PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION VOL. 14 NO. 4 WINTER 2007

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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THE BAR JOURNAL OF THE PUBLIC INVESTORS ARBITRATION BAR

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

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Winter, 2007 issue of *PIABA Bar Journal* is January 31, 2008. 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. Articles shall be submitted for black and white reproduction.
8. Attachments should be a clear, quality copy suitable for reproduction.
9. Attachments requiring reprint permission should be submitted with written authorization from the prior publisher.
10. 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 Samuel Edwards at sedwards@sselaw.com.

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Upcoming Events:

Deadline for receiving submissions to the Spring 2008 Bar Journal, April 15, 2008

Deadline for receiving submissions to the Summer 2008 Bar Journal, June 15, 2008

PIABA Board of Directors Meeting, July 19-20 2008. The Ritz-Carlton Dearborn. Dearborn, Michigan.

PIABA 17th Annual Meeting. Expert, Consultant & Mediator Materials due to PIABA Office, August 1, 2008

Deadline for receiving submissions to the Fall 2008 Bar Journal, September 15, 2008

PIABA 10th Annual Securities Law Seminar, October 22, 2008. The Broadmoor. Colorado Springs, Colorado.

PIABA 17th Annual Meeting, October 23-25, 2008. The Broadmoor. Colorado Springs, Colorado.

PIABA Annual Business Meeting and Election of Directors. October 23, 2008. The Broadmoor. Colorado Springs, Colorado.

PIABA Board of Directors Meeting, October 26, 2008. The Broadmoor. Colorado Springs, Colorado

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

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President's Column

Laurence S. Schultz

Dear Members:

How in the world do these guys get away with it? Talk about a license to steal. The financial community generates scam after scam, larger and larger, and the perpetrators just keep getting richer. Now, with the sub-prime disaster, the damage is so great and widespread, the entire economy is shaken, and the government, from the Federal Reserve to the Treasury, is engaged in a bailout.

Remember when investment losses were measured in measly billions. Those were the days when Prudential and the other major firms marketed fraudulent limited partnerships. That was followed by the S&L meltdown, and again losses were only in the billions. Of course there are also the innumerable and continuing sales practice and product-related scams, highlighted by the prominent and seemingly perpetual variable annuity abuses. Then there were the B shares, the mutual fund late trading, and on and on.

But we thought we had seen the granddaddy of them all when the analyst scandal, which extended over at least a three-year period from late 1998 through 2001, surfaced as another well-planned and immensely profitable industry-wide fraud on the public. Almost every major brokerage firm joined in. Market losses numbered in the trillions. Caught red-handed thanks to incriminating e-mails, major firms paid $1.4 billion in fines, but then went on their merry way with business as usual. No one even went to jail. As Eliot Spitzer said – everyone was doing it.

So now, in truth, it's of little surprise to those of us who follow these things that we have the sub-prime mortgage disaster – another massive industry-wide scam which involves mortgage brokers, money center banks, investment bankers, brokerage houses, and others. The sub-prime fraud has put the entire country into a recession, and the fallout probably will continue for years. The losses remain uncountable and will impact not just homeowners but retirees, savers, and virtually all investors.

Once again the brokerage industry and its affiliates have victimized their customers with new and uniquely different fraudulent products, new twists, and new dimensions. Sad to say, these scams are systemic. They have become part of the modus operandi of the industry.

Larry Schultz is a graduate of the University of Michigan Law School and has practiced in both Chicago and Detroit. He is a founding member and shareholder of the Troy, Michigan, law firm Driggers, Schultz & Herbst. He has specialized in securities law, with specific emphasis on securities litigation and arbitration, for over twenty years. He can be reached at 248-649-6000 or lssarb@aol.com.

We in PIABA have seen it before, and PIABA again is ready to respond.

We are tailoring a significant portion of the annual meeting to address the sub-prime issues – we will discuss where and how you find the victims, what lies behind the sub-prime fraud, and how you can relate the fraud to victim losses. As in the past, we will bring in some of the nation's top experts to provide support, analysis, and answers to your questions.

On a more timely basis, we are planning a pod cast to be presented over the Internet which will provide answers to your immediate questions.

You also can anticipate sub-prime-related articles in the *PIABA Bar Journal*.

The bottom line is that after several years of a rising market, the brokerage industry, responding to its insatiable greed, has again led its customers to the slaughter. And you can be absolutely certain that once this disaster has been absorbed by the American economy, and the markets recover, it will be followed by yet another industry-wide scam.

Ironically, it is in this climate of corruption that the Securities and Exchange Commission calls for further deregulation, effectively opening the gateway for the next disaster.

Those of us who witness the operation of the brokerage industry close up have long since concluded that it is corrupt. And worse yet, we repeatedly witness the tragic impact: how it damages and even destroys the lives of so many retirees, savers, and investors. The conclusion is obvious. ***We must have effective government regulation and enforcement.*** The brokerage industry cannot be allowed to just write checks and walk away. The people who run these businesses have to be made to hurt. Penalties must be stiffened. Top people must go to jail. There must be effective punishment. There must be meaningful deterrence.

Ben Stein, a prominent business writer and economist, well-stated his frustration over the sub-prime debacle in the *New York Times* on February 10, 2008, when he wrote:

> Is anyone ever going to wake up to the fact that there is a lot of larceny in the human heart and that there are a lot of sheep waiting to be shorn and that regulation is not a bad thing? Or will we just lurch from massive meltdown to massive theft and on and on. Is anyone ever going to get it? Anyone? Anyone?

We assure Mr. Stein that PIABA gets it. And, while we can't stop the next meltdown, you can be sure that we will react to it on behalf of investors who are among the primary victims.

Laurence S. Schultz, President

Enforcement Actions Against Hedge Funds

Ralph S. Janvey

Mr. Janvey is a Partner with Krage & Janvey, L.L.P. in Dallas, Texas and is Special Counsel to Gordon, Herlands, Randolph & Cox, L.L.P. in New York, New York. Mr. Janvey has served as a consultant to Patton Boggs LLP on securities issues, including hedge funds, 1940 Act, and commodity matters. Prior to joining Krage & Janvey, L.L.P. in 1980, Mr. Janvey served as a Staff Attorney and, eventually, the Assistant Director of Securities for the United States Comptroller of the Currency in Washington, D.C. Mr. Janvey can be contacted at rjanvey@kjllp.com.

I. Hedge Fund SEC Enforcement Actions

Although hedge funds are not registered under the Investment Company Act of 1940, they and their advisers (regardless of whether the investment advisers are registered under the Investment Advisers Act) are subject to the antifraud provisions of the federal securities laws. In recent years, the SEC has instituted a number of actions alleging hedge fund fraud pursuant to such provisions. In most cases, the SEC institutes enforcement actions against the hedge fund adviser and/or the adviser's principals.

The SEC has brought cases in which it asserted that hedge fund advisers defrauded hedge fund investors or used the funds to defraud others in amounts that the SEC staff estimates to exceed $1 billion. The SEC's enforcement actions have focused on allegations giving rise to securities law violations: (1) false and misleading statements regarding the fund's performance or risk; (2) misappropriation of investors' funds; (3) general advertising or solicitation; (4) fraudulent valuation; (5) style drift; (6) insider trading; and (7) market timing and late trading.

This paper discusses cases brought against hedge funds both by the SEC and private litigants.

(1) False and Misleading Statements

The greatest number of enforcement actions involve fraud resulting from false and misleading statements about the fund's performance, risk profile, or the performance of the investment adviser to the fund. In *SEC v. Platinum Investment Corp., et al.* (Litigation Rel. No. 17679 [August 14, 2002]), the SEC brought securities fraud charges against a registered broker-dealer and its principals for making material misrepresentation in the unregistered stock offerings, one of which was a purported hedge fund. The SEC alleged that the principals of Platinum Investment Corporation made false and misleading statements portraying New Focus Capital Partners as a domestic hedge fund with a successful track record and, as a result, raised over $1.5 million from at least 56 investors.

