PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION VOL. 13 NO. 1 SPRING 2006

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

FEATURES AND COLUMNS

www.PIABA.org

THE BAR JOURNAL OF THE
PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

From the Editor's Desk

by Jason Doss
PIABA Bar Journal
Editor-in-Chief
Page Perry, LLC
1040 Crown Pointe Parkway
Suite 1050
Atlanta, GA 30338
770.673.0047
770.673.0120 fax
jdoss@pageperry.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 Jason Doss, 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 Summer, 2006 issue of *PIABA Bar Journal* is June 30, 2006. 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 Jason Doss at jdoss@pageperry.com.

By mail, send submissions to:

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

President's Column

By Robert S. Banks, Jr.

This edition of the *PIABA Bar Journal* represents a bittersweet transition. After serving as Editor in Chief since the inception of the *PIABA Bar Journal*, Andrew Stoltmann has stepped down to pass the baton to another member. As Editor In Chief, Andrew always held the laboring oar. He was ultimately responsible for getting suitable articles for publication, passing them on to the PIABA office, and ensuring that the *PIABA Bar Journal* was published and mailed to members and subscribers. There had to be times during those four years when the quarterly deadlines seemed to come far too quickly. Under Andrew's leadership, the Journal has grown by leaps and bounds since its earlier incarnation as the PIABA Quarterly. I am happy to report that Andrew has agreed to continue as a member of the Board of Editors. We all owe Andrew a debt of gratitude for his service.

I asked Jason Doss to become the new Editor In Chief, and he has accepted the position. I have tried to bring some younger involved members into leadership positions in PIABA and Jason was an excellent fit. Jason works at Page Perry in Atlanta representing investors. He graduated from Florida State Law School in 2002, where he won the Best Trial Advocate Award. I know him to be a fine young lawyer who writes well and has good editorial skills. This is the first edition of the Journal with Jason as Editor In Chief. Congratulations, Jason!

The most difficult job for the *PIABA Bar Journal* editors is to get quality article submissions. Any of the readers of the *PIABA Bar Journal* are encouraged to submit articles for publication. The editors are interested in reviewing scholarly and practical articles on securities arbitration that will assist attorneys representing public customers in arbitration. PIABA members, law professors, law students, defense counsel, arbitrators, mediators, SRO administrators, and anyone with an interest in securities arbitration and something to add to the literature are encouraged to submit manuscripts to the *PIABA Bar Journal*.

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 five years, and is currently PIABA's president. He may be contacted at rbanks@bankslawoffice.com.

ProfLipner's I Love New York Law Column

By Seth E. Lipner

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

Statutes Of Limitations in New York: Measuring, Tolling and Shortening

In this space in the Fall '05 issue, I wrote of the reaffirmation of the peculiar aspect of New York permitting a judicial stay of arbitration on the ground that the statute of limitations has run. See Lipner, Statute of Limitations: The Court Finally Decides Who Decides, 12 PIABA B.J., No.3, at p.6 (2005) discussing CPLR 7502(b) and the decision in *Diamond Waterproofing*, 4 N.Y.3d 247, 826 N.E.2d 802, 793 N.Y.S.2d 831 (2005). Such proceedings, authorized only where explicit language is used in the agreement, are rare in securities arbitration.

The question of whether the Statute of Limitations has run is, for practical purposes, one for arbitrators. While arbitrators may hesitate to apply, with rigor, the statute of limitations, respondents will not hesitate to raise it. Claimant must be prepared to respond.

Arbitrator's Discretion to Apply

Some states have ruled that statutes of limitations do not apply in arbitration. See generally Long, Statutes of Limitations Don't Apply in Arbitration, 12 PIABA B.J., No. 3, at p.2 (2005). In New York, however, CPLR 7502(b) provides:

> If, at the time that a demand for arbitration was made or a notice of intention to arbitrate was served, the claim sought to be arbitrated would have been barred by limitation of time had it been asserted in a court of the state, a party may assert the limitation as a bar to the arbitration on an application to the court as provided in section 7503 or subdivision (b) of section 7511. *The failure to assert such bar by such application shall not preclude its assertion before the arbitrators, who may, in their sole discretion, apply or not apply the bar*. Except as provided in subdivision (b) of section 7511, such exercise of discretion by the arbitrators shall not be subject to review by a court on an application to confirm, vacate or modify the award. (Italics added).

Measuring and Accrual – Negligence

As the contractual state-of-choice, New York's discretionary treatment of statutes of limitations in arbitration has an effect even on arbitrations held outside of New York's borders. Knowledge of New York's limitations scheme is thus important for all lawyers practicing in this field.

A recent decision from New York is nicely illustrative of typical problems in this area. In *Hughes v. JP Morgan Chase*, 2004 WL 1403337 (S.D.N.Y., June 22, 2004), plaintiff Derek Hughes had a discretionary investment management account at defendant JP Morgan Chase & Co. ("Chase") since 1986. At that time, Chase sent plaintiff a letter stating that, "[a]pproximately 85% of the account will be committed to ... high quality, fixed income securities ... [such as] U.S. Treasury and government agency securities, high quality corporate bonds and various money market instruments....The balance of the portfolio will consist of up to 15% common stocks." Plaintiff further alleged that he informed Chase that his primary goal was "preserving the capital in the account." The initial deposit was $615,000.

In 1990, Plaintiff retired and advised defendant that he wanted to withdraw $7,500 per month from his account. Defendant explained that it would accommodate these withdrawals by investing a larger percentage in real estate investment trusts ("REITs"), a strategy at odds with the goal of capital preservation. There was no writing that memorialized any change in Chase's investment strategy or Plaintiff's investment objectives.

Beginning in 1991, the portion of Plaintiff's account invested in REITs increased, from 7% to 28% in 1991, to 59% at the end of 1996, to 70% at the end of 1997. Two "Investment Officers" at Defendant also indicated during internal reviews of Plaintiff's account in 1998 and 1999 that the heavy concentration in REITs might violate Chase's guidelines for this type of account. As of December 31, 1997, the market value of Plaintiff's account was $967,847.00. Shortly thereafter, REITs fell out of favor with the market, and REIT equities and fixed income issues began to lose value. By July 31, 1999, the value of the account declined to $661,969.00.

The court in *Hughes* addressed four different claims - breach of fiduciary duty (this was a discretionary account); negligence; negligent supervision; and breach of contract. The first three claims were assigned a three-year statute of limitations,[1] and the contract claim was judged under a 6-year standard.

Under New York law, the court explained, causes of action for negligence accrue when the careless act occurred, regardless of when the wrong was discovered. *Ackerman v. PriceWaterhouse*, 84 N.Y.2d 535, 620 N.Y.S.2d 318 (1994) (claim for accounting malpractice accrued when tax return was prepared, not later when liability and penalties were assessed); *Cf. Kronos Inc. v. AVX Corp*, 81 N.Y.2d 90 (1993)(holding that delayed injury in a negligence case can delay the running of the statute of limitation. But by its terms, New York's "discovery" toll, CPLR 203(f) and 213, applies only to cases of fraud.

The complaint in *Hughes* was filed in July 2001. The Defendants argued that claims of negligence on REITs acquired before that date were stale. Plaintiff, trying to hold onto the claims for securities purchased at earlier times, countered with two arguments: (a) that Defendants negligently failed to sell the earlier-acquired REITs in the post July 1998 period; and (b) that under the "continuous treatment" doctrine, the statute of limitations on the "purchase" claims and the "supervision" claims did not begin to run until the professional relationship between the parties ended and the account was closed. The court said that it had no need to accept the first argument, because it accepted the second.

[1] Breach of fiduciary duty cases sounding in negligence are judged by the three-year statute; those sounding in indemnity (i.e. contract) get the 6-year statute.

Continuous Treatment

Applying what it called the "continuous representation" doctrine, the court ruled that the pre-1998 purchase claims were timely. The court traced the history of the continuous treatment doctrine, showing how it originated in the medical malpractice decision *Borgia v. City of New York*, 12 N.Y.2d 151 (1962). In that case, the New York Court of Appeals concluded that "when the course of treatment which includes the wrongful acts or omissions has run continuously and is related to the same original condition or complaint, the 'accrual' comes only at the end of the treatment."

Heading toward the issue of whether the doctrine applied to investment managers, the court explained that the doctrine "is premised on the trust relationship" between the parties, "and the inequity of barring the client from suing [ ] based on the running of the statute of limitation during the life of the relationship. [citations omitted]". The court then observed:

> Subsequent to *Borgia*, the doctrine was extended to apply to other professionals, including accountants, investment advisors, lawyers, and architects. These cases have expanded the scope of the doctrine to apply in non-medical cases on the theory that professionals "who have had an ongoing relationship with their clients are in the best position to correct their alleged malpractice." [court cited a case applying the doctrine to engineers because of a "desire to protect clients who are forced to depend on the continued services of the professionals who caused the problem so that they may have their problems fixed.").

The *Hughes* court noted that the Second Circuit has never ruled on the issue of whether portfolio managers are subject to the continuing treatment doctrine. Defendants argued that portfolio managers are not "professionals," such that application of the continuous representation doctrine is improper. The court, however, observed that it had previously extended the doctrine to investment advisors. See *Dymm v. Cahill*, 730 F.Supp. 1245, 1263-64 (SDNY 1990)("Devins committed the allegedly wrongful acts not in his capacity as an accountant, but rather as plaintiff's investment advisor....[p]laintiff alleged he 'was and is not sophisticated or knowledgeable about financial matters and completely relied on Devins to handle his financial affairs [and that] Plaintiff reposed his faith and confidence in Devins.')

While stating that "extending the doctrine to this case [does not] fit[] squarely within the policy rationales originally asserted in *Borgia*," the court nevertheless applied the doctrine in light of "the more relaxed standards that courts have recently used." The court wrote:

> Defendants managed Plaintiff's account continuously through the time period at issue and Plaintiff was entitled to rely on their professional expertise to correct any potential malpractice they might have committed. [citation omitted].

Based on these observations, the court applied the continuous treatment doctrine to the situation, and ruled that negligence claims accruing both before and after July 1998 could remain.

There is no reason not to apply the "continuous treatment" doctrine to registered representatives of broker-dealers. Like portfolio managers and investment advisors, a securities broker's relations with its customers is based on trust. If the broker negligently recommends the purchase of an investment, the broker, like the manager ought not to be heard to argue that the purchase claims went stale three years from the purchase if, in the interim, he urged the client to hold the position, or, as in *Hughes*, the broker recommended subsequent purchases.

The continuous treatment doctrine should be applied to all financial professionals, regardless of their designation. So long as the professional relationship continued as to the security or investments involved, the time to sue for negligence ought to run from the end of the relationship, and not from an earlier point.

Measuring and Accrual – Breach of Contract

The breach of contract claims were handled differently by the *Hughes* court. Governed by CPLR § 213(2), which specifies a six-year statute of limitations, the contract statute of limitations begins to run when the contract is breached, even if no damage occurs until later. The continuous treatment doctrine, as well as the discovery rule, does not apply to contract claims.

In *Hughes*, Plaintiff alleged that Defendants breached the Agreement by, inter alia, "failing to exercise their discretion in good faith with respect to an account under their control and in failing to abide by industry standards of conduct." Plaintiff argued that Defendants breached the Agreement by purchasing REITs over and above the agreed upon 15%; Defendant argued that if the Agreement was breached, it was breached in 1991 when the 15% threshold was crossed, and that later claims of breach cannot stand. The court, however, rejected the defense's argument:

> In this case, the Agreement entailed continuing performance, so that "each breach may begin the running of the statute anew such that accrual occurs continuously and plaintiffs may assert claims for damages occurring up to six years prior to the filing of the suit." [citations omitted]

The Court thus held that Plaintiff may bring breach of contract claims regarding alleged breaches that arose on or after July 1995 because they are within the limitations period, but not those that arose prior to that date. As to the contract claims, the Plaintiff was prevented from reaching back for losses occurring before 1995; but since the obligation to manage was, under the agreement, "continuing", the purchase date for the investments was irrelevant to the contract claims.

Measuring, Accrual and Tolling - Fraud

In comparison to contract and negligence claims, fraud claims under New York law are subject to delayed accrual for non-discovery (see CPLR 203(f) and 213); such claims can also be tolled for fraudulent or active concealment.

The discovery rule allows a plaintiff to sue within six years from the time the cause of action accrued, or within two years from the time the wrongdoing was discovered or with reasonable diligence should have been discovered, whichever is more. The discovery rule creates an inquiry notice standard, which can be harsh when applied to the unsophisticated.

To counter that harshness, the "fraudulent" and "active" concealment doctrines complement the discovery rule. Thus, even if reasonable diligence would have revealed the fraud, a later active "cover-up" can keep the time period to sue open. For example, the failure to pay a promised dividend might put a plaintiff on notice of fraud, the defendant's subsequent active concealment of the fraud can provide an independent ground to toll the statute of limitations. See *Dymm*, supra, at 1255.

In order to invoke the doctrine of fraudulent/active concealment, a plaintiff must prove: (1) the wrongful concealment by the defendant of its actions, (2) the failure by plaintiff to discover the operative facts underlying the action within the limitations period, and (3) plaintiff's due diligence in trying to discover the facts. *Id*. at 1255-56. In such circumstances the fraud statute of limitations can be tolled even beyond the 2-year discovery period.

Estoppel

Equitable estoppel is an age-old doctrine which "closes the mouth" of a party to make assertions because of that person's acts or omissions. BLACK'S LAW DICTIONARY defines "estoppel by representation" (a species of equitable estoppel) as:

> aris[ing] when one by acts, representations, admissions, or silence when he ought to speak out, intentionally or through culpable negligence induces another to believe certain facts to exist and such other rightfully relies and acts on such belief, so that he will be prejudiced if the former is permitted to deny the existence of such facts.

