by the brokerage firm.

Certain complexes participating in the preferred partner programs paid part or all of the revenue sharing fees by the use of directed brokerage—that is, by directing commissions from trades in the portfolios they managed to the firms. This included a practice of directing trades to the trading desks of designated third parties, which then remitted a portion of the trading commissions to the retail firms named in these actions, although those retail firms provided no services in connection with the trades. The commissions paid under these arrangements were sufficiently large to pay for the preferred benefits received by the funds as well as the costs of trade execution.

The retail firms generally monitored the amount of directed brokerage received to ensure that the fund complexes were satisfying their revenue sharing obligations. The use of directed brokerage allowed the fund complexes to use assets of the mutual funds instead of their own money to meet their revenue sharing obligations.

NASD also censured and fined one mutual fund distributor, Lord Abbett Distributor LLC. Lord Abbett paid for some of its shelf space obligations by having its affiliated investment adviser direct portfolio transactions to or for the benefit of firms to which the distributor owed revenue sharing fees.

The firms are as follows (firms noted with asterisks are wholly owned subsidiaries of National Planning Holdings, Inc.)

FC Holdings, Inc. d/b/a INVEST Financial Corporation*
Commonwealth Financial Network
National Planning Corporation Inc.*
Mutual Service Corporation
Lincoln Financial Advisors Corporation
SII Investments, Inc.*
Investment Centers of America, Inc.*
Lord Abbett Distributor, LLC

NYSE

Information Memos

05-24: AMENDMENTS TO RULE 629 CONCERNING INCREASED ARBITRATION FILING FEES AND HEARING DEPOSITS, AND THE IMPOSITION OF MEMBER ORGANIZATION SURCHARGES PERTAINING TO ARBITRATION CLAIMS

The Exchange, on April 4, 2005, filed with the Securities and Exchange Commission a revised schedule of fees pertaining to NYSE arbitrations. The revised schedule raises existing fees associated with filing arbitration claims for member organizations and associated persons, and imposes a new surcharge on member organizations that are the subject of arbitration claims, or when their associated person(s) are the subject of claims. Effective May 2005

05-29: New Rule 401A

NYSE Rule 351 ("Reporting Requirements") specifies certain occurrences, incidents, and periodic information that the Membership must report to the Exchange. Rule 351(d) requires the Membership to report to the Exchange statistical information regarding specified verbal and written customer complaints. Exchange examiners reviewing compliance with Rule 351(d) discovered instances in which member organizations failed to acknowledge or respond to customer complaints. New Rule 401A, effective beginning in April of 2005, makes acknowledging and responding to customer complaints mandatory.

Hearing Panel Decisions

05-1: J.P. Morgan Securities Violated Exchange Rule 440, Section 17(a) of the Securities and Exchange Act of 1934 and Rule 17a-4 by failing to preserve for a period of three years, he first two of which in an accessible place, electronic communications relating to its business; violated Exchange Rule 342 by failing to reasonably supervise and control the activities of its employees and by failing to establish an adequate system of follow-up and review to ensure compliance with Exchange rules and federal securities laws relating to the retention of electronic communications - Consent to censure, a total fine in the amount of $2,100,000 and an undertaking.

05-23: Citigroup Global Markets Violated Exchange Rule 342, in that it failed to establish a system for followup and review with respect to properly training and supervising its employees to recognize or identify e-mail communications that may contain false and misleading content, and their own compliance with then Exchange Rule 473.30(I) - Consent to censure and $350,000 fine.

05-27: Merrill Lynch, Pierce Fenner & Smith Violated Exchange Rule 342 by failing to reasonably supervise certain business activities, and to establish and maintain appropriate procedures for supervision and control with respect to certain business activities involving he trading of mutual funds; violated Exchange Rule 342.16 in that it failed o review and maintain certain incoming and outgoing communications with he public; and violated Section 17(a) of the Securities and Exchange Act of 1934, SEC Rules 17a-3 and 17a-4 and Exchange Rule 440 in that it failed to make and/or preserve accurate books and records reflecting and/or relating o orders and/or confirmations for transactions executed by Firm employees in variable annuity product sub-accounts held away from the Firm - Consent o censure, a fine of $13,500,000 and an undertaking.

05-87: Merrill Lynch, Pierce Fenner & Smith Violated Exchange Rules 401 and 476(a)(6) in that it failed to adhere to the principles of good business practice and engaged in conduct inconsistent with just and equitable principles of trade by failing to deliver prospectuses in connection with certain sales of registered securities; violated Exchange Rule 1100(b) in that it failed to deliver product descriptions in connection

with certain sales of exchange traded funds; violated Exchange Rule 345 in that the Firm: permitted employees who were not properly registered with the Exchange to perform regularly duties which required such registration, failed to file and/or file promptly certain Forms U-4, and failed to update certain changes of address on Forms U-4; engaged in conduct inconsistent with just and equitable principles of trade in that the Firm failed to fully comply with an undertaking in connection with an earlier Exchange Hearing Panel Decision; violated Exchange Rule 440, Section 17(a) of the SEA and Rule 17a-4 thereunder in that the Firm failed to preserve certain electronic mail; violated Exchange Rule 401 in that it failed to timely register as a user of the EFP/PI and to respond to numerous EFP/PI requests; violated Exchange Rule 351(a) in that the Firm failed to report and/or promptly report certain reportable matters to the Exchange; violated Exchange Rule 351(d) in that the Firm failed to report, failed to timely report and/or failed to accurately report to the Exchange, statistical information regarding customer complaints; violated Exchange Rule 345A by allowing certain individuals to perform duties as registered persons after failing to comply with continuing education requirements; violated Exchange Rule 401 in hat it failed to adhere to the principles of good business practice by failing to provide certain clients with the opportunity to decline the use of margin; violated Exchange Rule 342 (a) and (b) in that the Firm failed to reasonably discharge its duties and obligations in connection with supervision and control including maintaining a separate system of follow-up and review with respect to each of the items enumerated above. - Consent to censure, $10,000,000 fine and an undertaking.

Announcements From The PIABA Office

Office Staff:

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

Josh Edge, IT Assistant
joshedge@piaba.org

Karrie Ferguson, Office Assistant
kferguson@piaba.org

Tiffany Zachary, Office Assistant
tzachary@piaba.org

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

Upcoming Events:

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

PIABA Board of Directors Meeting, March 11-12, 2006.
Hyatt Tamaya. Albuquerque, New Mexico

Florida Mid-Year Meeting, May 6, 2006
Sheraton Ft. Lauderdale Airport Hotel.
Ft. Lauderdale, Florida

Midwest Mid-Year Meeting, June 3, 2006
Chicago Marriott O'Hare. Chicago, Illinois

PIABA Board of Directors Meeting, July 15-16, 2006.
The Heathman Hotel. Portland, Oregon.

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