The SEC has also brought securities fraud charges against a hedge fund and its principals for making false and misleading statements in offering materials and on the hedge fund's website. In *SEC v. House Asset Mgmt., L.L.C.* (Litigation Rel. No. 17583 [June 24, 2002]), the SEC alleged that the defendants solicited potential investors to invest their retirement savings in the hedge fund, House Edge, L.P., by making material misrepresentations about the fund's return.

The complaint alleged that the defendants told investors that the hedge fund had generated cumulative returns of 148% since its inception by engaging in a sophisticated securities trading strategy, when in fact the fund had suffered losses of more than $850,000 since its inception. The defendants raised approximately $2.9 million from at least 60 investors. The complaint further alleged that the defendants made false and misleading statements about the principals' investment experience and background and did not disclose that one of the principals was terminated as a registered representative for unauthorized sales of hedge fund shares and was barred by the NASD. The SEC also alleged that the principals borrowed approximately $425,000 from the fund to purchase personal residences. The SEC obtained an order of permanent injunction from the U.S. District Court for the Central District of Illinois enjoining the defendants from violating the antifraud provisions of the securities laws and freezing the assets of the defendants pending the court's determination of disgorgement and civil penalties.

In addition to making misstatements in solicitation and offering materials, many private funds have been subject to SEC enforcement actions for making false and misleading statements in continuing communications to shareholders. In *Edward Thomas Jung and E. Thomas Jung Partners, Ltd.* (Exchange Act Rel. No. 45669 [March 28, 2002]; *see also SEC v. Jung, et al.,* Litigation Rel. No. 17417 [March 15, 2002]; *SEC v. Jung, et al.,* Litigation Rel. No. 17041 [June 20, 2001]), the SEC filed a civil complaint in the U.S. District Court for the Northern District of Illinois against the manager of a private, unregistered hedge fund for fraudulent statements made both in offering materials and also in quarterly account statements sent to investors in the fund. The SEC's complaint alleged that between 1994 and 1998, the fund and its manager were responsible for issuing a series of false performance reports that materially overstated the fund's and the manager's prior trading record and falsely stated that investor assets would be used solely to conduct the fund's business and to collateralize trading on behalf of the fund. The complaint alleged that the manager placed the fund's assets in its own account and used them to collateralize the principal's own personal margin trading, which resulted in a loss of more than $21 million. To conceal this loss, the manager sent false quarterly account statements to the fund's investors that materially overstated the current value of their investment.

In *SEC v. Jean Baptiste Jean Pierre, et al.* (Litigation Rel. No. 17303, January 10, 2002), the SEC brought suit against two brokers and a college professor in connection with the fraudulent offering of limited partnership interests in JB Stanley, a hedge fund. The complaint charged the defendants with making false and misleading statements, both orally and in the fund's offering materials, concerning the investment strategy of the fund, the fund's business history and prospects, and one of the broker's past performance. The complaint also alleged that most of the offering proceeds were misappropriated to pay for the brokers' personal expenses. In order to induce investors to maintain their investments in the fund, the defendants also distributed false account statements that materially misrepresented the fund's performance. The charges brought by the SEC included violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Sections 206(1) and 206(2) of the Advisers Act.

The SEC has also brought actions against investment advisers to hedge funds for their role in providing misleading performance reports to investors. In *Charles K. Seavey* (Admin. Proc. No. 3-10336, February 10, 2002), the SEC found that Morgan Fuller Capital Management and its employee, Charles Seavey, violated Section 206 of the Adviser Act by making material misstatements and omissions in letters and performance reports sent to investors in Paradigm Capital Fund, a hedge fund,

regarding the stock of a Lithuanian bank. The performance report reflected the fund's investment in the bank's stock despite the fact that the purchase transaction had never settled and the fund did not, in fact, own the shares. The inclusion of the bank stock in the performance report caused the fund's performance to appear much more favorable than it actually was. The SEC imposed a censure, suspension, and cease-and-desist order on Seavey for his role in preparing and distributing the performance report, as well as a $10,000 fine.

In *SEC v. Hoover and Hoover Capital Management, Inc.* (Litigation Rel. No. 17666, August 8, 2002), the SEC filed a securities fraud complaint in the U.S. District Court for the District of Massachusetts alleging that Stevin Hoover, a registered investment adviser, solicited and obtained investments in the Chestnut Fund, L.P., a domestic hedge fund, by making fraudulent misrepresentations to prospective investors, both orally and in writing in the fund's private placement memorandum. The SEC further alleged that, during an 18-month period after establishing the fund, Hoover misappropriated more than $625,000, used these funds for personal and business expenses, and concealed the misappropriation by distributing fictitious account statements to investors. Hoover pled guilty to one count of securities fraud.

In *Michael Smirlock* (Litigation Rel. No. 17630, July 24, 2002), the SEC brought civil charges against a registered investment adviser for falsely increasing the value of an investment portfolio he managed for three hedge funds in order to induce additional investors to invest. The complaint alleged, among other things, that, between December 1997 and June 1998, the adviser engaged in securities fraud by inflating the values reported for thinly traded securities. The adviser settled the SEC's action by agreeing to the entry of a final judgment that permanently enjoined him from further violations of the securities laws and permanently barred him from association with an investment adviser. In a criminal case filed concurrently with the SEC's civil action, the adviser pled guilty to two counts of securities fraud and was sentenced to four years in prison and ordered to pay $12.6 million in restitution. *See United States v. Smirlock*, Litigation Rel. No. 17536 (May 28, 2002).

(2) Misappropriation of Investor's Funds

A number of actions have been brought by the SEC against private funds and, more frequently, against the individuals operating such funds, for misappropriation of investors' assets. The SEC generally takes the view that any investor funds used in a manner inconsistent with that disclosed in the offering material can be deemed misappropriated for the purposes of the antifraud provisions of federal securities laws.

In *SEC v. Chabot, et al.* (Litigation Rel. No. 17276, December 17, 2001), the SEC brought securities fraud charges against Sirens Synergy, an offshore hedge fund, and Peter Chabot, its manager, alleging that Chabot misappropriated more than $1.2 million in investor funds. The complaint alleged that Chabot, individually and through his broker-dealer and adviser entities, raised over $1.2 million from approximately 14 investors by making false and misleading statements concerning the fund's investment strategy. Specifically, Chabot claimed that he was an experienced trader who had developed a mathematical model to predict when to buy stocks and whether to take long or short positions. According to the complaint, Chabot never bought securities with the investors' funds, but instead used those assets to purchase consumer goods and services, including computers, clothes, travel, tickets to prestigious sporting events, furniture, oriental rugs, and jewelry. In addition, the complaint alleged that Chabot made over 130 ATM withdrawals totaling $60,000 from a bank account that contained investor funds. The SEC obtained a preliminary injunction enjoining Chabot and his entities from further violations of the

securities laws and freezing their assets pending resolution of the litigation.

Misappropriation of investor funds for uses other than personal expenses has also been a focus of the SEC. In *SEC v. House Asset Management, L.L.C., et al.* (Litigation Rel. No. 17583, June 24, 2002), the SEC alleged that the defendants misappropriated investor funds, in part, because they borrowed funds from the hedge fund to purchase an office building for the fund's adviser. Similarly, in *SEC v. Hoover, et al.* (Litigation Rel. No. 17666, August 8, 2002), the SEC charged that the investment adviser of a hedge fund misappropriated fund assets to pay, among other things, office rent and repayments to former clients who were victims of an earlier securities fraud scheme.