The New York Court of Appeals has explained that the purpose of the estoppel doctrine is to serve the interests of justice - to prevent enforcement of rights which would work fraud or injustice against one who, in justifiable reliance, was misled. See *Nassau Trust Co. v. Montrose Concrete Products Corp.*, 56 N.Y.2d 175, 451 N.Y.S.2d 663 (1982). The law books are replete with judicial statements that one who covered up his earlier wrong was estopped to assert that the injured party delayed in bringing a timely action. See *e.g. Powers Mercantile Corp. v. Feinberg*, 109 A.D.2d 117, 490 N.Y.S.2d 190 (1st Dept. 1985) *affirmed* 502 N.Y.S.2d 1001.

Indeed, N.Y.Gen.Obl.L. 17-103(4)(b) expressly authorizes a court to find by reason of the conduct of a party that it is "inequitable to permit him to interpose the defense of the statute of limitation." As the Court of Appeals wrote in *General Stencils, Inc. v. Chiappa*, 18 N.Y.2d 125, 219 N.E.2d 169 (1966):

> Plaintiff does not argue that the statute has been tolled, or that the cause of action did not accrue until discovery, but rather that the doctrine of equitable estoppel should be applied-because of defendant's affirmative wrongdoing and concealment- to prevent defendant from asserting the Statute of Limitations. The principle that a wrongdoer should not be able to take refuge behind the shield of his own wrong is a truism. The United States Supreme Court has espoused the doctrine in these terms: 'To decide the case we need look no further than the maxim that no man may take advantage of his own wrong. Deeply rooted in our jurisprudence this principle has been applied in many diverse classes of cases by both law and equity courts and has frequently been employed to bar inequitable reliance on statutes of limitations.' [citation omitted]. Thus in *Erbe v. Lincoln Rochester Trust Co.*, 13 A.D.2d 211, 214 N.Y.S.2d 849 (4th Dept., 1961), the Appellate Division properly ruled that the defendants, trustees of an estate of which plaintiffs were beneficiaries, could not take advantage of their affirmative concealment of a breach of fiduciary duty, and that the issue of equitable estoppel could thus be raised at the trial in answer to the defense of the Statute of Limitations.

Professor Siegel warns, however, that the estoppel doctrine is "applied sparingly" in the run-of-the-mill tort or contract case, but that, by comparison, "there is nothing like the stealth involved in embezzlement." He also adds that "[i]f there is a fiduciary duty or other special relationship between the parties", then the proponent of the theory may have an easier time. He cites a case involving a physician, showing that the existence of a "fiduciary" duty is not key. See D. SIEGEL, New York Practice (3d Edition), at p.68-69.

Shortening

A persistent issue in cases involving financial institutions is the common provision in customer agreements that complaints about errors or activity must be lodged, in writing, within 10 (or in some cases 15) days, or else they will be not be valid. A recent decision from New York, this one from the state's highest court, the Court of Appeals, addresses that important aspect of timeliness. The case, dealing with banks and the Uniform Commercial Code rather than with securities firms, is nevertheless instructive on the subject.

In *Regatos v. North Fork Bank*, 5 N.Y.3d 395, 838 N.E.2d 629, 804 N.Y.S.2d 713 (2005), the Court of Appeals declared void an agreement between a bank and its customer requiring the customer to notify the bank of discrepancies on monthly statements within 15 days. The Court ruled that the UCC's 1-year statute of repose on such claims could not be shortened by the agreement.

A bank, the Court reasoned, is required to have appropriate security procedures (*e.g.* checking the validity of a drawer's signature). The enforcement of an agreement requiring notice within a short period was held to be antithetical to the statutory scheme's design - it was tantamount to exonerating the bank for its failure to have security procedures:

> Permitting banks to vary the notice period by agreement would reduce the effectiveness of the statute's one-year period of repose as an incentive for banks to create and follow security procedures.

The *Regatos* case did not deal with an NASD or NYSE firm, but its logic prevails in that arena as well. NASD and NYSE firms may not be bound by Article 4 of the UCC, but, like banks, securities firms must have appropriate security and supervisory procedures. The rationale for *Regatos* thus applies - enforcement of a 10-day or 15–day notice provision would serve to exonerate firms from the effects of having sloppy supervisory procedures, reducing the incentive created by law and industry rule to act carefully with respect to client/broker activity.

Conclusion

New York's statute of limitations is a complex mix of periods and tolling. Arbitrators have discretion to apply the statutes, and, while the law provides fixed periods, arguments directed toward accrual, tolling and estoppel extend these periods.

Whether addressing timeliness or substance, arbitrators should be reminded that, as the New York Court of Appeals in *Silverman v. Benmor Coats*, 61 N.Y.2d 299, 473 N.Y.S.2d 774 (1984), they should apply their own "sense of law and equity," doing "justice as they see fit." Hyper-technical application of the law of timeliness has no place in arbitration.

Investment Policy Matters!! Constructing a Retiree Portfolio With the Highest Probability of Success

By Frank Armstrong, III

Frank Armstrong, III, founded Investor Solutions, Inc., a fee-only Registered Investment Advisor to provide investors with objective advice and leading edge investment management. With over 30 years experience in the securities and financial services industry, he holds a B.A. in Economics from the University of Virginia and is a CERTIFIED FINANCIAL PLANNER® practitioner and Accredited Investment Fiduciary (AIF). His best selling book, The Informed Investor was cited by Business Week as one of the best investment books of 2002. His first publication, Investment Strategies for the 21st Century, is one of the first books ever published and serialized on the internet in multiple languages. Mr. Armstrong was also a featured columnist on Morningstar.com and is a frequent contributor to CNNfn.com, AccountsWorld.com, and Fundsinteractive.com. He has appeared on "CNN Headline News", "Your Money with Stewart Varney", "PBS Morning Business Report", and Net Financial News has been featured on numerous radio shows including CNBC, Money Life with Chuck Jaffee, and various Public Radio stations. Frank is widely quoted in the media and lectures nationwide on principles of investment management. Frank can be reached at frank@InvestorSolutions.com, or (800) 508-8500.

Retiree accounts do not vaporize in a vacuum. Absent a nuclear exchange or catastrophic failure of the world's financial markets, retirees following well-defined prudent investment practices should expect that their portfolio will last as long as they do.

Prudent investment practices are embedded in ERISA, the Uniform Prudent Investment Act, Management of Public Employees Retirement System (MPERS), Common Law, Restatement of Trusts, and implied under NASD suitability standards.

Any person in a position of trust that invests funds for another is a fiduciary and owes the beneficiary both prudence and loyalty. While investment advisors are clearly fiduciaries, stock brokers providing advice other than "purely incidental" to the sale of a security may also be deemed fiduciaries and held to the same standards of care.

Standards of care are no mystery. They are widely known and are virtually uniform across the various acts. For instance, a concise outline of the standards of care is contained in *Prudent Investment Practices* published by the Center for Fiduciary Studies of the University of Pittsburg and edited by the AICPA.

Because no one can predict the future, and no one can guarantee a particular result, we judge the prudence of the investment strategy recommended, not the outcome. A prudent investment strategy is no guarantee of excess returns, or even positive returns. But, implied in the various fiduciary statutes is the concept that prudent practice will lead to positive returns over time.

Imprudent investment strategies may occasionally produce exceptional returns. Certainly bad strategies are less apparent in bull markets. After all, a rising tide carries almost all ships. Positive returns, however, do not equate to a prudent investment strategy. If I take your family fortune to Las Vegas, place it all on the red and win, am I a genius? Would a prudent man endorse the process? Have I met my fiduciary obligations? Was my investment policy suitable? Whenever failures in an investment portfolio occur, they can invariably be traced to lapses of prudence or loyalty. Failures tend to cluster around bear markets where the lack of prudence is more readily apparent.

A prudent investment process starts with a well-defined investment policy. This policy should be agreed to by both the client and investment advisor and reduced to writing. The Investment Policy Statement (IPS) becomes the business plan for the account and should contain sufficient detail for a third-party to administer if necessary. An IPS is required of all fiduciaries, but is an essential first step for even do-in-yourself investors.

Modern investment practice is about managing risk at the portfolio level. No single investment should be judged in isolation; rather we must evaluate its impact on the portfolio. Even risky investments have a place in a properly designed conservative portfolio. This is not an argument, however, for simply throwing any investment into the mix. Each investment in the portfolio must be selected after a comprehensive due diligence effort, and must be reasonably expected to improve the efficiency of the account at the portfolio level. Minimum documentation for each investment should include expected rate of return, risk, correlation to other assets in the portfolio and impact on the portfolio's modeled risk-reward characteristics. Both capital market assumptions and portfolio modeling should be included in the IPS.

Sustainable Withdrawal Rates

For an investor who relies on an investment portfolio to generate immediate income, withdrawal rate is probably the most important variable of their investment policy.

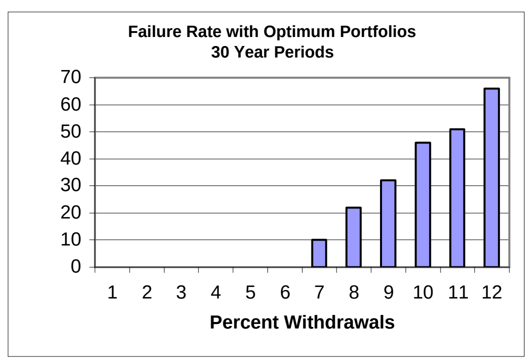
The traditional financial planning assumption about retirement income generation goes something like this: The investor will make 10% on average, withdraw 6% per year, each year the account balance and income will grow by an average of 4%, the investor will die rich, and his children will receive a windfall. This sounds wonderful in theory, but experience and academic analysis has established that it's a bust in the real world.

The fatal problem with the traditional assumption is that it conveniently ignores the variability of returns in the real world facing the retiree. Past experience has shown that projecting average returns forward in a straight line is totally inappropriate. Average returns count for nothing if a client's retirement precedes a period like the Depression, 1973-1974[1] or 2000-2002 in which a retiree's nest egg stood a high chance of self-liquidating.

The real world is much more complicated and risky than an "average" return might indicate. Brokers who pretend otherwise are, at the least, of doubtful competence.

A Pioneering Study

In 1998, three business professors from Trinity University of Texas, Philip L. Cooley, Carl M. Hubbard and Daniel T. Walz, published an influential paper: "Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable".[2] The professors employed



[1] If a worker had retired in 1972 with $500,000, invested in stocks and withdrawn 8% per year, owing to the 50% decline in the market in 1973-1974 and the aggressive withdrawal rate, by the end of 1974, he would have lost over 60% of his principal.

[2] "Retirement Savings: Choosing a Withdrawal Rate That is Sustainable", by Philip L. Cooley, Carl M. Hubbard, and Daniel T. Walz, February 1998.

historical back testing to demonstrate the relationship between withdrawal rates, time horizon, and asset allocation. The results reveal that portfolio “failure rates” (by which the authors mean running out of money before the end of the 30 year period) are directly related to time horizon and withdrawal rates, and influenced by asset allocation.

Using the S&P 500 and bonds in various combinations over varying time periods commencing in 1926, the study tracked failure rates against withdrawal amounts. Even in the best possible case where there were no taxes, no expenses or transaction fees, and the optimum portfolio was known in advance, significant failure rates occurred above 6%.

The Cooley, Hubbard, Waltz study highlights the need for conservative withdrawal rates, and by implication the need to accumulate liberal amounts of capital to fund a comfortable retirement. Historical back testing is a useful tool and provides a powerful “sanity check”. Like any modeling tool, it has limitations. Unless past results will re-occur in exactly the same sequence the expected return will not be as robust as anticipated. For instance, running the sequence backwards or any other re-shuffling will result in entirely different results. Furthermore, historical back testing leaves us with no simple method to vary either rates of return or volatility in the sample set.

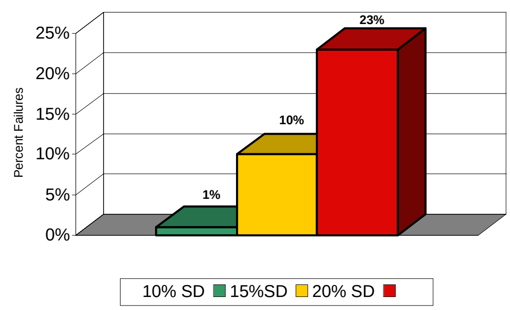
New and more powerful modeling tools confirm these principles and add additional insight, but do not replace the need for very conservative assumptions if the retiree wishes to have a high probability of success.

The fact remains that the highest risk factor a retiree faces (and the only decision directly under his control) is the withdrawal rate.

Recognizing the Effect of Volatility

Monte Carlo simulation and today’s powerful spreadsheet applications give us far more insight into the problem, and point out some additional solutions that would not have been possible with historical back testing.

Simply put, a Monte Carlo simulation utilizes random draws of numbers from pools constructed with specified rates of return and volatility (risk). Much like a lottery, it builds a pool of numbers and pull them out at random to construct a single test. The process is then repeated 1000 or 10,000 times and the results are summarized. The summary provides a quantitative estimate of the range and distribution of the possible returns. By varying the construction of the pools of numbers we can examine different strategies to see which ones give a higher probability of success.



To the effects of volatility, three tests could be conducted using a pool of numbers with a 10% rate of return but a standard deviation of 10%, 15%, and 20%, and a withdrawal rate of 6% per year. At 30 years only 1% of trials fail at 10%, but 23% fail at a standard deviation of 20%. Failure rates soar with the higher volatility!

The simulation reveals a clear link between volatility and survival of the portfolio at any given time horizon. Therefore, any action taken to reduce portfolio volatility (given the same rate of return and withdrawal rates) will significantly enhance the chance that a retiree’s nest egg will survive.