The SEC has also alleged misappropriation in instances where a fund's manager has failed to invest in a manner consistent with that described in the offering materials. In *Brian Prendergast* (Exchange Act Rel. No. 44632, August 1, 2001), the SEC upheld disciplinary actions taken by the NASD against a hedge fund manager for, among other things, misappropriating investor funds. The fund's private placement memorandum described an investment allocation of 60% in S&P stock index futures and 40% in load and no-load mutual funds. Instead of following this allocation, the SEC charged that the manager began investing in vehicles other than those identified in the private placement memorandum, including Chicago Board of Trade Treasury Bond futures and foreign currency options. No mutual fund shares were ever purchased. The NASD censured the manager and barred him from association with any NASD member in any capacity.

A number of the misappropriation actions brought by the SEC involve a Ponzi scheme disguised as a hedge or other private fund. For example, the SEC brought a civil action against Paramount Financial Partners, L.P., a hedge fund, and its principals for securities fraud in connection with the offering of partnership interests. (*SEC v. Cummings, et al.,* Litigation Rel. No. 17598, July 3, 2002). The complaint alleged that, from May 2000 through March 2001, the defendants raised over $15 million from investors by portraying Paramount as a registered hedge fund that generated returns of as much as 99%. The defendants told investors that Paramount had access to certain discounted securities that it could purchase and re-sell at a substantial profit. The defendants also told investors that they were required to maintain their principal and interest with Paramount for a set period of time. The complaint alleged that investor proceeds were not used to buy securities, but rather were used to pay earlier investors and to pay personal and business expenses. The SEC obtained a preliminary injunction enjoining Paramount and its principals from selling securities or accepting additional funds from investors. The injunction also enjoined the defendants from committing further securities law violations and directed that they provide sworn accountings to the SEC to account for investor funds.

In *SEC v. Vestron Financial Corp., et al.* (Litigation Rel. No. 17200, October 22, 2002), the SEC brought a civil complaint against the operators of two hedge funds alleging that the defendants misappropriated more than $2 million of investor funds and engaged in a Ponzi scheme by paying off earlier investors with new investor proceeds. The complaint alleged that the defendants raised more than $11.6 million from over 350 investors by promising high returns from stocks and commodities trading in both a U.S. and an offshore hedge fund. The SEC charged that, of that $11.6 million, only 14% was used for actual trading. The funds' operators used the remaining investor funds to purchase condominiums, boats, cars, and other personal items. In addition, the SEC alleged that the defendants were conducting a Ponzi scheme whereby investors who chose to receive their purported monthly gains in cash were paid out of new investor funds.

(3) General Advertising or Solicitation

In *Brian Prendergast* (Exchange Act Rel. No. 44632, August 1, 2001), the SEC upheld disciplinary action taken by the NASD against a hedge fund manager for, among other things, engaging in an improper general solicitation in connection with a private placement of unregistered securities. Brian Prendergast, an associated person with a former NASD member firm, managed Prism Financial, L.L.C., a hedge fund exempt from registration pursuant to Regulation D under the Securities Act. During the period hedge fund shares were being offered and sold, Prendergast placed an advertisement in a newspaper announcing a free seminar, conducted by Prism, on hedge funds. This seminar was described in a letter to current fund investors as a means to attract new investors to Prism and was, therefore, considered to be a general solicitation in violation of the restriction against such seminars and advertisements under Rule 502(c) of the Securities Act.

In *SEC v. Saxena* (Fed. Sec. L. Rpt. [CCH] ¶ 91,657 [1st Cir. Dec. 21, 2001]), the SEC brought securities fraud charges against the manager of two private funds in part because he engaged in a general solicitation and public advertisement in connection with a private placement of unregistered securities pursuant to Regulation D. The manager provided free advertising for the investment funds and permitted the funds access to his investment newsletter subscriber lists for use in promoting their offerings. The U.S. District Court for the District of Massachusetts granted summary judgment in favor of the SEC, as well as disgorgement and civil penalties. The U.S. Court of Appeals for the First Circuit upheld the judgment on appeal.

(4) Fraudulent Valuation

(A) ***Granite Partners, L.P. v. Bear Stearns & Co.,* 58 F. Supp. 2d 228, 1999 U.S. Dist. LEXIS 11523, 1999-2 Trade Cas. (CCH) P72604 (S.D.N.Y. 1999)**

Facts:

Plaintiff Quartz Hedge Fund ("Quartz") (collectively with Granite Partners and Granite Corp., the "Funds"), a Cayman Islands corporation, collapsed in early 1994. The Funds invested primarily in collateralized mortgage obligations ("CMOs"). The Funds acquired portfolios that included esoteric and highly "toxic" CMOs. When short-term interest rates rose in early 1994, these securities radically eroded in value.

The Complaint alleged that the defendants (Merrill Lynch and Bear Stearns and individual brokers, collectively "Brokers") recommended and sold to the Funds inappropriate and, at times, highly toxic CMOs. The Complaint also alleged that the Brokers deliberately supplied the Funds with erroneous "marks" purportedly representing the Brokers' own valuations of the Funds' holdings despite contracts between the Funds and the Brokers requiring the provision of accurate and timely Broker marks. In their sales of securities to the Funds, the Brokers recouped significant profits – in part due to the Brokers' charging of excessive markups.

The Complaint alleged that the Brokers once again took advantage of the Funds during their liquidations. In particular, the Brokers are alleged to have liquidated the Funds' holdings by "deeming" sales of the Funds' securities to themselves at unreasonable, below-market prices. The Brokers allegedly colluded with each other to exchange sham bids, thus facilitating bad-faith liquidation. Having obtained the Funds' securities at artificially low prices, the Brokers then proceeded to sell those same securities on the open market – recovering profits far in excess of those they would have obtained

had they liquidated the Funds' portfolios in a non-collusive manner.

Cause of Action:

In the case before the Court, the Brokers moved to dismiss several claims. The Complaint alleged antitrust claims, claims of common law fraud and breach of contract, claims for tortious interference with contracts.

Holding: Granted Brokers' motions to dismiss claims for common law fraud, tortious interference with contracts and antitrust claims. Denied Brokers' motions to dismiss claim for breach of contract.

(B) ***SEC v. Berger*, 244 F. Supp. 2d 180; 2001 U.S. Dist. LEXIS 18448 (S.D.N.Y. 2001)**

Facts:

Berger was the sole shareholder of defendant Manhattan Capital Management, Inc. ("MCM") and was also a director of the fund.

The fund had an investment strategy that primarily involved the concentrated short-selling of securities of certain internet and technology-related U.S. companies. Because the prices of most internet stocks increased dramatically between 1996 and 2000, the fund consistently suffered losses. Rather than accurately reporting losses the fund was experiencing, as reflected in the daily Bear Stearns statements, Berger used the Bear Stearns statements as templates to create fictitious account statements, purportedly generated by its Broker Dealer.

A criminal proceeding was commenced against Berger in the Southern District of New York in August of 2000. On November 27, 2000, Berger entered a plea of guilty to securities fraud charges under Section 10(b) and Rule 10b-5. On September 24, 2001, represented by new counsel, Berger filed a motion to withdraw his guilty plea.

Cause of Action:

The SEC moved for Summary Judgment alleging violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, and Sections 206(1) and (2) of the Investment Advisers Act of 1940.

Holding: Summary Judgment Granted.

A permanent injunction, disgorgement of $19,874,735.44, prejudgment interest on the amount of disgorgement of $132,498.24, and a civil monetary penalty of $100,000 were imposed.

(C) ***In re Springer Investment Management*, 2005 SEC LEXIS 2390, Investment Advisers Act of 1940 Release No. 2434 (Sept. 21, 2005)**

Facts:

Keith Springer and his investment firm, Springer Investment Management, Inc. ("SIM"), misrepresented the performance of the hedge fund SIM managed by overvaluing a struggling "dot com" in which the hedge fund had invested. As the rest of the hedge fund's publicly traded investments declined in value, SIM bolstered the fund's overall performance by inflating the value of its stock in the struggling company, a privately-held Internet security called Citi411.com, which constituted the fund's largest holding. Notwithstanding the dramatic decline in the price of publicly-traded Internet stocks during the early 2000s, SIM continued to value the fund's Citi411.com shares at several times the price paid. SIM's overvaluation of the shares allowed Springer and SIM to provide misleading assurances of the hedge fund's performance to fund investors.

Cause of Action:

SIM and Springer violated Section 206(2) of the Advisers Act; Section 204 of the Advisers

Act, Rule 204-1(a)(2) thereunder; and aided and abetted SIM's violation of the same.

Holding: Accepted settlement.

Agreed to hire an independent consultant (further details of consultant's duties specified in case); agreed to mail Order of Settlement to each existing advisory client and each prospective client for 12 months; Censure; Cease and Desist; and $50,000 civil money penalty.

(D) ***In re Daniel*, 2005 SEC LEXIS 3063, Investment Advisers Act of 1940 Release No. 3063 (Nov. 29, 2005)**

Facts:

Joseph W. Daniel was a managing general partner of Critical Investments, LLC, the general partner acting as an investment adviser for the Critical Infrastructure Fund, an unregistered hedge fund. Daniel engaged in improper practices in the management of the hedge fund including: (1) making material misrepresentations to investors about the assets, holdings, and performance of the hedge fund; (2) failing properly to value holdings of the hedge fund; and (3) allowing certain investors to make withdrawals from the hedge fund at improper valuations to the disadvantage of remaining investors.

On October 7, 2005, in *SEC v. Daniel*, the Court entered an order enjoining Daniel from violating Sections 17(a)(l-3) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act.

Cause of Action:

This settlement appears to impose sanctions arising out of the earlier case.

Holding: Accepted Order of Settlement.

Bar from association with any investment adviser.

(E) ***In re Stoler*, 2006 SEC LEXIS 1708, Securities Act of 1933 Release No. 8726; Securities Exchange Act of 1934 Release No. 54246; Investment Advisers Act of 1940 Release No. 2539, Accounting and Audit Enforcement Release No. 2470 (Jul. 31, 2006)**

Facts:

Lawrence A. Stoler, former audit partner at PWC, used improper professional conduct in the audits of the 2000 annual financial statements of three hedge funds (collectively, the "Funds") – managed by Lipper Holdings, LLC ("Lipper Holdings"). Stoler was the engagement partner on the 2000 audits and prior years' audits. The Funds' portfolio manager, Edward J. Strafaci ("Strafaci"), intentionally overstated the value of the convertible bonds and convertible preferred stock in which the Funds were invested. As a result, investors and prospective investors received materially false statements about the Funds' value and performance. Stoler's conduct in the Funds' 2000 audits was highly unreasonable and by virtue of his conduct, Stoler was a cause of violations of certain provisions of the Securities, Exchange, and Advisers Acts committed by the Funds, Strafaci, and/or Lipper Holdings.

Cause of Action:

Stoler failed to comply with GAAS and GAAP; engaged in improper professional conduct within the meaning of Rule 102(e)(1)(ii) of the Commission's Rules of Practice because of his highly unreasonable conduct (Rule 102(e)(l)(iv)(B)(l)). Stoler caused Strafaci's and the Funds' violations of Sections 17(a)(2,3) of the Securities Act, Lipper Holdings' violations of Section 206(1) of the Adviser's Act, and two of the Hedge Funds'

violations of Section 17 of the Exchange Act and Rule 17a-5 thereunder.

Holding: Offer of Settlement accepted.

Cease and desist; denied privilege of appearing before Commission as accountant (may be reinstated in 1 year).

(F) ***Able Fund et al. v. Dobbins*, 2006 U.S. Dist. LEXIS 41900 (N.D. Tex 2006)**

Facts:

Defendant J. Robert Dobbins of Texas was a director of a British Virgin Islands hedge fund, Dobbins Offshore, Ltd. ("Fund"), which was managed by a Texas management company, Dobbins Offshore Capital, LLC ("Dobbins Capital") (collectively, the "Dobbins Defendants"). Plaintiffs complained that the Dobbins Defendants made a series of misrepresentations to induce Plaintiffs to purchase overvalued shares in the Fund, or to maintain existing investments in the Fund. Plaintiffs claimed that Citco, which provided administrative services to the Fund, participated in the alleged fraud and negligence by failing to verify independently that the Fund's portfolio was accurately valued, and by disseminating false monthly Net Asset Valuation ("NAV") statements to investors from approximately January 2000 through May 2003. Defendant KPMG Accountants, N.V. ("KPMG") is accused of, among other actions, wrongfully issuing a "clean" audit report to investors for the year ending December 31, 2000.

This case is closely related to a previously filed case on the Court's docket, *Securities and Exchange Commission v. DB3 Holdings, et al*. In the SEC lawsuit, J. Robert Dobbins consented to Final Judgment and injunction, entered on July 12, 2005, in favor of the SEC. The Court retained jurisdiction to oversee the Receivership established by the Judgment.

Cause of Action:

In the present matter, Defendants Citco and KPMG asked the Court to dismiss them from the case for lack of personal jurisdiction. In addition, Citco moved for dismissal on the claims of fraud (for failure to plead with specificity) and negligence (for failure to state a claim for which relief may be granted).

Underlying claim: Plaintiffs asserted causes of action against the Dobbins Defendants for fraud, breach of fiduciary duty, and negligence. Against Citco, Plaintiffs brought claims for fraud and negligence. Against KPMG, as against Citco, Plaintiffs alleged claims for fraud and negligence.

Holding: Case dismissed.

Finding no personal jurisdiction over either Defendant, the Court does not reach the remaining grounds for dismissal.

(G) ***Pension Comm. Of the Univ. of Montreal v. Banc of America Securities*, 2007 U.S. Dist. LEXIS 11807 (S.D.N.Y. 2007)**

Facts:

A group of investors brought this action to recover losses stemming from the liquidation of two British Virgin Islands ("BVI") based hedge funds in which they held shares: Lancer Offshore, Inc. and OmniFund Ltd. ("Funds"). The Funds were managed by Michael Lauer ("Lauer") through Lancer Management Group, LLC ("Lancer Management").

All of the claims asserted by Plaintiffs derive from the same set of operative facts related to mismanagement of the Funds by Lauer and Lancer Management. Plaintiffs alleged that much of their losses were caused by a fraudulent scheme known as "marking the close." To execute this scheme, Lauer and Lancer Management acquired substantial and sometimes controlling stakes in thinly-traded stocks on behalf of the Funds. Then,

prior to the end of the Funds' reporting periods, Lauer would purchase additional shares of these stocks at significantly higher prices, with the intent of raising the closing market price of the stocks. Each Fund would report its net asset value ("NAV") based on the artificially high prices, creating the appearance of a portfolio value vastly higher than its true value, and generating large fees for Lauer and Lancer Management.

Cause of Action:

The matter before the Court in this case was the defendants' motion to dismiss the federal securities claims for failure to plead scienter.

Underlying Claim:

Plaintiffs brought claims for violations of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, against one former director of OmniFund, Inter Caribbean Services, Ltd. ("ICSL"), and three former directors of Lancer Offshore, and a former administrator of the Funds, Citco Fund Services.