Totally Skewed

In the traditional analysis referred to above, it would appear that half of all trials would result in greater than expected returns, and half less. But, it's worse than that. The only case where each trial yields the average result occurs where there is no portfolio volatility. In that special case, every trial survives and gets the identical result.

With volatility, outcomes become skewed. Even though we obtain the expected rate of return across the sample was obtained, the median return was less than the average. The higher the volatility, the greater the sample becomes skewed at any time horizon. As the number of failures goes up, the number of extraordinary results also goes up. A small number of players obtain much higher than expected results, while a large number of players' portfolios either fail or obtain lower than expected results.

For example, suppose we expect a terminal value of $100,000 for a particular withdrawal rate, rate of return and time horizon. If one result yields $1,000,000, and nine results yield $0 at some particular risk level, we have achieved our average return. But, nine of ten retirees are broke!

Monte Carlo analysis generally confirms the historical back testing of Cooley, Hubbard and Waltz. Even with moderate volatility, high withdrawal rates lead to high portfolio failure rates.

Constructing the Asset Allocation

Every step of the investment policy must support the retiree's objectives. The ideal policy will support the required withdrawal rate while maximizing the probability of success.

The first problem that faces the retiree is that "guaranteed" investment products are unlikely to provide sufficient total return to meet his reasonable needs. Meanwhile, equities are far too volatile to provide a reliable income stream. A compromise must be reached. A combination of stocks and bonds will probably best meet the needs.

Because at least part of the portfolio will be volatile, the question of risk management moves to the forefront. Our first step is to construct a "two bucket" portfolio, or a portfolio that balances the need for long-term growth with adequate liquidity to withstand market downturns.

Bucket One – Adequate Liquid Reserves

Investment policy that does not provide adequate liquidity to account for down market periods ideally positions the retiree to witness the self-liquidation of his portfolio at the first market dip. Many of the dramatic portfolio failures of 1973-1974, 1987-1991 and 2000-2002 can be traced to a simple lack of liquidity.

Market downturns are an unpleasant fact of life, which can be excruciatingly long and stressful for retirees. Three years can seem like forever as portfolios shrink due to a combination of market decline and withdrawals. This problem is especially acute where downturns occur shortly after retirement. Because market downturns are random, and because the retiree only has one draw in the game of life, the portfolio must be designed to anticipate down market experience beginning on day one.

Recognizing that equity investments are too volatile to support even moderate withdrawal rates safely, investors must temper their portfolios with a near riskless asset that will lower the volatility at the portfolio level and be available to fund withdrawals during down market conditions. As a minimum liquidity requirement, high quality, short-term bonds are typically sufficient to cover seven to ten years of cash flow needs from the portfolio at the beginning of retirement.

While it is tempting to chase higher yields with longer duration or lower quality issues, past experience indicates that the enormous increase in risk swamps the small additional yield benefit. In a portfolio with longer duration low quality bonds, rising interest rates will devastate capital. This additional risk is not rewarded by higher total returns over the market cycle.

As an example of portfolio construction that provides adequate liquidity, if you expected to draw down 5% of your capital each year for income needs you might want to have 35-50% in fixed investments. That way if the market takes a dive, (as it probably will sometime during retirement), the retiree will have plenty of time for it to recover. Meanwhile the retiree can draw down the bonds without market loss. This investment strategy protects the growth assets during market declines.

Bucket Two – World Equity Market Basket

Long experience backed by modern financial theory suggests that a good starting point for the equity portfolio is the world market index. Under Capital Asset Pricing Model (CAP-M) this is the point that should produce the highest return per unit of risk. In fact, this portfolio is dramatically lower in risk than a domestic only portfolio without sacrificing return.

An investment policy of global diversification recognizes the impact of volatility and employs standard portfolio construction concepts to reduce it. Modern Portfolio Theory techniques include utilization of multiple asset classes with low correlations to one another. Low risk (low volatility) portfolios have a much higher chance of survival than higher risk portfolios.

Investors are systematically compensated for bearing market, size and value risk, nothing else. Diversification is the primary investor defense, and the best way to lower risk. Said another way, the investor's chief goal should be to ruthlessly eliminate any uncompensated risk. Given that the investor gives up nothing in the way of expected return by diversifying away all individual security, industry, or country risk it is amazing that everyone doesn't carry this policy to its logical conclusion.

Further refinement is possible. For example, an effective portfolio might contain nine distinct global equity asset classes, over weighted in small and value stocks to increase expected returns while diversifying into dissimilar asset classes. Each of these asset classes has high-expected returns at tolerable risk levels and relatively low correlation to each other.

The portfolio can further diversify an equity position by including defined weights in real estate and commodities futures. These last two asset classes have very low correlation to traditional stocks. Every time an appropriate dissimilar asset class is added to an existing portfolio an expected reduction in risk at the portfolio level occurs. As diversification increases, risk goes down, and the chance of having a happy ending improves. High risk in a retiree portfolio is never prudent.

Implementation

Once an appropriate asset allocation plan has been selected, the need to effectively and economically execute it is just as important.

Market Efficiency

Index funds and Exchange Traded Funds (ETFs) are the investment of choice for fiduciaries in that they provide pure market exposure to attractive global markets at minimum risk.

Markets are remarkably efficient, and attempts to beat them through either individual stock selection or market timing have a very low probability of success. Active management has a predictably negative impact on performance. On average, actively managed funds and separately managed accounts fall short of indexes by approximately 2% per year, an amount equal to their trading costs and management fees. Worse yet, the few active managers who have "beaten" the indexes in past markets fail to reliably repeat in subsequent periods. Nevertheless, in any period 20-25 percent of managers outperform their indexes giving hope in spite of the overwhelming evidence against active management. Given the low probability of success and the high cost in turns reduced average total return, the trade off is distinctly unfavorable.

The 2% number understates the magnitude of potential risk associated with active management. On occasion a high-flying fund or manager craters so spectacularly that little is left of the portfolio. Recall the astoundingly poor performance of many concentrated stock funds in the aftermath of the large cap growth and tech meltdown of 2000 to 2002. These uncompensated risks are completely avoidable at no cost to expected return.

The systematic underperformance of active managers along with their wide variation in returns (risk) is totally avoidable by simply utilizing no-load institutional class index funds and exchange traded funds (ETFs). Indeed, they should be the default investment medium. This policy spreads risk as widely as possible in some of the world's most attractive markets while controlling costs, preventing "style drift", minimizing taxes, and eliminating "management" risk.

It's hard to argue with the low cost, low risk approach to obtaining the rewards generated by the world's markets. It would take a very strong belief set to overcome the argument for passive investments in any asset class.

Hedge funds are active management on steroids, but without accountability, transparency, and liquidity. At least 17 distinct strategies might be labeled as hedge funds. All are a huge bet against the efficient market, boast astronomical fees, lack any meaningful track record, and are almost impossible to model in terms of risk, reward, and correlation to other investments in the portfolio. It is difficult to imagine that any level of due diligence might correct these deficiencies to the point where they would pass muster in any well designed investment policy.

Concentrated Holdings

Concentrated stock positions occupy one extreme edge of the irresponsible investment policy universe. The number of large highly visible firms beginning with Enron that simply vaporized staggers the mind. The human costs of such failures can be enormous.

Concentrated stock positions can be either single firm, single industry, or single country. They all generate huge amounts of uncompensated risk. Investors are NEVER compensated for risk that they could have diversified away. No one should be surprised whenever a concentrated stock portfolio fails. There can be no argument that a concentrated position in a retiree account is responsible, prudent, or suitable. Diversification is an absolute non-negotiable requirement of any prudent investment policy.

Cost Containment

Market returns are finite, and costs reduce them. Professional advice, transaction costs, and other expenses are not free. Commissions, expense ratios, management fees all add up. But, the market is competitive, and total costs can easily be closely controlled by appropriate policy guidelines that insure that expenses are directly related to value received.

Unfortunately, abuses are common. Without specific control measures, costs can escalate far beyond the range of reasonableness or suitability. Churning, proprietary products, high annual expenses, back end surrender charges (B Shares Variable Life and Annuity products), trail commissions (12b-1 Fees), annuity and life insurance charges can reduce real returns so drastically that performance is irrevocably impaired. In some cases forensic accounting may be necessary to figure out where all the money went.

Controlling Conflicts of Interest

Conflicts of interest and lack of disclosure are a primary concern, which can only be cured by full disclosure and total transparency.

The transaction oriented, commission based compensation system is so corrupt that managing the imbedded conflicts of interest is functionally impossible. Certainly not every investment advisor fiduciary is a sage saint, and not every commissioned salesman is a greedy fool. But, whenever a system rewards an advisor more for one recommendation than another, the possibilities for mischief are boundless, inappropriate advice flourishes, and the concept of objective advice loses meaning.

Guarding Against Inadequate Supervision

Any organization large or small can have a rogue agent. It is the responsibility of management at all levels to develop auditing systems to monitor and if necessary weed out the incompetent, greedy or delusional.

Fraud and Theft

Occasionally an investment advisor or broker makes headlines by simply stealing tons of money from trusting clients. An appropriate investment policy secures assets in strong third party custodians, demands adequate accounting and transparency, requires appropriate bonding and insurance, and maintains accounts under the jurisdiction of US courts.

Summary

Investment policy matters! Following simple prudent practices vastly reduces the chance of a bad outcome for retirees. Because of the risk associated with systematic withdrawals, every effort must be made to control portfolio volatility, and provide adequate liquidity. Implementation should be effective, low cost, low risk and tax efficient.

Prudence can be systematically engineered while loyalty can be monitored within a framework of full disclosure, total transparency, and continuous supervision.

The Myth of Time Diversification: Analysis, Application, and Incorrect New Account Forms

By Jack Duval[1]

Jack Duval is a Managing Director of Duval Asset Management LLC (a Registered Investment Advisor www.duvalassetmanagement.com) and a Managing Director of John Duval Associates LLC (Litigation Consultants www.johnduval.com). He can be reached at (914) 771-7774 or emailed at: jack@duvalassetmanagement.com. In addition to managing portfolios, Jack is an expert witness as well as an arbitrator for both the NYSE and NASD.

Introduction

Investors are frequently encouraged to increase their risk exposure based upon a long time horizon. When working with clients to determine risk tolerance, registered representatives typically show charts and graphs depicting the decreasing volatility of equities over time and the decreasing likelihood of losing principal over time.

Underlying these sales presentations is the belief in time diversification: the idea that the longer an investment is held, the less likely it is to produce a loss. It is an idea that enjoys wide circulation on Wall Street. It is wrong.

This article will show that time does not reduce risk but actually *increases* risk. How time increases risk will be shown through three examples: the increasing magnitude of potential losses as time increases, the increasing cost of insuring investments as time increases, and the increasing likelihood of experiencing within-horizon losses as time increases.

After proving the myth of time diversification, harmful applications of the myth will be explored. These include: the fact that investors typically think of risk in dollar terms and not percentage terms (as does time diversification), the omission of within-horizon risk discussions, and the reality that most investors do not end up being long-term holders of investments.

Finally, this article will address how the myth of time diversification manifests itself on new account forms. In my experience as an expert in securities arbitrations, the registered representatives' mistaken belief that time reduces risk frequently appears in the selection of "Long-Term Growth" as the investment objective on new account forms. The "Long-Term" part of the investment objective is often communicated to the client as a risk-reducing factor that justifies risky "Growth" oriented investments[2]. Unfortunately, just as flipping a coin 20 times does not change the odds of getting a tails on any one flip, designating an investment as "Long-Term" does not reduce the probability of experiencing a loss on that investment in a ny one year. Thus investors

[1] The author would like to thank Chuck Austin, Jason Doss, John Duval, Meghan Duval, Jay Salamon, and Rosemary Shockman for thoughtful comments and suggestions on this paper. Of course, any errors are the sole responsibility of the author.

[2] Many brokerage firms do not require the client to sign the new account form and in these cases the registered representative fills it out by him or herself without ever showing it to the client.

are put into risky portfolios thinking they have reduced their risk through the intention of long-term holding periods but when the inevitable decline comes, it proves too extreme.

This article advocates that client investment objectives should be based on "time-independent" risk tolerance (i.e. the risk the client would accept in any one year). For most investors, the time-independent risk tolerance is much lower than what they are encouraged to select under the conventional time diversification belief. Indeed, the only case in which time should be a determining factor of risk tolerance is when the anticipated need for the money is known to be short term. For instance, if an investor knows they will need their money in 3 years for a down payment on a house, they should not take any risk with their investments. Investors with a five-year or longer expected time horizon should base their risk tolerance on how much risk is acceptable to them if they were invested for only one year, picked at random from their expected time horizon.

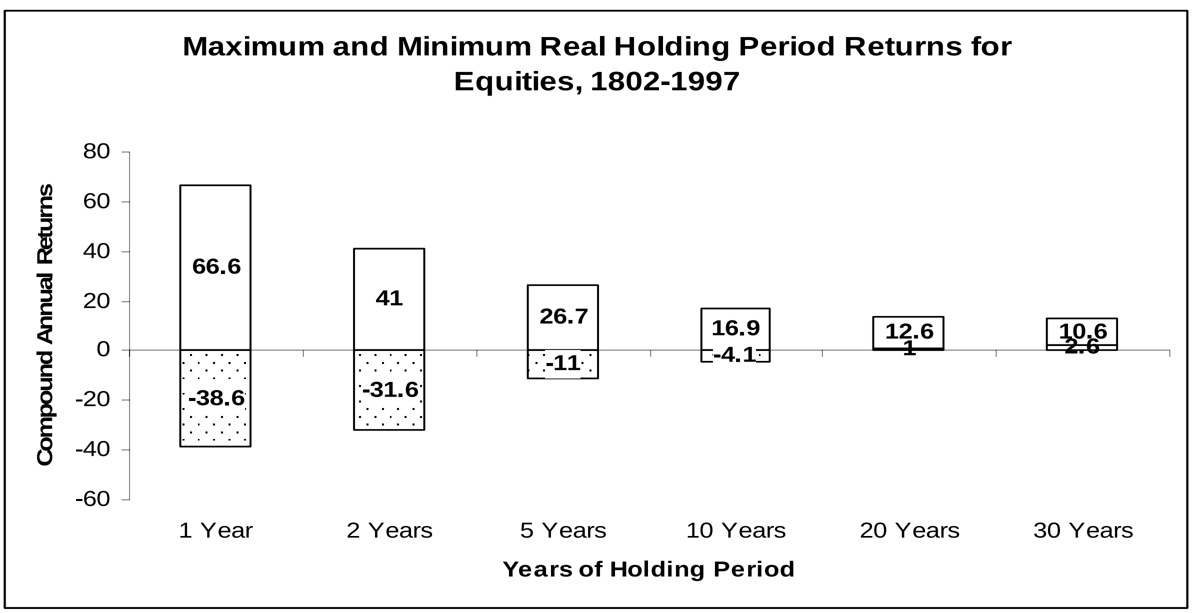
Time Diversification

Time diversification is part of the conventional wisdom of Wall Street. Consider this quote from a Vanguard web page for investor education:

> **"Time horizon.** The more time you have until you'll need your money, the greater your ability to weather short-term declines in the prices of your holdings. So if your time horizon is at least ten years, emphasizing stocks in your investment program may help you achieve your financial goals more readily."[3]

Like the Vanguard passage above, almost all investment literature from brokerage firms, mutual fund companies and separate account managers extols the ability of time to reduce risk. A typical chart will show the percentage chance of loss decreasing with longer investment periods.

A good example of the marketing material shown to investors is the chart below, which is adapted from Jeremy J. Siegel's *Stocks for the Long Run*. In this chart, the risk of loss is shown decreasing as the years of the holding period increase. For any one year period from 1802 to 1997 the worst one year return was –38.6 percent; for any five year period the worst five-year compounded average



Adapted from: Jeremy J. Siegel (1998)[4].

annual return was –11 percent; and for any 30 year period, the worst 30 year compounded average annual return was +2.6 percent.

These analyses of time diversification are based, in part, on the "Law of Large Numbers." For investors, this concept implies that as the time horizon increases, so does the likelihood that an investor's actual average return will achieve its long-run historical average. The investment implication is that an investor with a lengthy time horizon can pick a more aggressive asset allocation and *keep it the same* throughout their investment horizon - thus achieving the "holy grail" of investing: increasing returns and decreasing risk at the same time. Consequently, investors often wind up with portfolios that are riskier than their time-independent risk tolerance would allow. The excessive risk becomes apparent only after the inevitable market decline proves to be too extreme.

The truth of the time diversification claim relies on risk being defined solely as the likelihood of loss at the end of the investment horizon. This definition of risk is very narrow and ignores human nature, basic economics, and contrary statistical evidence. The investment pitch of registered representatives is based on a belief in the unequivocal risk-reducing effects of time. This belief will be proven false below.

Three Critiques of Traditional Time Diversification

Economists and finance experts, beginning with economics Nobel laureate Paul Samuelson in 1963, continuing with his protégé Professor Zvi Bodie, and most recently including author and CFA Mark Kritzman, have developed three distinct critiques of time diversification.

1. Paul Samuelson

In his 1963 paper "Risk and Uncertainty: A Fallacy of Large Numbers,"[5] Paul Samuelson recalls an encounter he had with a colleague who refused to take a bet with favorable odds on a single flip of a coin but agreed to a series of 100 flips at the same odds. At first glance, Samuelson's colleague seems to have been making sense; isn't it logical that many repetitions of the bet would reduce the risk of a loss? However, upon deeper reflection, the proposition is irrational. If an individual finds the risk of a bet unacceptable, why would they find a series of the exact same bet acceptable? The truth is that the series of bets is not acceptable and Samuelson's paper proves it by accounting for the magnitude of risk taken with each bet.

A parallel to Samuelson's colleague is a hypothetical investor who finds a 100 percent equity portfolio too aggressive for one year, but agrees to hold the 100 percent equity portfolio for 30 years. According to conventional wisdom, the investor is doing exactly what he or she should.

Yet this strategy completely ignores the crucial fact that over those 30 years, the investor's investment base will increase dramatically. Recall that the time diversification strategy requires that an

---

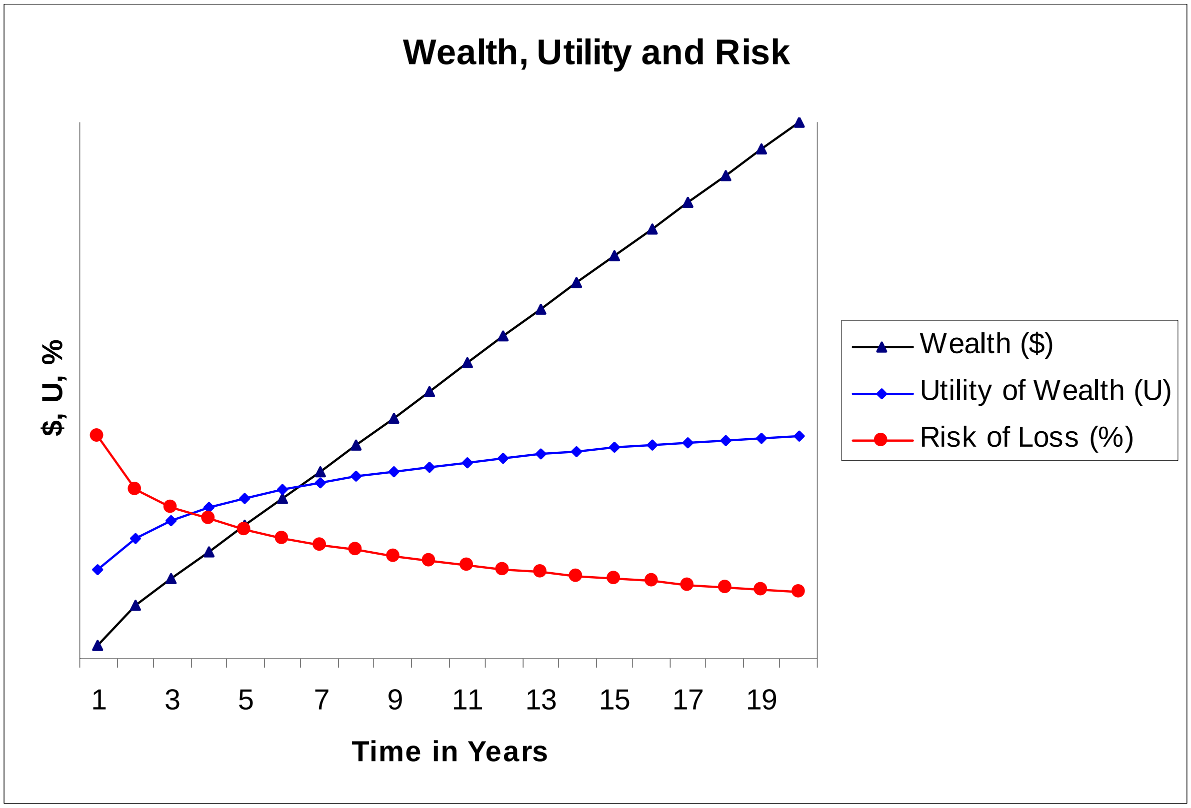
[3] Vanguard, "Personal Investors, Planning & Education, Stock, bond and cash investments: Time horizon"; http://flagship2.vanguard.com/VGApp/hnw/content/PlanEdu/InvestorEdu/PEdIESBCInvestmentsContent.jsp; Internet; accessed 8 March 2006.

[4] Siegel, Jeremy J., "Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies," Second Edition, (New York: McGraw-Hill 1998), 27.

[5] Paul A. Samuelson, "Risk and Uncertainty: A Fallacy of Large Numbers," *The Collected Scientific Papers of Paul A. Samuelson*, ed. Joseph E. Stiglitz (Cambridge: MIT Press, 1966), 153-8.

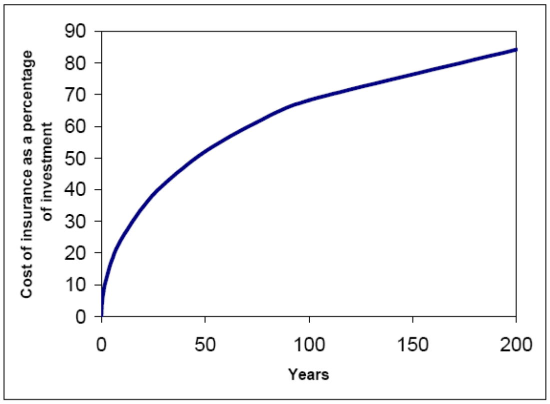
investor with a 30-year time horizon keep the *same* asset allocation for all 30 years. Thus, time diversification is telling us that a potential 20 percent loss on a $1 million retirement nest egg in year 30 is just as acceptable as a potential 20 percent loss on a $2,000 IRA account in year one. My experience working with investors and the fundamental economic concept of the diminishing marginal utility of wealth tells us that this is absolutely not true. Investors are *not* indifferent between a $200,000 loss on the eve of retirement and a $200 loss when they are just out of college. Thus the investor should not accept the risk of a portfolio unless the risk in each individual period is acceptable. In the example above, unless the investor finds the potential $200,000 loss acceptable, he or she should not invest in the 100 percent equity portfolio.

Samuelson proves this point by showing that the *decrease* in the probability of a loss is exactly offset by the *increase* in the potential magnitude of loss. Therefore instead of increasing an investor's portfolio risk based upon their time horizon, investors should choose an asset allocation based upon the amount of risk they are willing to take in any one year. The risk profile of the "invest for any one year" portfolio will typically be much more conservative than a risk profile based on a lengthy time horizon.



Source: John Duval Associates LLC (2006)

The above-chart illustrates how three things happen over time: wealth increases, the utility (or usefulness) of wealth increases at a slower rate over time, and the risk of loss (defined as end-of-horizon loss) decreases over time. What Samuelson shows us is that the benefit from the decreasing risk of loss is exactly offset by the declining benefit of having more wealth. (In mathematical terms, the slopes of the utility and risk graphs sum to zero in each time period.)



Source: Zvi Bodie (1995)

Compare year one, when the risk of loss is high and wealth is low to year twenty, when the risk of loss is low but wealth is high. The conventional time diversification model focuses solely on the diminishing risk of end-of-horizon loss and completely ignores the exponential increase in wealth at risk.

2. Zvi Bodie

Professor Zvi Bodie of Boston University, a former student of Paul Samuelson's at MIT, has also argued against time diversification using the cost of put options over time. Bodie's argument rests on the assumption that the market is able to determine whether risk increases or decreases over time. He writes: "If it were true that stocks are less risky in the long-run, then the cost of insuring against earning less than the risk-free rate of interest should decline as the length of the investment horizon increases. *But the opposite is true."*[6]

Bodie uses the cost of put options as a proxy for the cost of insuring an investment. (Put options go up in value if the underlying investment they are derived from goes down, thus they can be rightfully viewed as insurance on that investment.) Expressed as a percentage of the investment, the cost of a one year put option in his example is 7.98 percent, the cost of a five year put option is 17.72 percent, and the cost of a 30 year put option is 41.63 percent, increasing infinitely as the time horizon increases[7].

This data is summarized in the chart below and can be verified independently by anyone willing to look at the options tables in their daily newspaper. Put options premiums for the same underlying security, with the same strike price, differing only in expiration date will increase in price as the expiration date extends further into the future.

Clearly, the options market has determined that risk increases as the time horizon increases. Otherwise, put options would become *less* expensive as the expiration date was extended.

3. Mark Kritzman

Mark Kritzman, the CEO of Windham Capital Management and a frequent contributor to finance journals, has made another critique of time diversification.

Like Samuelson and Bodie, Kritzman proves that risk *increases* with time. Kritzman's analysis directly disproves the notion that the probability of loss decreases with time.

Through a statistical analysis known as "first-passage time probability," Kritzman has quantified what should be self-evident - the more periods an investor is in the market, the more likely he or she is to experience periods with negative returns. These negative returns occurring during the investment period are called within-horizon losses. The increasing likelihood of within-horizon losses as the time horizon increases should be intuitive to everyone. Just as the more times a fair coin

[6] Zvi Bodie, "On the Risk of Stocks in the Long Run," *Financial Analysts Journal*, May-June 1995, 18-22.

[7] *See Id.* at 20.

is flipped, the more likely it is that tails will appear; the more years an investor is in the market, the more down years that investor is likely to experience. Thus, the probability of incurring a loss *increases* with time, not decreases as the conventional wisdom tells us.

Kritzman concludes from his analysis that since "probability of loss rises rather than falls with time… even those who construe risk narrowly as probability of loss no longer have a leg on which to stand."[8]

The chart below, which is summarized from a paper by William J. Trainor, Jr. building on Kritzman's work, shows that as the investment time horizon increases, the risk of within-horizon losses on equities increase as well. For example the risk of a 10 percent or more loss stands at 41.8 percent for any one-year period and increases to 59.7 percent for a 20 year investment period. Remarkably, the risk of a 25 percent or more loss for a five-year period stands at 19.5 percent, even though the risk of an end-of-horizon loss of 25 percent or more is only 4.5 percent. This means that investors leaving their money in the market for five years have an almost 20 percent chance of being down by 25 percent *or more* at some point during those five years – a fact they might find disconcerting if all they have been shown is the 4.5 percent risk of the same loss at the end of the five years!

Thus, even though the end-of-horizon probability of loss declines with time, the within-horizon risk of loss increases with time.