Plaintiffs also brought a claim under Section 20(a) of the Securities and Exchange Act against The Citco Group Limited ("CGL"), based on CGL's alleged status as a control person. Plaintiffs also brought various common law claims under New York law against the Citco Defendants and Banc of America Securities, LLC ("BAS"), the former prime broker and custodian of the Funds.

Holding: Citco's motion to dismiss granted with respect to the claims against ICSL and Stocks and denied in all other respects. BAS's motion to dismiss granted.

(H) ***Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt.*, 479 F. Supp. 2d 349, 2007 U.S. Dist. LEXIS 31107 (S.D.N.Y. 2007)**

Facts:

Plaintiffs are investors in hedge funds that were managed directly or indirectly by Beacon Hill Asset Management, LLC and its four principals. The funds consisted of portfolios of investments including collateralized mortgage obligations ("CMOs") and short positions in U.S. treasury securities. The stated approach was to hedge the positions in CMOs, mostly by shorting U.S. treasury bonds in an effort to achieve a low risk, stable return that would be sheltered, at least to a significant extent, from fluctuations attributable to interest rate movements.

According to the second amended complaint, the Beacon Hill Defendants allegedly overstated the Funds' NAVs by using phony prices for individual securities in the funds' portfolios in order to create the false appearance of steadily rising values. Rather than using independent prices, the Beacon Hill Defendants allegedly used their own fraudulent valuations.

They allegedly did so primarily by means of a two step process relating to the valuation of the funds' CMOs. The first step involved calculating a so-called "hedge-adjusted" NAV for a fund by determining the gain or loss in a fund's short U.S. treasury hedge position and then "plug[ging] the change in value in the treasury position into a computer spreadsheet that allocated value changes to the portfolio's CMOs that matched, in the opposite direction, any loss or gain in the short U.S. treasury position." The second step involved manual adjustments to the values of individual CMOs, allegedly to maintain the appearance that the funds' portfolios steadily increased in value over time.

On November 27, 2002, Beacon Hill disclosed that the NAV of the funds had actually declined by 61.22% from the NAV reported as of August 31, 2002.

Cause of Action:

Investors brought this action against the funds' managers and certain financial institutions for participating in an alleged fraud under Section 10(b), common law fraud, aiding and abetting and breach of fiduciary duty. Banc of America Securities, LLC ("BAS") and Prudential Financial, Inc., Prudential Equity Group, LLC, and Wachovia Securities, LLC (collectively "Prudential") are charged with aiding and abetting fraud and breach of fiduciary duty by the funds' managers.

Holding: Prudential's motion to dismiss was granted; Banc of America's motion to dismiss was partially granted; the claims of all plaintiffs insofar as they allege liability based on aiding and abetting prior to May 2002 were dismissed; the motion to dismiss was otherwise denied.

(5) Style Drift

(A) Style drift occurs if an investment manager moves away from the investment mix that is appropriate to a portfolio based on the portfolio's objectives and style.

Such a drift typically occurs if the core portfolio is providing disappointing returns while other investments in the marketplace are performing better. In this case, a manager may feel pressure to increase the bottom line. The drift may also occur inadvertently if some of a portfolio's underlying investments take on different characteristics. For example, a small company may become a mid-sized company or a value investment may increase substantially in price.

The danger of style drift from a portfolio perspective is that the investor might end up owning investments that are more or less risky than the investor intended or that expose the investor unexpectedly to portfolio overlap.

(B) ***Faye L. Roth Revocable Trust v. UBS Painewebber Inc.*****, 2004 Mass. LEXIS 557 (Mass. 2004)**

Facts:

Plaintiffs claimed that USB PaineWebber made misrepresentations regarding the PW Aspen (Hedge) Fund which was sold to them. The defendants allegedly explained that the hedge fund would buy stocks long and short so that when the market went down, they would make money on short purchasing to offset losses on long purchasing. The fund was not registered but was made pursuant to Rule 506 and the plaintiffs received a Confidential Offering Memorandum stating that the fund was not registered. Plaintiffs discovered that the fund was solely invested in long-term investments, which was contrary to what the Plaintiffs believed was the fund's investment strategy.

Cause of Action:

Plaintiffs' sole claim was that defendants violated §12(a)(2) by making misrepresentations in the private offering of the hedge fund, and other communications through which the subject funds were sold.

Holding: Defendant's motion for summary judgment granted.

The court held that plaintiffs had not stated a claim for fraud pursuant to §12(a)(2) because defendants did not offer the funds through the use of a registered public offering, and therefore, as a matter of law, plaintiffs could not bring a §12(a)(2) claim in connection with their investments with the defendants.

(C) ***Marram v. Kobrick Offshore Fund*****, 2004 Mass. LEXIS 557 (Mass. 2004)**

Facts:

Edward Marram, trustee for the profit sharing plan of Geo-Centers, Inc. (a professional services firm), was induced to invest in the

Kobrick Offshore (hedge) Fund, which was managed by Frederick Kobrick. Kobrick gave Marram an offering memorandum and subscription agreement (as well as oral representations) which stated an overall investment strategy of investing in equity securities and equity related instruments while seeking to control risk (and using short positions as a hedge). The oral representations were that the fund was diversified.

In reality, the hedge fund was not diversified and was heavily invested in high tech stock. The value of the fund's holdings fell but Kobrick urged Marram to keep investing.

Cause of Action:

The matter before the Court was an appeal from the Defendant's Motion to Dismiss (for failure to state a claim) which had been granted.

Marram sued under Massachusetts Uniform Securities Act G.L. c. 110A §410, which provides protection for a buyer who received misleading information from a seller of securities. Marram also sued for negligent misrepresentation (regarding the oral statements). Marram also alleged violations of G.L. c. 93A §11 (unfair or deceptive trade practices under Massachusetts law).

Holding: The Court vacated the order to dismiss and remanded the case.

(D) ***SEC v. Conway*, Lit. Rel. No. 19807 (Aug. 17, 2006); *SEC v. Conway*, Lit. Rel. No. 20145 (Jun. 6, 2007)**

Facts:

Mark R. Conway acted as the managing partner of Groundswell Capital LP, a quantitative systemic hedge fund doing business in Massachusetts. Conway made numerous misrepresentations to investors, including that the hedge fund would follow a specific investment strategy devised by Conway. In fact, he ceased using the promised investment strategy without notice to, or the approval of, the investors. He tried to hide this deviation from the promised strategy by creating false documentation which resulted in defrauding approximately 50 investors of more than $20 million.

Cause of Action:

Thirteen counts of mail and wire fraud (criminal).

Holding: Guilty plea accepted.

Conway sentenced to 7 years in prison to be followed by 3 years of supervised release, a $1,300 special assessment fine and payment of restitution in the amount of $20 million.

(E) **Amaranth Hedge Fund**

Amaranth Advisors LLC was an American multistrategy hedge fund managing $9 billion in assets. In September 2006, it collapsed after losing roughly $6 billion in a single week on natural gas futures. The failure was the largest hedge fund collapse in history.

The company was founded by Nicholas Maounis and based in Greenwich, Connecticut. Its name, "amaranth," is Greek for "unfading." Throughout much of the firm's history, convertible arbitrage was the firm's primary profit center. As more and more capital began flowing into the convertible arbitrage strategy during the early 2000s, trading opportunities became more difficult to find.

By 2004-2005, the firm had shifted much of its capital to energy trading. Amaranth's energy desk was run by a Canadian trader named Brian Hunter. Hunter had made enormous profits for the company by placing bullish bets on natural gas prices in 2005, the year Hurricane Katrina had severely impacted natural gas and oil production and refining capacity. Hoping for a repeat performance, Amaranth wagered with 8:1 leverage that the price of the March '07 and March '08 future

contracts would increase relative to the price of the April '07 and April '08 contracts (i.e., they would "long" the March contracts and "short" the April contracts).