Time Diversification and the Typical Investor

The conventional time diversification story presents an appealing proposition to the investor – invest for long enough and you can eliminate the risk of investing. This rosy scenario is at best a partial truth and has the potential to lead the investor into bad decisions that will haunt them later in the form of destroyed retirement funds, unmet goals and the prospect of having to work for their entire lives.

Where does the conventional story go wrong? It fails the investor in three primary ways that are supported by the three critiques presented above.

1. Percentage versus nominal losses

The first failure is that the conventional model measures risk in percentage terms when investors measure risk in dollar terms. Recall that the conventional model requires the investor to hold the same asset allocation for their entire investment horizon – over which their wealth will grow dramatically. We know that the risk of loss is the same in any year, so the potential magnitude of loss increases every year as wealth grows.

The conventional time diversification story assumes that the investor is indifferent between a small dollar loss and a large dollar loss. However, anecdotal evidence, basic economic theory, and common sense indicate this is false.

Theoretical probabilities for losses of 10 to 25 percent or more

	One-year Horizon		Five-year Horizon		Ten-year Horizon		20-year Horizon	
	End-of-horizon	Within-horizon	End-of-horizon	Within-horizon	End-of-horizon	Within-horizon	End-of-horizon	Within-horizon
10% or more loss	15.3%	41.8%	10.7%	56.6%	5.8%	58.9%	1.8%	59.7%
15% or more loss	9.0%	23.6%	8.3%	40.9%	4.7%	44.0%	1.5%	45.1%
20% or more loss	4.7%	11.9%	6.3%	28.7%	3.8%	32.2%	1.3%	33.5%
25% or more loss	2.1%	5.2%	4.5%	19.5%	2.9%	23.0%	1.0%	24.4%

Note: Assumes: 100% lump sum equity investment; 10 % expected return, 20% standard deviation. Adapted from: William J. Trainor, Jr. (2005).

Unfortunately, the increasing magnitude of potential losses is not explained to investors. The focus is on the reduced probability of end-of-horizon losses. This focus ignores the crucial fact that the probability of loss in any one year is the same in each year of the investment horizon, and thus a big loss could come at the end of the investment period, when the dollar amounts of the loss would be severe and (most likely) irreplaceable.

2. Increasing risk with time

The second failure of conventional time diversification is that it ignores the fact that risks increase on equity investments the longer they are held. This is especially pernicious for investors who are trying to decide how much risk to take. If the investor is told only that time reduces risk, then they will take an investment stance that increases their risk (typically through their asset allocation) while they believe they are doing the opposite!

We know from the evidence above that within-horizon risks increase with the time horizon. Because of this, investments should be made based on a time-independent basis. A key question that should be asked of clients is: "How much (in dollars) are you willing to lose in any year?" Importantly, the maximum acceptable loss question assumes the risk of within-horizon loss and not the conventional end-of-horizon "guarantee" of positive returns.

Unfortunately, this question is rarely asked, and if it is, it is usually part of a long series of questions and carries relatively little weight. In reality, investors will change their asset allocation once their portfolios have reached a certain loss level. All end-of-horizon predictions will be lost in the pain of the moment and the client will demand that the registered representative "get them out at any price." These decisions are almost always of the "selling low" variety and hurt the investor greatly. Thus avoiding the "get me out at any price" moment is of paramount importance – and the only way to avoid it is to address it before any money is invested.

The "how much money are you willing to lose" question addresses within-horizon loss directly and should be the centerpiece of the risk tolerance discussion.

3. Where are the "long-term" investors?

The third failure of the conventional time diversification model is that the vast majority of investors *do not* hold their investments for long time frames. Many unexpected events can upend investor intentions of long-term investing, some of which include:

- Market volatility
- Health emergencies
- Disability
- Need to support additional family members
- Lawsuits
- Layoffs
- Early retirement

Mutual fund data supports the reality of investors' short time horizons. According to Dalbar's Quantitative Analysis of Investor Behavior (QAIB) study, from 1984 to 2004, the average equity mutual fund investor held their fund only 2.5 years[9]. The QAIB study also shows that although the stock market has averaged almost 12 percent over the past 20 years, individual equity investors only averaged four percent over the same time period[10]. The reason for the discrepancy in market versus realized returns is evident in

[8] Mark Kritzman, "A New Twist on Time Diversification," *InvestmentNews*, 31 October 2005.

[9] Cited in Trainor, Jr., William J. "Within-horizon Exposure to Loss For Dollar Cost Averaging and Lump Sum Investing," *Financial Services Review* (2005), 322.

[10] *Id.*

the QAIB reported fund flows – investors are buying high and selling low[11]. In short, year-to-year (within-horizon) losses are overwhelming the promises of end-of-horizon success.

Time Diversification and New Account Forms

The myth of time diversification also extends to the new account forms that registered representatives are required to complete upon opening a new brokerage account. Brokerage firm new account documents commonly contain the client investment objective entitled "Long-Term Growth." While this selection may or may not be reviewed with the client, it can be an inappropriate objective and frequently used against the investor in an arbitration.

For the typical client, "Long-Term Growth" means that they plan on being invested for the rest of their lives and they'd like their investments to grow. For the typical registered representative, "Long-Term Growth" means the conventional time diversification model is in force and they can put the client in more aggressive investments because of their long time horizon.

Furthermore, if the registered representative explains risk only in the terms of conventional time diversification, the client wrongly believes the "long term" part of the investment objective means they are *reducing* their risk. The "growth" part of the investment objective is generic to all clients – after all, everyone wants their investments to grow. However, the universal applicability of the term "growth" renders it virtually meaningless. (For example, an investor can achieve "growth" in a 100 percent treasury bill portfolio.) The only distinction that really matters is how much risk the client is willing to take to achieve that growth.

As mentioned above, new account forms should ask: "how much money are you willing to lose in any one year?" The question should be answered in nominal terms and it should have a signature line next to it. This would force both client and registered representative to address within-horizon risk before any investments were made and (hopefully) avoid the "get me out at any price" decision.

Lastly, if aggressive investments made for a client under the conventional time diversification model prove too risky and the matter ends up in a hearing, the "growth" part of the "Long-Term Growth" investment objective will be cited as the clients' *willingness* to take risk. This argument may come to the dismay of the clients who were told that the "long-term" part would *reduce* their risk.

Counter-Arguments

The evidence I have presented above does not preclude all defense of the conventional time diversification model. An obvious critique is that while my argument may hold for someone aged 65 who is retiring, it does not hold for a 21 year old college graduate who is just entering the labor force.

This critique is based on the economic concept of human capital, which is simply the present value of an individual's expected lifetime labor income. For the 65-year-old retiree, their typical human capital is zero (they have no more expected labor income) and their total wealth is equal to their investment assets. For the 21-year old college graduate, their human capital is large (they have all of their working years in front of them) and their total wealth is equal to their human capital (they have no investment assets).

The counter-argument states that if an individual has all (or most) of their working

[11] *Id.*

years in front of them, then they can afford to take risks with their investments. If those investments sustain losses then the individual can offset the losses by increasing their human capital through working more hours, taking an additional job or delaying retirement.

The problem with this critique is that it assumes human capital is *riskless*. This is far from the case. In today's dynamic economic environment, even professionals with significant investments in human capital can find their jobs obsolete. For example, managers with MBAs can be laid off due to corporate restructuring and more recently, radiologists have seen their work emailed to India where x-rays are read by equally qualified doctors at a fraction of the costs. The risk to human capital argues for the 21-year old college graduate to take very little risk with their investments because they don't know the value of their human capital.

In my experience, risks abound for investments and human capital. As human capital is turned into investment capital, it should be invested to protect the investor from losses in the market and employment.

Conclusion

For claimants' attorneys, the broader understanding of time risk outlined above should provide a powerful counter to the common suitability defense of time horizon. Some implications are that:

1. risk tolerance should be established independently from time horizon;
2. clients should be asked explicitly on new account forms: "how much money (in dollars) are you willing to lose in any year?";
3. asset allocations should be determined by how much risk an investor is willing to take in any one year;
4. investments made on the basis of conventional time horizon are likely to be unsuitable;
5. registered representatives who are only telling their clients that time reduces the risk of loss are not following the rules of fair practice and are, in fact, negligent.

Investors care about losses at every step along their investment path, not only at some far away terminal date. Just as stocks do not magically turn into bonds if held for long time periods, portfolio risks do not disappear with longer time horizons. The risk of a loss is the same in each time period.

Risk must be explained to investors in terms of the potential magnitude of declines and the increased likelihood of experiencing within-horizon losses as their time horizon increases.

When Words Collide: Arbitrating Securities Claims When Oral Misrepresentations by a Broker Contradict a Written Prospectus

By Kenneth B. Gorton

Kenneth B. Gorton is a Federal Judicial Law Clerk for the Honorable Robert J. Bryan, United States District Court for the Western District of Washington. Mr. Gorton graduated from Pepperdine School of Law in May 2005, with a Juris Doctor and Masters in Dispute Resolution, and with an emphasis in Securities Arbitration. While in law school, Mr. Gorton clerked for Aidikoff and Uhl in Beverly Hills, the NASD Arbitration Department in Los Angeles, and Steptoe and Johnson's International Arbitration Department in London. Mr. Gorton also served as the National Student Editor for the American Bar Association's Student Lawyer Magazine. He can be reached at kgorton@comcast.net.

I. INTRODUCTION

Any plaintiff's attorney who specializes in securities can easily imagine the following scenario: Your client receives a prospectus when purchasing a security, such as a hedge fund, but does not read the 20 plus pages of fine print. Instead, your client relies on the advice of his or her broker, who says that the fund will not hold more than 5% of its assets in any one stock, and that the hedge fund is a great investment. Several months later, your client is dismayed when the hedge fund manager invests more than 50% of the fund's assets in a penny stock and loses big. On closer inspection of the prospectus, you discover that it mentions nothing about limiting investments in one stock to 5% of the fund's assets. In fact, it says that the hedge fund may, at times, invest heavily in only one or a few stocks. Clearly, the broker's statement and the prospectus contradict each other. Does this sound like a clear case of Rule 10(b)-5 fraud against the broker?

Rule 10(b)-5 states that it is unlawful to "make any untrue statement of a material fact … in connection with the purchase or sale of any security." *See* Appendix A. On its face, the broker's statement appears to be an untrue statement of a material fact. Yet the client did receive a written prospectus and, arguably, could have taken the time to read it. The question then becomes: Does a written prospectus trump an oral statement or misrepresentation made by a broker? Or, perhaps another way to look at it: Can you throw caution to the wind, forget the prospectus, and just rely on your broker's advice? Like many securities claims involving Rule 10(b)-5 or any other federal securities laws, the answer hinges on what case law you apply. And, like with many issues involving federal regulation, jurisdictions are split on how they interpret the federal rules and cases in question. It may come as no surprise that California takes a much more liberal approach to this problem than New York. Because both California and New York law play a predominant role in securities arbitration, and are often at odds with one another, this article will focus on a comparison of these two jurisdictions.

A review of California and New York federal case law has revealed that these two jurisdictions are almost in direct opposition regarding whether a written prospectus bars claims based on contradictory oral misstatements. In California, the following cases hold that a prospectus does not constitute constructive knowledge for common law fraud, 10(b)-5, and 12(2) actions, but does constitute inquiry notice for the purpose of determining the statute of limitations. New

York, however, applies the "Prospectus Rule" for fraud, 10(b)-5, and 12(2) actions, which holds that a written prospectus bars most claims against conflicting oral misstatements (the prospectus controls). In other words, if you apply New York law to the above problem, your client is probably out of luck with regard to a 10(b)-5 fraud claim, and you will have to look for some other argument (e.g., breach of fiduciary duty, state securities violations). Several New York cases are also discussed below.

Clearly, in the case of our hypothetical, the entire claim may be won or lost based on what law you are permitted to apply in arbitration. The brokerage industry, of course, has been well aware of the importance of applying New York law for years because it favors them in many areas. In the early 1990s, many brokerage firms attempted to contract out of punitive and other damages through the use of choice-of-law provisions that specified New York law. Under then existing New York law, punitive damages and attorneys' fees could not be awarded in arbitrations, and the statute of limitations was more restrictive than under SRO rules. In response, the NASD issued Notice to Members 95-16 and 95-85 outlawing such practices unless there is an adequate nexus between the law chosen and the transaction or parties at issue. The NASD stated:

> Where the governing law clause is used to limit an award, it violates Section 21(f) of the NASD Rules of Fair Practice. … Similar compliance problems are raised by provisions that attempt to limit the courts before whom awards may be confirmed or limit the role of arbitrators. Indeed, the use of a governing law clause or other clause anywhere within a customer agreement that thwarts any NASD arbitration provision will be deemed violative. … NASD staff, District Business Conduct Committee, and arbitration panels will view provisions in such agreements that can be construed as limiting the ability of customers to file claims or of arbitrators to issue awards as being inconsistent with NASD Rules. NASD Notice to Members 95-16, ¶ 6-7.

Under the NASD rules, in order to prevail in our hypothetical 10(b)-5 fraud claim, the plaintiff's attorney will have to successfully argue that California law, or some other friendly law, applies because of an adequate nexus between the client and the law.

II. CALIFORNIA AUTHORITIES

A. *Luksch v. Latham*, 675 F. Supp. 1198 (N.D. Cal. 1987)

In *Luksch*, plaintiffs made several investments in limited partnerships formed to engage in oil and gas drilling. Plaintiffs alleged that they had been convinced of the soundness of their investment by defendant Capital Analysts, Inc., a broker-dealer and investment advisor who also acted as the underwriter for the partnerships' offerings. After the limited partnerships were discovered to be a shell corporation allegedly used by defendant Latham for his personal benefit, and after the limited partnerships lost most, if not all, of their value, plaintiffs brought a variety of claims in federal court, including federal securities fraud, violations of state corporations statutes, common-law fraud, negligent misrepresentation, and professional malpractice. Defendant Latham moved for summary judgment claiming that plaintiffs, as a matter of law, were on constructive or inquiry notice of their claims upon receipt of offering materials that directly contradicted the oral representations made by the broker-dealer. Defendant Latham essentially urged the court to adopt a rule of law that knowledge of the contents of such materials must automatically be imputed to investors who receive them, without any factual inquiry into what those investors actually knew or should have discovered in the exercise of reasonable diligence. However, the court held that the mere receipt of a prospectus containing information that contradicts material oral representations does not put investors on constructive notice of section

10(b) and rule 10(b)-5 claims as a matter of law.

The court stated the following, which can be applied directly to an arbitration statement of claim regarding similar actions:

> For all of these reasons, the Court believes that the Ninth Circuit is highly unlikely to adopt the far-reaching concept of constructive notice urged by defendant. The foregoing is not to say, of course, that knowledge of a prospectus should never be imputed to an investor for the purposes of the statute of limitations. *Id.* at 1203.
>
> Accordingly, the Court holds that mere receipt of a prospectus containing information that contradicts material representations made orally to investors, standing alone, does not put such investors on constructive notice of section 10(b) and rule 10b-5 claims as a matter of law. Capital's motion for partial summary judgment on these claims is therefore denied as to all five alleged misrepresentations. *Id.* at 1204.

The court made it clear that the receipt of a prospectus does not constitute constructive knowledge, and does not therefore start the clock for the statute of limitations regarding a securities fraud claim under Rule 10(b)-5. The court, however, also strongly emphasized that it is important for the trier of fact to review all evidence in such situations, pointing the way toward allowing such fraud claims to be heard when oral statements contradict a written prospectus, rather than barring them at the outset through summary judgment. This by no way indicates that such claims will prevail in court, but rather indicates that they should get their day in court, which contrasts heavily with New York's solution of simply barring such claims through summary judgment (discussed below).

B. *Acebey v. Shearson Lehman Brothers, Inc.*, 1993 U.S. Dist. LEXIS 19659 (C.D. Cal. June 4, 1993)

In *Acebey*, plaintiffs invested in several limited partnerships as a private offering through broker-dealer Shearson Lehman Brothers, Inc. The limited partnerships, which were promoted as a low risk investment for conservative investors, owned and managed rental apartments in Dade County, Florida. Unfortunately, the limited partnerships suffered serious losses when the Dade County condominium market became over saturated and Hurricane Andrew hit Miami. The investors brought suit for fraud, breach of fiduciary duty, and RICO violations, claiming, among other things, that the broker-dealer's oral statement that the investment was low risk constituted fraud. Defendants responded with a motion to dismiss, and argued that plaintiffs received a prospectus that contradicted the oral statements. Defendants further argued that such a prospectus constituted constructive notice of the inconsistencies, and therefore commenced the running of the statute of limitations. Plaintiffs had signed a document stating that they had read and understood the prospectus, and later claimed to have relied on the prospectus in their statement of claim. The court held that plaintiffs' claims were indeed barred by the statute of limitations, because they received and read the prospectus, and dismissed the case with prejudice.

The court discussed *Luksch* (the previous case above) in detail and distinguished between the concepts of inquiry notice for statute of limitations claims and constructive notice as a matter of law. The court noted the following:

> Luksch has a more limited holding than plaintiffs believe. The case rejected the argument that mere receipt of a prospectus containing information that contradicts material representations made orally to investors, standing alone, put

> investors on constructive notice of their securities fraud claims as a matter of law. … It did not hold that inquiry notice could never be imputed as a matter of law from the receipt of a prospectus that contradicted other representations made to investor-plaintiffs. Essentially, the case required proof that each investor charged with constructive notice of his claims had read the prospectus and appreciated the importance of the fact that the prospectus contradicted other representations that defendants had made. *Id.* at 37.

The court again concerned itself with constructive notice from a statute of limitations perspective, and shed light on the *Luksch* case. The court interpreted *Luksch* as standing for the proposition that a plaintiff must have read the prospectus, and understood that it contradicted the broker's oral statements, before he or she is on constructive notice as a matter of law of a securities fraud claim.

Applying the holding in *Acebey* to our hypothetical fraud claim, it seems appropriate that the statute of limitations did not begin to run when our client received the prospectus, because—unless our client read and understood it—he or she was not on constructive notice that the statements by the broker were fraudulent. Moreover, both *Luksch* and *Acebey* can be interpreted as suggesting that a prospectus cannot be used to defeat a claim on summary judgment, and that a trial on the merits is warranted. Perhaps ironically, another rule we can take away from these two cases is that the less you read and understand the prospectus, the better your chances of bringing a claim in court.

When applying these two cases to securities arbitration, it appears safe to make a good-faith argument that, because the prospectus does not constitute constructive notice of its contents, the broker's contrary statement should not be barred by the prospectus. Further, because there does not appear to be any California case law holding that the prospectus must control when there are conflicting oral misstatements, or that the claim is barred through summary judgment, the oral misstatements should be enough for a fraud claim to proceed to a hearing.

C. *Casella v. Webb*, 883 F.2d 805 (9th Cir. 1989)

In *Casella*, plaintiffs invested in several limited partnerships based on their investment advisor's incorrect statements that the partnerships were an approved tax shelter, and that they were a "sure thing" when it came to profitability. Unfortunately, the IRS did not agree with the investment advisor regarding his tax shelter scheme, and, moreover, the partnerships lost a substantial amount of money over time. Plaintiffs brought an action that alleged violations of section 12(2) of the Securities Act of 1933 and common law fraud. Defendant successfully moved to dismiss the claim because, among other reasons, plaintiffs had received a prospectus disclosing the risks of the partnerships. The summary judgment was reversed. The appellate court held that defendant's statements were actionable misrepresentations, and defendant's statutory liability under section 12(2) was neither dependent upon a causal connection between the alleged misrepresentations and plaintiffs' damages, nor barred by plaintiffs' constructive knowledge of their investment risks. The court held that constructive knowledge cannot bar a purchaser's recovery under section 12(2). The court stated:

> It was also error to grant summary judgment against the Casellas on the ground they had constructive notice the alleged misrepresentations were not true. The Offering Memorandum Chalmers provided to the Casellas stated Hondo House limited partnership interests were a risky investment, the IRS had not approved and would probably challenge some of the deductions, and buyers

> should not rely on oral descriptions of the security. The Casellas asserted they relied upon Chalmers' contrary oral representations and did not read the Offering Memorandum or have actual knowledge of its contents. The district court held the Casellas "are presumed to know the information contained in the Offering Memorandum and cannot rely on oral statements to the contrary."

Constructive knowledge cannot bar a purchaser's recovery under section 12(2). Section 12(2) on its face treats the state of mind of sellers and purchasers differently in this respect. Sellers are charged with constructive knowledge under section 12(2), but purchasers are not. Sellers may defeat recovery only by proving they did not know "and in the exercise of reasonable care could not have known" of the untruth or omission; purchasers may recover unless they have actual knowledge of the untruth or omission. Sellers may be liable for misrepresentations they did not know were false if they should have known it; purchasers need only establish they did not know the statements were untrue. "Constructive knowledge, which plaintiff might have acquired by exercising ordinary care, will not preclude him from recovery. . . . Contributory negligence has been rejected as a defense under § 12(2)." 3 A. Bromberg & L. Lowenfels, Securities Fraud and Commodities Fraud § 8.4(317), at 204.14-204.15 (1986). " A plaintiff under § 12(2) is not required to prove due diligence. All that is required is ignorance of the untruth or omission." Sanders v. John Nuveen & Co., 619 F.2d 1222, 1229 (7th Cir. 1980) (citation omitted); accord Alton Box Bd. Co. v. Goldman, Sachs & Co., 560 F.2d 916, 919 n. 3 (8th Cir. 1977); Hill York Corp v. American Int'l Franchises, Inc., 448 F.2d 680, 696 (5th Cir. 1971); cf. Gilbert v. Nixon, 429 F.2d 348, 356 (10th Cir. 1970). Id. at 808.

A few years after this case was published, the U.S. Supreme Court held that section 12(2) is limited to the public offering process. See Gustafson v. Alloyd Co., 513 U.S. 561 (1995). Gustafson held that federal securities liability in private offerings is to be governed strictly by Rule 10(b)-5, which imposes a scienter standard, rather than a due diligence standard. Beyond this, however, Gustafson is unclear and does not explain what constitutes a public offering (e.g., whether a Rule 505, Regulation D offering is public or private), which has created splits among the district courts. None the less, it appears that Casella can be applied to securities arbitrations, because cases brought in the arbitration forum typically focus on misstatements made by a broker, rather than whether an offering is public or private.

Interestingly enough, the court in *Casella* skipped the question of whether the prospectus constituted constructive knowledge, and instead held that *any* form of constructive knowledge does not bar a plaintiff's claim under section 12(2). The holding in *Casella* clearly moots the question of whether the client received a prospectus that contradicted the investment advisor's misstatements. The court in *Casella* also applied the due diligence standard to brokers and investment advisors, and disregarded whether the client knew or should have known that the investment advisor's statement was false (the reliance argument under the scienter standard). In short, under *Casella*, a broker or investment manager's misstatement is actionable, pursuant to section 12(2), regardless of whether there was a written prospectus to the contrary.

Moreover, it is important to note that many statements of claim brought in arbitration include a claim under a particular state's blue sky laws. Most anti-fraud provisions under state securities law are patterned after section 12(2) of the Securities Act of 1933, and not section 10(b) of the Securities Exchange Act of 1934. Because of this, the holding in *Casella* can arguably be applied to claims brought in arbitration that allege a violation of state securities laws.

D. *Calvi v. Prudential Securities, Inc.*, 861 F. Supp. 69 (C.D. Cal. 1994)

In *Calvi*, plaintiff was an unsophisticated widow who decided to invest the proceeds of her husband's life insurance policy at Prudential Securities. She alleged that her broker induced her to purchase three securities that were not suitable in light of her stated investment objectives and financial goals by telling her the investments were "safe," and that the broker "would not allow her to get into anything risky." When the investments went bad, plaintiff brought an action for unsuitability and breach of fiduciary duty, alleging that the broker fraudulently failed to disclose material facts. Rather than argue the unsuitability claim, defendant filed a motion for summary judgment based on the statute of limitations. Defendant argued that, in the exercise of reasonable diligence, plaintiff should have discovered all of the facts necessary to bring a claim when she received a prospectus and signed the subscription agreement. Defendant further argued that plaintiff should have known that the oral representations made by the broker were untrue inasmuch as they conflicted with the written prospectus. The court dismissed the claim as being barred by the statute of limitations, and stated the following:

> Inasmuch as plaintiff was provided with documents detailing the risks involved in each of the investments she purchased -- and in fact signed forms stating that she had read the material given to her -- and because the warnings in these documents directly conflicted with her broker's alleged representations, plaintiff was on inquiry notice of her claims in 1985. Whether or not she had been financially damaged at that time is irrelevant -- she could have brought an action for rescission. Plaintiff did not file the instant action until 1993, eight years after she purchased the investments at issue. Therefore, both of Calvi's claims -- for negligence and breach of fiduciary duty -- are barred by the statute of limitations. *Id.* at 13.

Despite the claim having been dismissed, the court suggested that plaintiff could have sued for rescission had her action not been tolled by the statute of limitations. The court apparently suggested rescission, rather than negligence, because the client had not yet been financially damaged when she received her prospectus. On its face, *Calvi* stands for the proposition that a client is on inquiry notice when he or she receives a contrary prospectus. However, *Calvi* also suggests that, absent a problem with the statute of limitations, a claim against a broker for unsuitability and breach of fiduciary duty, based on a broker's oral misstatement, should go forward even if there is a prospectus to the contrary.

E. *In re Archer Communications Securities Litigation*, 1992 U.S. Dist. LEXIS 22636 (N.D. Cal. Oct. 29, 1992)[1]

In *Archer*, plaintiffs filed a 10(b) fraud action to recover their investment losses, which occurred when Archer Communications' common stock lost a substantial portion of its value in a short period of time. In their motion for summary judgment, defendants argued that the statute of limitations had run for all 10(b) fraud claims, because plaintiff-investors were on inquiry notice as a consequence of volatile changes in the price of Archer stock, as well as negative information in press reports published in magazines, newspapers, financial analysts' reports, and SEC filings. The motion was denied because constructive notice of the information in such reports may not be imputed to investors as a matter of law. Specifically, the court stated:

> Plaintiffs were not required, as a matter of law, to subscribe to or otherwise obtain

[1] Interestingly, *Archer* was not cited by the California court in *Calv*i (previous case), which dealt with similar statute of limitations issues.

> and review the various press reports, financial analysts' reports, SEC filings, and other materials on which defendants' motion is based. Constructive notice of information in such reports and filings may not be imputed to plaintiffs as a matter of law. … What investors would have inferred had they reviewed those materials presents a question of fact that generally may not be determined as a matter of law on defendants' motion for summary judgment. *Id.* at 3.

While the issue in this case is slightly different from our hypothetical, it suggests that no amount of third-party documentation will save a broker from having his or her fraudulent representations tried before the finder of fact because constructive notice will not be made as a matter of law to bar such claims. Such claims survive summary judgment and progress to trial. When combined with the rest of our California case law, a clear picture begins to emerge: If a broker makes an oral misstatement, the resulting claim of fraud should not be barred, regardless of whether contrary information exists either in the form of a written prospectus or any other supporting documentation available to the investor. Of course, surviving a summary judgment or motion to dismiss is just a first step, and the investor must still convince the finder of fact as to the merits of the case. But at least the investor is likely to get his or her day in court, which contrasts sharply with New York case law.