Unfortunately for Amaranth, they did not. The spread between the March and April 2007 contracts, for example, went from $2.49 at the end of August 2006 to $0.58 by the end of September 2006. The price decline was catastrophic for Amaranth, resulting in a loss of $6.5 billion. Historically, the spread in future prices for the March and April contracts have not been easily predictable. The spread is dependent on meteorological and sociopolitical events whose uncertainty makes the placing of such large bets a precarious matter.

On July 25, 2007, the Commodity Futures Trading Commission (CFTC) charged Amaranth and head energy trader Brian Hunter with Attempted Manipulation of the Price of Natural Gas Futures, including making false statements to the New York Mercantile Exchange (NYMEX). The case is still pending.

(6) Insider Trading

(A) **General Overview of Insider Trading: (quoted from *SEC v. Kornman*)**

Two general theories of liability exist under §10(b) of the Exchange Act and Rule 10b-5: the "classical theory" of insider trading and the "misappropriation theory" of insider trading. *See United States v. O'Hagan*, 521 U.S. 642 (1997). Under the "classical theory" of insider trading, "§10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." *Id.* As stated in *O'Hagan*, "trading on such information qualifies as a deceptive device 'under § 10(b) ... because a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.'" 521 U.S. at 652 (quoting *Chiarella v. United States*, 445 U.S. 222 (1980)). The classical theory applies to officers, directors, and other permanent insiders of a corporation, as well as to attorneys, accountants, consultants and others who temporarily become fiduciaries of the corporation. *Id.* (citing *Dirks v. SEC*, 463 U.S. 646, 655 (1983)). Moreover, under *Dirks*, third party "outsiders" may also be liable for securities fraud under the classical theory when the corporate officer does not trade himself, but instead "tips" a corporate outsider, such as a friend or a family member, with the information so that the outsider can trade. *Dirks*, 463 U.S. at 660. The tipper is liable for divulging the information for securities trading purposes in breach of his fiduciary duty to the source of information (namely, the corporation and its shareholders), if he benefits directly, or indirectly, from the tip. The tippee is liable "only when the insider has breached his fiduciary duty ... and the tippee knows or should know that there has been a breach." *Id.*

Under the "misappropriation theory" of insider trading: [A] person commits fraud "in connection with" a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase and sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. *O'Hagan*, 521 U.S. at 652. "In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on the fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.* at 652-53. Whereas the classical theory targets "a corporate insider's breach of duty to shareholders with whom the insider transacts[,] the misappropriation theory

outlaws trading on the basis of nonpublic information by a corporate outsider in breach of a duty owed not to a trading party, but to the source of the information." *Id.*

In upholding the misappropriation theory of insider trading, the *O'Hagan* court found that the theory itself, like the classical theory of insider trading, was "well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence." *Id.* at 657. The Supreme Court detailed the reasons behind §10(b) and Rule 10b-5: Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-a-vis a misappropriator with material nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill. *Id.* at 658-59. As stated by the Supreme Court in *O'Hagan*, there is "no general duty between all participants in market transactions to forgo actions based on material nonpublic information"; rather, the "misappropriation theory bars only trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information." *Id.* at 663 (internal citations and punctuation omitted).

(B) ***SEC v. Kornman*, 2005 U.S. Dist. LEXIS 22046 (N.D. Tex 2005)***

Facts:

Gary M. Kornman, a tax attorney and director of two hedge funds, received confidential information during tax-planning discussions with executives of publicly-traded companies. All stock purchases were made through Kornman's hedge funds.

Cause of Action:

The matter before the court is Defendant's Motion to Dismiss.

SEC alleges violation of Section 10(b), Rule 10b-5 thereunder.

Holding: Motion to dismiss denied.

SEC seeks civil penalties, cease and desist, disgorgement of any ill-gotten gains from his allegedly unlawful conduct, with prejudgment interest.

* Mr. Janvey was one of the attorneys who represented Mr. Kornman in the SEC case. Mr. Kornman pled guilty to one count of securities fraud and received a probated sentence.

(C) ***CompuDyne Corp. v. Shane*, 453 F. Supp. 2d 807; 2006 U.S. Dist. LEXIS 71447 (S.D.N.Y. 2006)**

Facts:

Hilary L. Shane manages hedge funds FNY Millennium and FNY Capital, both of which are under the umbrella of FNY Securities. Shane was approached as a prospective investor in a PIPE (in CompuDyne stock). Because the PIPE had not yet been registered with the SEC, Shane agreed to keep the PIPE confidential. Immediately thereafter, Shane sold CompuDyne stock short in accounts of her hedge funds based on her nonpublic information about the PIPE. Shane and her hedge funds conducted extensive "naked" short sales, later using the shares obtained in the PIPE transaction to "cover" these short positions at a lower price.

The NASD and SEC had already sued Shane by the time this action was brought. In connection with those cases, Shane agreed to pay $1.45 million in profits and was permanently barred from associating with any NASD registered firm.

Cause of Action:

The motion before the court is a motion to dismiss.

Underlying claim:

The Complaint asserted seven causes of action. Count I alleged violations by Shane, FNY Millennium, and FNY Capital of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rule 10b-5 promulgated thereunder. Count II alleged "control person" liability of FNY Securities and FNY Capital under Section 20(a) of the Exchange Act. Count III alleged common-law fraud on the part of Shane, FNY Millennium, and FNY Capital. Counts IV and V alleged alternative claims of breach of contract and unjust enrichment, respectively, against Shane, FNY Millennium, and FNY Capital. Count VI alleged respondeat superior liability of FNY Securities for the damages plaintiffs suffered as a result of Shane's allegedly unlawful conduct. Count VII alleged that FNY Capital is liable under a theory of partnership liability for the damages plaintiffs suffered as a result of the allegedly illegal short sales carried out through FNY Millennium.

Holding:

Motions by Defendant Shane and related hedge funds to dismiss were denied with the exception of the motion to dismiss unjust enrichment.

(D) ***SEC v. Lyon et. al.*, Lit. Rel. No. 19942, 2006 SEC LEXIS 2887 (Dec. 12, 2006) (Complaint synopsis only)**

Facts:

Lyon and Gryphon Partners engaged in illegal insider trading by selling short the securities of certain PIPE issuers prior to the public announcement of the PIPE, while using nonpublic information they received when being solicited to invest in the PIPE. Specifically, Lyon and Gryphon Partners sold short the issuer's stock, frequently through "naked" short sales in Canada, and then used the PIPE shares to cover the short positions - a practice prohibited by the registration provisions of the federal securities laws.

To avoid detection and regulatory scrutiny, Lyon and Gryphon Partners employed a variety of deceptive trading techniques, including wash sales, matched orders, and pre-arranged trades, to make it appear that they were covering their short sales with open market shares, when, in fact, Lyon and Gryphon Partners were on both sides of the transactions and were covering with their PIPE shares.

Cause of Action:

The SEC alleged that defendants violated the registration provisions of the Securities Act (Sections 5(a), 5(b), and 5(c)) and the antifraud provisions of both the Securities Act (Section 17(a)) and the Securities Exchange Act of 1934 (Section 10(b) and Rule 10b-5, thereunder).

Holding: The Commission's complaint seeks to enjoin, disgorge of ill-gotten gains plus pre-judgment interest and civil monetary penalties.