III. NEW YORK AUTHORITIES

A. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2nd Cir. 1993)

In *Brown*, approximately 40 unsophisticated, income-oriented investors purchased interests in limited partnerships referred to as the Hutton/Indian Wells 1983 Energy Income Fund, Ltd. According to the prospectus, the fund was designed to buy and operate oil wells, and provide regular payments to investors from the sale of oil and gas. When the partnerships proved worthless, the investors sued brokerage house E.F. Hutton under section 10(b) of the Securities Exchange Act of 1934. Plaintiffs claimed that the investments were unsuitable, and that they relied on their broker's oral statements that the partnerships were low-risk or no-risk investments. The district court granted summary judgment for defendants. The appellate court affirmed, holding that the information available in the prospectus accurately reflected the suitability of the investment, and therefore the investors' reliance on the broker's oral misrepresentation was reckless and unjustifiable. The court stated the following:

> We find that the Limited Partners' reliance on the oral statements presumptively made by Hutton as to the low risk, conservative character of the investment is not justified as a matter of law and that the alleged oral statements are contradicted by the offering materials sent to the Limited Partners. … An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth. *Royal American Managers, Inc. v. IRC Holding Corp.,* 885 F.2d 1011, 1015-16 (2d Cir. 1989). … The dominant considerations here, however, are that the Hutton brokers forwarded the offering materials to the Limited Partners; that the offering materials detailed the investment characteristics bearing upon suitability; that they did so in comprehensive and understandable language; and that the ***offering materials thereby contradicted the brokers' alleged general assurances.*** *Id.* at 1031-32 (emphasis added).

The court then cited several authorities in support of their decision, both from New York and from other circuits. The New York authorities include: *Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 334 (S.D.N.Y. 1993) (reliance on tax opinion unreasonable when opinion contradicted by more detailed disclosure in private placement memorandum); *Brown v. E.F. Hutton Group, Inc.*, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990) (statements in sales brochure directly refuted by offering memorandum cannot form basis of federal securities law claim, because "any reasonable investor knows to be somewhat wary of a selling agent's oral representations and to check them against the written materials."); *Marlow v. Gold,* 1991 WL 107268, at *9 (S.D.N.Y. June 13, 1991) (investor recklessly disregarded written warnings in reliance on oral assurances from accountant); *Treacy v. Simmons,* 1991 WL 67474, at *6 (S.D.N.Y. Apr. 23, 1991) (investor's failure to read risks disclosed in prospectus and reliance on broker's oral statements unreasonable).

In *Brown*, the court did not actually say that *all* claims for oral misrepresentation are barred by a contrary written prospectus. In fact, the court points out in a footnote:

> However, we agree with the Limited Partners that … information or representations outside of the Prospectus may be material and justify reliance. As stated by the Tenth Circuit in Zobrist, "we do not imply that the defendants can disclaim responsibility for their misrepresentations simply by disclosing the risks in the memorandum and therein warning investors not to rely on representations not contained within the memorandum." *708 F.2d at 1518.*

However, the pragmatic effect of *Brown* and the other New York cases has been to bar claims through summary judgment when an oral misrepresentation is contradicted by a written prospectus that properly discloses the risks of the investment. The *Brown* court justifies this stance by rationalizing that a plaintiff bringing an action pursuant to section 10(b) fraud claim could not have reasonably relied on oral misrepresentations when a written prospectus disclosed the full risks of the investment.

The court declines to say just how egregious an oral misstatement has to be in order for the case to survive summary judgment, or when it is OK for an investor to rely on his or her broker's statements. New York case law overwhelmingly denies an investor a remedy in such situations. Cases from several other circuits appear to follow New York regarding the prospectus rule. *See e.g. Kennedy v. Josephthal & Co.,* 814 F.2d 798, 804 (1st Cir. 1987); *Myers v. Finkle,* 950 F.2d 165, 167 (4th Cir. 1991); *Molecular Technology Corp. v. Valentine,* 925 F.2d 910, 918 (6th Cir. 1991); *Davidson v. Wilson,* 973 F.2d 1391, 1400 (8th Cir. 1992); *Zobrist v. Coal-X, Inc.,* 708 F.2d 1511, 1516 (10th Cir. 1983); *Bruschi v. Black*, 876 F.2d 1526, 1529 (11th Cir. 1989).

B. *Yang v. Morgan Stanley Dean Witter*, 724 N.Y.S.2d 149 (N.Y. App. Div. 2001)[2]

The state courts in New York appear to have latched onto the holding in *Brown*, applying the prospectus rule with even more force and less apology than the federal courts. In *Yang*, the investors purchased limited partnerships from Morgan Stanley that engaged in the trading of futures and options contracts. The investors brought suit after the partnerships lost money, claiming they were conservative investors and that Morgan Stanley's broker orally misrepresented the suitability of the investment. The court held that plaintiffs' actions for fraud and negligent misrepresentation were barred by the prospectus, which stated that the investments were high risk and speculative in nature. In a fairly short opinion, the court stated:

[2] Please note that this action was filed in state court, rather than federal court. It has been included because this is a recent case that cites *Brown* (previous case), and because this opinion is typical of New York's position regarding an oral statement versus a written prospectus.

> To the extent the named plaintiffs have alleged with particularity that any broker made such misrepresentations to them, their causes of action for fraud and negligent misrepresentation are barred by the prospectuses for the limited partnerships, which prominently disclosed in plain language that the investments in question were "speculative," involved a "high degree of risk," and should be made only with funds the investor could afford to lose entirely. ***Such disclosures in the written offering materials rendered any reliance on alleged contradictory oral representations unjustifiable as a matter of law (see, e.g., Brown v E.F. Hutton Group, 991 F2d 1020, 1032-1033 …).*** *Id.* at 150 (emphasis added).

These holdings reflect New York and the Second Circuit's apparent unwillingness to consider oral misstatements in the face of a contrary prospectus, especially when unsuitability or fraud is at issue.

Turning our attention back to our hypothetical hedge fund investor, who trusted his broker's statement that only 5% of the fund's assets would be held in any one stock, it appears fairly certain that New York would bar the claim at its outset. Like *Brown*, the New York court would likely hold that it was unreasonable for our investor/client to rely on his broker's assertion when he could have, and should have, simply read the prospectus himself (all 20 plus pages). In other words, the client cannot reasonably rely on the broker's oral misstatements and the 10(b) fraud action fails if it is found unreasonable to ignore the prospectus. Our client is out of luck unless he can establish that some other law applies. This brings us to the question of how such claims progress and survive in arbitration, which—of course—is considerably different than litigation in federal or state court.

IV. REVISITING RED COAT[3]

Red Coat Capital Management ("RCCM") was a Delaware limited partnership, which operated four different variations of hedge funds between its creation in 1997 and its dramatic collapse in 2002. RCCM's last hedge fund was called Red Coat Capital Partners III L.P. ("Red Coat"), which was approved and marketed by CIBC Oppenheimer ("CIBC") to several of their customers through CIBC's Los Angeles office. Typically, hedge funds like Red Coat are largely unregulated securities that use a variety of investment strategies including short selling, leverage, and options to enhance portfolio returns. The following redacted case, which was arbitrated before the NASD, involves a claim similar to our hypothetical client's hedge fund problem. Our unfortunate story begins with CIBC in the year 2000, continues with Jonathan Smith's investment of $250,000 in Red Coat in 2001, and ends with the arbitration panel's decision in early 2005.

In 2000, CIBC offered hedge funds to its customers through its Alternative Investment Group (AIG), which was run by James Archer. Prior to CIBC offering any funds to its investors, it represented to its customers that it conducted extensive and continuing due diligence on the hedge fund and the hedge fund's managers. CIBC approved Red Coat as a hedge fund for solicitation in November 2000. Donald Black, the branch manager of CIBC's Los Angeles office, was the driving force behind having Red Coat approved. Black met with principal members of RCCM in September 2000, including CEO Richard Johnson, and shortly thereafter sent a memo dated September 7, 2000 to Archer pushing his department to approve Red Coat as a recommended hedge fund. Black told Archer that Red Coat had assured him that, if approved for sale by CIBC, Red Coat would

[3] This case has been redacted for publication. It appears here with permission of the law firm that represented the plaintiff-investors in this matter. The personal names have been changed, but the details of the case remain, for the most part, as pled in the arbitration proceedings. The author does not contend or assert that plaintiffs' allegations in this matter are true.

generate three million dollars in commissions for CIBC in the new year alone. Black also said that Red Coat had done "extremely well" in recent years. Shortly thereafter, Black gave permission for a broker under his supervision, Brad Morgan, to leave CIBC to work for RCCM as a partner soliciting customers, including CIBC customers, to invest in Red Coat. In fact, Black signed an agreement with Morgan in November 2000 stating that, as long as CIBC's Los Angeles office earned at least $1.5 million per year in commissions from RCCM in the next two years, Morgan's remaining loan balance in the amount of $105,000 with CIBC would be forgiven.

Meanwhile, in sharp contrast to Black's enthusiastic comments about Red Coat, the fund was having a miserable fourth quarter, ending the year down nearly 70%. Archer later stated in a memo that he had "serious due diligence concerns" about Red Coat, but that after sharing his discomfort with Jerry Capra, the head of CIBC's Private Client Group, Archer was assured that Red Coat would only be marketed in Los Angeles by two brokers and that, at any rate, "investors would never purchase a fund that was down as much as Red Coat was in the prior year." According to Archer, Black emphasized that this was an important relationship for the Los Angeles office, and Capra later "prevailed upon us to allow the relationship to go forward" despite Archer's strong concerns.

On November 22, 2000, CIBC circulated an inter office memorandum to its brokers announcing their new relationship with Red Coat. In this memo, CIBC encouraged brokers to get in on this "ground floor opportunity," and touted Red Coat's past performance by stating "Red Coat has generated annualized returns of 37% since inception in 1997 ... These returns have been achieved utilizing no bonds, currencies or commodities with a low net exposure and without the use of 'market direction' or 'market timing' techniques." Contrariwise, on the same day, Red Coat released a letter to its limited partners stating, "we have had a very disappointing performance this year." By the year's end, the fund was still down nearly 70%.

On November 27, 2000, Red Coat held a sales presentation for the brokers at CIBC's Los Angeles branch, including Paul Born. At this presentation, Red Coat's management team allegedly told CIBC's brokers that the fund would invest in a broad range of companies in a well-diversified portfolio. Red Coat management allegedly stated that the fund was not to have more than 5% of its assets in any one stock and that the fund implemented a 15% strict stop loss discipline to hedge market risk. CIBC brokers, including Born, allegedly repeated these representations to their clients.

By the end of 2000, knowledge of RCCM's allegedly reckless investment style and "miserable performance" was not limited to a handful of CIBC managers. Indeed, the hedge fund community was well aware of RCCM's unorthodox and aggressive style, and the likelihood that RCCM would become insolvent in the near future. On December 29, 2000, the online investment magazine TheStreet.Com ran an article titled "Red Coat is Going? Red Coat is Going?" in which it listed RCCM's current value at $100 to $125 million, down from $273 million from three months earlier. The article stated that RCCM was down because "Johnson failed to follow his own preset rules about selling stocks that have fallen by a given percentage, choosing instead to press his bets." The article also stated that RCCM was facing an exodus of "high-priced talent," a situation similar to what happened to another well-known hedge fund that became insolvent earlier in the year. The article reported that another hedge fund manager suggested Johnson might be better served to shut down RCCM and "start over again" with a new fund.

During this time, Black was allegedly pushing his brokers in CIBC's Los Angeles office to solicit customers to purchase Red Coat. According to Archer, several brokers in the Los Angeles office called Archer to ask why

Black "would push Red Coat" under the circumstances. In fact, Archer wanted to cancel the agreement with Red Coat III in early February 2001. Nevertheless, shortly thereafter, in or about April 2001, Born solicited Jonathan Smith to invest in Red Coat. Born allegedly told Smith that Red Coat had been approved by CIBC as an Approved Hedge Fund, and allegedly provided Smith other details of the fund's investment philosophy, *including the fact that the fund would not invest more than 5% of its assets in one stock and that it used a 15% stop loss discipline as a risk management tool*. Based on these representations, on May 1, 2001, Smith invested $250,000 in Red Coat. Neither Born nor anyone else at CIBC ever told Smith about RCCM's significant losses in 2000, that CIBC had serious concerns about RCCM and/or Red Coat, or that the head of CIBC's AIG department wanted to cancel the agreement.

CIBC continued to recommend Red Coat as an Approved Hedge Fund even though they allegedly performed no due diligence on this fund. Five months later, in or around early October 2001, CIBC finally cancelled its selling agreement with Red Coat. According to Archer, one of the reasons for the cancellation was Red Coat's extraordinary concentration in two positions, and Archer's "extremely uncomfortable" opinion of CIBC's relationship with Red Coat. CIBC sent notice of the cancellation to investors shortly thereafter, informing them that CIBC would no longer conduct due diligence of Red Coat. Many investors attempted to liquidate their investments. However, Red Coat investors, including Smith, were locked in and unable to liquidate their investment for a period of one year from the date of purchase based on the underlying contract. In addition, Red Coat only allowed liquidations on specific dates, which were six months apart. As a result, Smith would not be allowed to liquidate his position until June 30, 2002, approximately eight months later.

On August 20, 2001, less than two months before CIBC cancelled its selling agreement with Red Coat, Black (the branch manager of CIBC's Los Angeles office) decided to liquidate his entire position in Red Coat. Black had invested $100,000 in the fund on January 2, 2001, and was therefore subject to the same one-year lock-in requirements as other investors. However, on August 22, 2001, before the one-year period had expired, Black sent a letter to Johnson requesting a check for $100,000, stating, "I understand that this is a confidential matter and will treat it as such." Johnson allowed Black to redeem his $100,000 from Red Coat before Black's one-year term had concluded, even though no other individual investor, including Smith, was allowed this privilege. Archer later called Black's sale a "preferential" liquidation that constituted a "significant ethical breach."