(E) ***SEC v. Guttenberg*, Lit. Rel. No. 20022, 2007 SEC LEXIS 383 (Mar. 1, 2007) (Complaint synopsis only)**

Facts:

The SEC alleged that in the first scheme, which has been ongoing since 2001, many people made thousands of illegal trades and millions of dollars in illicit profits using inside information misappropriated by a UBS executive to trade ahead of UBS analyst recommendations (the "UBS Scheme"). The complaint alleged that in the second scheme, many people made dozens of illegal trades and hundreds of thousands of dollars in illicit profits using inside information misappropriated by an attorney at Morgan

Stanley to trade ahead of corporate acquisition announcements (the "Morgan Stanley Scheme"). Collectively, the complaint alleged the defendants made at least $15 million in illicit profits from these two insider trading schemes.

Cause of Action:

As a result of the conduct described in the complaint, the Commission alleged that each of the defendants violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and that certain defendants also violated Section 17(a) of the Securities Act of 1933.

Holding:

The Commission's complaint seeks permanent injunctive relief, disgorgement of illicit profits with prejudgment interest, and the imposition of civil monetary penalties.

(F) ***SEC v. Aragon*, Lit. Rel. No. 19995A, 2007 SEC LEXIS 295 (Feb. 13, 2007) (Complaint synopsis only)**

Facts:

Seven individuals participated in a scheme to trade in the stock and option contracts of Taro Pharmaceuticals Industries, Ltd. ("Taro"), an Israeli-based publicly traded pharmaceutical company, ahead of eight earnings announcements and five FDA approval announcements. In the later stages of the scheme, certain of the defendants broadened the scheme by trading on information stolen from Pricewaterhouse Coopers LLP ("PwC") and Ernst & Young, LLP ("E&Y") concerning two possible mergers.

Zvi Rosenthal ("Zvi"), a Vice President at Taro, abused his position at Taro by systematically stealing material, nonpublic information concerning 13 separate company announcements, including earnings results and pending generic drug approvals by the FDA. Zvi then traded on the information and passed it on to his family members who then traded in Taro stock and options. Zvi provided information to his son, who traded in personal accounts he controlled, and in the account of the family-owned and controlled hedge fund, Aragon Partners, LP. Other defendants also misappropriated material, nonpublic information concerning impending mergers from their respective employers, PwC and E&Y.

Cause of Action:

The SEC filed on 2/13/07 a civil action in federal district court in New York relying on the antifraud provisions of the federal securities laws.

Holding: The SEC seeks permanent injunctive relief, disgorgement of all illegal profits and losses avoided plus prejudgment interest and the imposition of civil monetary penalties against the defendants. The complaint also seeks an officer and director bar against Zvi.

(7) Market Timing and Late Trading

(A) **General Overview of Market Timing and Late Trading: (quoted from *In re Flynn*)**

The share price of mutual funds is based on their net asset values (NAV). Market timing involves frequent purchases and sales of mutual fund shares, often with the intent of earning arbitrage profits if the NAV of the mutual fund differs from the value of its underlying portfolio holdings. This discrepancy in valuation may occur if the prices used to calculate the daily NAV became stale.

Mutual funds generally calculate their NAVs at 4:00 p.m. Eastern time by using the closing prices of their portfolio securities on the exchange or market on which the securities principally trade. Mutual funds that invest in overseas markets are particularly vulnerable to market timers because of time zone

differences between the foreign markets on which international funds' portfolio securities trade and the United States markets that generally determine the time as of which the NAV is calculated. Market timing opportunities are not, however, limited to international funds. Mutual funds that invest in small-cap securities and other types of investments that are not traded frequently also can be the targets of market timers. For example, in the case of a United States-based mutual fund that invests primarily in securities traded on the London Stock Exchange, the fund's daily NAV would be set at 4:00 p.m. Eastern time using stock prices from the close of the London market at 11:00 a.m. Eastern time—that is, stock prices that are five hours old. If favorable news emerged following the close of the London market, market timers could purchase shares in the fund at an understated NAV that did not account for the positive late-breaking news. The market timer would then redeem the fund's shares the next day when the fund's share price would reflect the increased prices in foreign markets.

Although market timing is not per se illegal, the practice can harm a fund's shareholders in several ways. For example, market timing may dilute the value of long-term shareholders' interests in a mutual fund if the fund calculates its NAV using closing prices of its portfolio securities that are no longer accurate. Market timing also may cause a fund to manage its portfolio in a disadvantageous manner, such as maintaining a larger percentage of its assets in cash or liquidating certain portfolio securities prematurely to meet higher levels of redemptions due to market timing. Additionally, a mutual fund also may incur increased brokerage and trading costs, as well as tax liabilities, related to the frequent purchases and redemptions associated with market timing. Accordingly, the potential for market timing to harm the interests of mutual fund investors led many mutual funds to adopt policies intended to limit market timing within their family of funds. These policies vary from fund to fund.

"Late trading" is placing orders to buy or redeem mutual fund shares after the NAV is calculated, but the transaction price is based on the previously calculated NAV instead of the NAV next calculated after the orders were placed.

(B) ***SEC v. Mutuals.com*, Lit. Rel. No. 18489 (Dec. 4, 2003)***

Facts:

The SEC alleged that the defendants fraudulently helped institutional brokerage customers and advisory clients carry out and conceal thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds. Whenever a fund tried to restrict timing activities, Mutuals.com and its principals used means such as: (1) formation and registration of two affiliated broker-dealers through which they could continue to market time; (2) changing account numbers for blocked customer accounts; (3) use of alternative registered representative numbers for registered representatives; (4) use of different branch identification numbers; (5) switching clearing firms; and (6) suggesting that their customers use third party tax identification numbers or social security numbers to disguise their identities.

Cause of Action:

The SEC alleged violations of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; Section 15(c)(1) of the Exchange Act; and Rule 22c-I of the Investment Company Act.

Holding: The SEC seeks to enjoin the defendants, civil money penalties, disgorgement of illicit profits plus prejudgment interest, and the appointment of a Special Monitor.

*Mr. Janvey was the Special Monitor in this case.

(C) ***In re Pilgrim*, 2004 SEC LEXIS 2642, Securities Act of 1933 Release No. 8505; Securities Exchange Act of 1934 Release No. 50680; Investment Advisers Act of 1940 Release No. 2328, Investment Company Act of 1940 Release No. 26655 (Nov. 17, 2004)**

Facts:

Gary L. Pilgrim is the former President, Officer, and Director of Pilgrim Baxter & Associates, Ltd. ("PBA"), the investment adviser to the PBHG family of mutual funds; and a former director of PBHG Shareholder Services, Inc.

Pilgrim invested in a hedge fund that was managed by a friend (the "Hedge Fund"). In March 2000, the Hedge Fund, with the knowledge and permission of Pilgrim, and contrary to the PBHG Funds' disclosed policies, began market timing, among other PBHG funds, the PBHG Growth Fund. Moreover, from at least June 1998 through August 2001, PBA, under the leadership of Pilgrim and PBA co-founder, Harold J. Baxter ("Baxter"), permitted several additional investors to market time certain PBHG funds.

Cause of Action:

The SEC alleged violations of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; Sections 206(1) and 206(2) of the Advisers Act; and Section 34(b) of the Investment Company Act.

Holding: Offer of Settlement Accepted

Pilgrim is ordered to cooperate with the SEC, disgorge $60 million, and pay a civil money penalty in the amount of $20 million.