By the end of 2001, before Smith was allowed to liquidate his investment because of the lock-in period, Red Coat was down over 71% for the year. At this time, contrary to Red Coat's allegedly stated rule that it would not invest more than 5% of its assets in one stock, *137% of Red Coat's assets were held in one stock on margin, E-Medsoft.com, which was a penny stock traded over the counter*. In early 2002, Red Coat refused to return their investors' money. Investors who asked CIBC for help in getting their money back were referred to an attorney in New York. In early 2002, some of the investors received a small percentage of their funds back from Red Coat. However, the bulk of what little money remained was being held by Red Coat, who refused to return it. By the time Smith sought arbitration before the NASD, he had lost $250,000, or 100% of his investment in Red Coat.

In a Hollywood ending to this story, the arbitration panel found in favor of Smith, and several other Red Coat investors, returning over $3.5 million of their money. The story was sensational enough to earn an article in the Wall Street Journal.[4] It remains unclear, however, exactly why the arbitration panel made the award. Unlike a judge, an arbitration panel is rarely required to give a reasoned written opinion, and they did not explain their award in this case. This leaves us to wonder whether the award was motivated by CIBC's allegedly blatant due diligence violations, the arbitration panel's sympathy for the staggering losses suffered by plaintiffs, or something more. Some of the facts in this case match our hypothetical investor. Smith was allegedly told by CIBC's broker that the fund would not invest more than 5% of its assets in one stock, even though the written prospectus contradicted this statement. Further, the claims filed by Smith against CIBC included fraud by misrepresentation and omission, and focused primarily on the broker's oral misrepresentations. Smith's argument included his reliance on CIBC's oral statements, as well as his resulting damages. ***Perhaps the most interesting aspect of this arbitration, however, was the fact that the arbitration panel applied California law, rather than New York law.***

All of this suggests that an arbitration panel, when applying California law, will hear a claim for oral misrepresentation on its merits, even when the oral statement is directly contradicted by a written prospectus. The written prospectus does not bar the claim. Of course, each arbitration panel is different, and legal arguments do not have as much weight before a panel of industry experts who are not trained as judges. Moreover, unlike court opinions, arbitration decisions do not create common law precedent for other arbitrators to follow. Red Coat may or may not influence arbitrators in the future. However, in order to be persuasive, a plaintiff in an arbitration proceeding must still base his or her argument in law to some degree, especially when facing a sharp defense attorney who understands the difference between California and New York law as it relates to fraud and the reasonable reliance element. In the case of our hypothetical, even in front of an arbitration panel, the battle may turn on the single question of which coast you prefer, west or east, and which law applies, California or New York.

APPENDIX A

<u>Section 10(b) of the Securities Exchange Act of 1934</u>:

Manipulative and Deceptive Devices
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

b. To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

APPENDIX B

<u>Rule 10b-5 promulgated under the Securities Exchange Act of 1934</u>:

Employment of Manipulative & Deceptive Devices
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

[4] *See* Susanne Craig, *Hedge Funds Can be Headache for Broker, as CIBC Case Shows*, The Wall Street Journal, Feb. 22, 2005.

a. To employ any device, scheme, or artifice to defraud,

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

APPENDIX C

<u>Section 12(2) of the Securities Act of 1933:</u>

Section 12 -- Civil Liabilities Arising in Connection with Prospectuses and Communications

a. In General. Any person who—

    1. offers or sells a security in violation of section 5, or

    2. offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) and (14) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

b. Loss Causation. In an action described in subsection (a)(2), if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

APPENDIX D

<u>Section 3(a)2 & 3(a)14 of the Securities Act of 1933:</u>[5]

Exempted Securities

a. Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

[5] Incorporated by reference in section 12(2).

2. Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing; or any security issued or guaranteed by any bank; or any security issued by or representing an interest in or a direct obligation of a Federal Reserve bank; or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian; or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security; or any interest or participation in a single trust fund, or in a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, (B) an annuity plan which meets the requirements for the deduction of the employer's contributions under section 404(a)(2) of such Code, or (C) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A), (B), or (C) of this paragraph (i) the contributions under which are held in a single trust fund or in a separate account maintained by an insurance company for a single employer and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust or separate account itself) issued by the employer or any company directly or indirectly controlling, controlled by, or under common control with the employer, (ii) which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code, or (iii) which is a plan funded by an annuity contract described in section 403(b) of such Code. The Commission, by rules and regulations or order, shall exempt from the provisions of section 5 of this Act any interest or participation issued in connection with a stock bonus, pension, profit-sharing, or annuity plan which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of the Internal Revenue Code of 1954, if and

to the extent that the Commission determines this to be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter. For purposes of this paragraph, a security issued or guaranteed by a bank shall not include any interest or participation any collective trust fund maintained by a bank; and the term "bank" means any national bank, or any banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as in the Investment Company Act of 1940;

14. Any security futures product that is ---

    A. cleared by a clearing agency registered under section 17A of the Securities Exchange Act of 1934 or exempt from registration under subsection (b)(7) of such section 17A; and
    B. traded on a national securities exchange or a national securities association registered pursuant to section 15A(a) of the Securities Exchange Act of 1934.

Recent Arbitration Awards

By Jason Doss

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

Ottilia Dee Baldwin, Trustee of the Ottilia Dee Baldwin Revocable Trust v. Wachovia Securities, LLC and Dennis Bielfeldt
NASD Case No. 05-02573

Claimant opened a non-discretionary trust account at Wachovia Securities and employed Wachovia's registered representative, Dennis Bielfeldt to manage the account. Because the account was non-discretionary, Mr. Bielfeldt needed to receive approval prior to executing any transaction in the account. Claimant alleged that less than two months after opening the account at Wachovia, Mr. Bielfeldt began effectuating unauthorized trades. As a result, Claimant delivered a letter through Joanna Sunderland, Claimant's co-trustee and legal guardian, to the broker instructing him to stop all trading except as necessary to fund her monthly expenses.

Despite the letter, the broker continued to engage in unauthorized transactions in the account, which allegedly caused Claimant to suffer over $500,000 in state and federal capital gains taxes. In addition, Mr. Bielfeldt reaped over $74,000 in commissions.

Claimant asserted the following causes of actions: omission of facts, breach of fiduciary duty, failure to supervise, *respondeat superior*, negligence, breach of contract, fraud and misrepresentation, NASD rules and violations of the Indiana Securities Act.

Claimant requested compensatory damages between $500,000 and $999,999, attorney's fees, disgorgement of commissions, pre-judgment and post-judgment interest and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various defenses. In addition, Respondent filed a counterclaim for indemnification against the trustees of the trust for failing to prevent the unauthorized trades from occurring.

1. The Panel found Respondents jointly and severally liable and required to pay Claimant the sum of $320,000 in compensatory damages.

2. The Panel also required Respondents to pay $4,325 in costs, including reimbursement of the non-refundable NASD fee.

3. The Panel also awarded $106,667.00 in attorney's fees

The award is significant because it led to a full recovery of both the net capital gains taxes that had to be paid due to the unauthorized liquidation of Claimant's stocks and also awarded a straight attorney fee amount of 1/3 of the award. Furthermore, the account had actually gained $232,000 while being managed by Respondents.

Claimant's Counsel – Andrew Stoltmann Esq. of Stoltmann Law Offices, P.C., Chicago, Illinois.

Respondents' Counsel – Beverly Jo Slaughter, Esq. of Wachovia Securities, LLC in Richmond, Virginia.

Bernard Andres v. PNC Brokerage Corporation n/k/a J.J.B. Hillard Lyons
NASD Case No. 03-08848

Claimant alleged that based on a recommendation from Respondent, he rolled over his holdings from his employment retirement plan into a Putnam Investments Variable Annuity, based on the assurance that this was a safe investment. Claimant alleged that the annuity was unsuitable given his investment objectives and that Respondent failed to disclose the risks of the investment.

Claimant asserted the following causes of actions: breach of contract, breach of fiduciary duty, constructive fraud, *respondeat superior*, negligence, negligent supervision, violation of the Kentucky Securities Act and violations of NASD conduct rules.

Claimant requested compensatory damages in the amount of $56,639.95 plus pre-judgment and post-judgment interest, attorney's fees, punitive damages, and costs.

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

The Panel found Respondent liable in the amount of $56,000 to Claimant in compensatory damages.

The award is significant because the Panel awarded 100% of net out of pocket damages.

Claimant's Counsel - Keith L. Griffin, Esq. of Maddox Hargett & Caruso, P.C., Fishers, Indiana.

Respondent's Counsel - Joseph S. Simms, Esq. of Ulmer & Bern LLP, Cleveland, Ohio

Robert C. Rachel v. Donna Sulzbach and Vestax Securities Corp. n/k/a Multi-Financial Securities Corp.
NASD Case No. 04-05356

Claimant alleged that Respondents mismanaged his account by investing in a variable annuity, which was wholly unsuitable for her investment objectives and risk tolerance.

Claimant asserted the following causes of action: unsuitability, negligence, failure to supervise and breach of fiduciary duty.

Claimant requested compensatory damages in the amount of $170,786.39, exemplary damages in the amount of $200,000, attorney's fees, forum fees, costs and any other relief deemed appropriate.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested that the Statement of Claim be dismissed in its entirety.

1. The Panel found Respondents jointly and severally liable and required them to pay Claimant compensatory damages in the amount of $148,562.80 plus pre-judgment interest at 7% per annum from March 2001 to the date of payment of the award.

2. The Panel also held Respondents liable jointly and severally for punitive damages in the amount of $133,700. The Panel stated that they awarded punitive damages because Respondent Sultzbach's conduct

demonstrated a conscious disregard for the rights of Claimant and Respondent's conduct had a great probability of causing substantial harm in accordance with Ohio law.

This award is significant because the Panel awarded punitive damages.

Claimant's counsel - John S. Chapman, Esq., Cleveland, Ohio

Respondents' counsel - Jonathon W. Phillips, Esq. of Janik & Dorman, LLP, Cleveland, Ohio

Delores White, individually and on behalf of the Delores White IRA v. A.G. Edwards & Sons, Inc.
Case No. 05-01300

Claimant alleged that Respondent mismanaged her account by investing in a Manulife Financial Venture variable annuity within her IRA account, which was wholly unsuitable for her investment objectives and risk tolerance.

Claimant asserted the following causes of action: elder abuse, breach of fiduciary duty, fraud, constructive fraud, intentional and negligent misrepresentation, failure to supervise, violation of federal and state securities laws, violation of California statutory and common law, and violation of NASD Rules of Fair Practice and NYSE Rules.

Claimant requested compensatory damages in the amount of at least $70,000, lost opportunity costs, disgorgement, restitution, unspecified punitive damages, pre- and post-judgment interest and costs, including attorney's fees.

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

1. The Panel held Respondent liable to Claimant for compensatory damages in the amount of $142,839.00 plus post-judgment interest at a rate of 7%.

2. The Panel also held Respondent liable for punitive damages in the amount of $100,000 for constructive fraud and breach of fiduciary duty.

3. The Panel awarded Claimant attorney's fees in the amount of $97,135.00.

This award is significant because the Panel awarded more than 100% of the net out of pocket losses and also awarded punitive damages.

Claimant's Counsel - Philip M. Aidikoff, Esq. and Orousha Brocious, Esq. of Aidikoff, Uhl & Bakhtiari, Beverly Hills, California

Respondent's Counsel – Dennis J. Capriglione, Esq., A.G. Edwards & Sons, Inc., St. Louis, Missouri

Announcements From The PIABA Office

Office Staff:

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

Karrie Ferguson, Office Assistant
kferguson@piaba.org

Tiffany Zachary, Technical 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:

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

PIABA 8th Annual Securities Law Seminar. October 25, 2006. Westin La Paloma. Tucson, Arizona.

PIABA 15th Annual Meeting, October 26 - 28, 2006. Westin La Paloma. Tucson, Arizona.

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

New Members

Matthew V. Bartle	(816) 305-6288
Scott Ira Batterman	(808) 535-8400
Jonathan D. Berg	(212) 599-0990
Hugh H. Bernstein	(305) 670-8877
Joseph H. Bocock	(405) 552-2256
Rick A. Buchwalter	(727) 450-1199
Richard Lyle Coffman	(409) 832-4767
Richard Carl Detwiler	(803)256-2371
Christopher R. Fehr	(618) 259-2222
Daniel Feinberg	(510) 839-6824
Michael A. Fleishman	(520) 325-4200
Bryan Forman	(903) 597-2221
Jon C. Furgison	(310) 356-6890
Eric Grannis	(212) 903-1025
Michael J. Harrington	(510) 593-2500
Nicholas P Iavarone	(618) 259-2222
Patrick J. Kanouff	(303) 534-9000
Sean M. Keane	(312) 759-7500
Thomas W. Kyle	(920) 261-9962
Steven J. Lownds	(214) 880-1807
Michael S. MacDonald	(651) 307-0637
Justin F. Madden	(216) 522-9000
Brian O'Mara	(619) 231-1058
John Jeffrey Pankauski	(561) 655-1556
Brad Pigott	(601) 354-2121
David C. Pishko	(336) 724-2828
Peter C. Rageas	(313) 961-8400
Kevin T. Roberts	(216) 781-6166
Timothy L. Sifers	(816) 931-2230
Gregory B. Simon	(312) 759-7500
Audwin Carey Spence	(323) 752-2949
Sean P. Thomas	(760) 720-9600
Michael R. Thomas	(415) 951-4881
Gregory L. Thorpe	(914) 576-8070
Roger W. Van Deusen	(216) 781-4000
Timothy L. Van Eman	(614) 224-8187
Katharine A. Wark	(312) 759-7500
William S. Wetterer, III	(502) 451-3030
Rachelle Kuznicki Zidar	(440) 930-8096