(D) ***In re Laughlin*, 2005 SEC LEXIS 948, Securities Exchange Act of 1934 Release No. 51624; Investment Advisers Act of 1940 Release No. 2380, Investment Company Act of 1940 Release No. 26860 (Apr. 28, 2005)**

Facts:

Michael J. Laughlin is a former officer of Alliance Capital Management, L.P. ("Alliance Capital"), a registered investment adviser to the Alliance Capital mutual funds. In return for investments in Alliance Capital's hedge funds, Alliance Capital provided "timing capacity" in certain of its mutual funds ("Funds") to Daniel Calugar ("Calugar"), the owner and President of Security Brokerage, Inc., a registered broker-dealer in Las Vegas, Nevada. Laughlin approved Calugar's market timing arrangement. Laughlin aided and abetted Alliance Capital's violative conduct by not disclosing Calugar's arrangement that was potentially harmful to the Funds, and by failing to apprise the Funds of the conflict of interest created by this arrangement which increased Alliance Capital's advisory fees.

Cause of Action:

Laughlin aided and abetted and caused Alliance capital's violations of Sections 206(1) and 206(2) of the Advisers Act; aided and abetted and caused Alliance Capital's violations of Section 17(d) of the Investment Company Act and Rule 17d-1.

Holding: Offer of Settlement accepted.

Cease and desist; suspension for 12 months from association with any broker, dealer, or investment adviser; for 3 years, Laughlin cannot serve as chairman, director, or officer of any broker, dealer, or investment adviser and civil penalty of $325,000.

(E) ***SEC v. Federighi*, Lit. Rel. No. 19510, 2005 SEC LEXIS 3284 (Dec. 22, 2005)**

Facts:

Federighi and Hoffman co-managed the Ilytat hedge fund. The SEC alleged they deliberately exploited a loophole in their broker's mutual fund order entry system to place over 3,000 fraudulent late trades in over 400 different mutual funds. This caused losses of approximately $49 million with other mutual fund investors through the hedge funds' improper receipt of stale fund prices. Additionally, they allegedly engaged in short-term trading in mutual funds in violation of the mutual funds' rules. They used multiple, non-consecutively numbered accounts to conceal their identities from the funds.

Cause of Action:

The SEC alleged Hoffman and Federighi violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 and Sections 206(1) and 206(2) of the Advisors Act of 1940 and Section 37 of the Investment Company Act.

Holding: Seeks to enjoin, disgorge of ill-gotten gains plus pre-judgment interest and civil monetary penalties.

(F) ***In re Veras Capital Master Fund*, 2005 SEC LEXIS 3290, Securities Act of 1933 Release No. 8646; Securities Exchange Act of 1934 Release No. 53011; Investment Advisers Act of 1940 Release No. 2466, Investment Company Act of 1940 Release No. 27197 (Dec. 22, 2005)**

Facts:

Respondents (Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners, LLC, Kevin D. Larson, and James R. McBride) used deceptive techniques to continue market timing in mutual funds that previously had detected and restricted the Veras hedge funds' trading. To evade trading restrictions, Respondents created legal entities with names unrelated to "Veras", opened multiple accounts at multiple broker-dealers, and traded mutual fund shares after 4 p.m. and received the same day's price. As a result, the value of the mutual funds was diluted, in the aggregate, by approximately $35.5 million.

Cause of Action:

The SEC alleged Respondents violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. The SEC further alleged Respondents willfully aided and abetted another's violations of the same and willfully aided and abetted violations of Rule 22c-1(a) under the Investment Company Act of 1940 by certain mutual funds, persons authorized to consummate transactions, underwriters, and dealers.

Holding: Accepted Offer of Settlement

Cease and Desist; Larson and McBride are barred from association with any investment adviser with the right to reapply for association in all capacities after 18 months; disgorgement of $35,554,903 and $645,585 in pre-judgment interest; civil monetary penalty of $750,000.

(G) ***SEC v. Treadway*, 430 F. Supp. 2d 293, 2006 U.S. Dist. LEXIS 28312 (S.D.N.Y. 2006)**

Facts:

The SEC alleged that Treadway and Corba arranged and approved an arrangement granting Canary Capital Partners LLC (a domestic hedge fund) special market timing privileges in its investments in certain PIMCO funds in exchange for long-term or "sticky asset" investments in other PIMCO funds and that this arrangement conflicted with PIMCO's public disclosure regarding market timing.

Cause of Action:

The matters before the court in this case are the SEC's and Corba's motions for summary judgment and Corba's motion to strike the Kohler Declaration.

Holding: Court denies Plaintiff and Defendant's motions for summary judgment and denies motion to strike Kohler Declaration.

The SEC also brought a related action against various PIMCO Entities, including PIMCO Advisors Fund Management LLC, PEA Capital LLC f/k/a PIMCO Equity Advisors LLC, and PIMCO Advisors Distributors LLC. On September 13, 2004, these PIMCO Entities settled with the SEC, agreeing, without admitting or denying the allegations in the complaint, to entry of an SEC order mandating payment of a $40 million fine and $10 million in disgorgement and imposing several changes in PIMCO's governance structure intended to prevent recurrence of the alleged scheme. *See SEC v. PIMCO Advisors Fund Mgmt.*, 341 F. Supp. 2d 454, 461-62 (S.D.N.Y. 2004) ("PIMCO I").

(H) ***SEC v. Markovitz*, Lit. Rel. No. 19862, 2006 SEC LEXIS 2302 (Oct. 11, 2006)**

Facts:

In October 2003, the SEC settled with Markovitz based on his late trading of mutual funds at Millennium Partners, L.P., a hedge fund based in New York for which Markovitz was a trader. Such settlement resulted in a bar to Markovitz from associating with an investment adviser. However, Markovitz and others formed an offshore investment adviser to conduct business, violating his bar.

Cause of Action:

The SEC alleged Markovitz violated an order barring him from association with an investment adviser and Section 203(f) of the Investment Advisers Act, prohibiting violating such orders.

Holding: Accepted settlement.

Markovitz consented to a permanent cease and desist, a disgorgement of $50,000 and civil penalty of $120,000. Markovitz also received a $400,000 civil penalty for late trading conduct.

(I) ***In re Flynn*, 2006 SEC LEXIS 1766, Initial Decision Release No. 316 (Aug. 2, 2006)**

Facts:

Paul A. Flynn, while employed at Canadian Imperial Bank of Commerce ("CIBC"), is alleged to have assisted 2 hedge fund clients (Samaritan Asset Management and Canary Capital Partners, LLC) and others to engage in late trading and market timing of mutual fund shares.

The trades were leveraged with financing from CIBC. It was widely known throughout CIBC that these hedge funds were market timing with the borrowed money. Security Trust Company ("STC") was using a variety of methods to conceal trades which were described by STC as the "shotgun method," the "rotating omnibus method," the "rotating tax identification numbers method," and the "piggybacking method." The shotgun strategy allowed the hedge funds to trade through one account each. In the rotating omnibus method, the hedge funds each had 5 accounts with the same tax identification number, through which they could trade 1 time per week, with the trades being spread out over the 5 accounts. The rotating tax identification numbers strategy was substantially similar, except that each of the five accounts was assigned a different tax identification number. The piggybacking method involved combining, in one account, the hedge funds' market-timing trades with trades from a retirement plan's participants.

STC routinely received the hedge fund's orders after 4 p.m. and allowed the hedge funds to receive the NAV calculated as of 4 p.m. the same day.

Almost every mutual fund timed by the hedge funds contacted STC at some point. STC was found guilty in Arizona by a District Court for certain violations of securities laws.

Cause of Action:

The SEC alleged Flynn aided and abetted and caused violations of others of Section 17(a) of the Securities Act, Exchange Act Section 10(b) and Rule 10b-5 and Rule 22c-l under the Investment Company Act of 1940 (a.k.a. forward pricing rule).

Holding: Case Dismissed.

STC and Samaritan, acting with scienter, falsely represented to mutual fund companies that the hedge fund's trades were made by a retirement plan participant. This was material and involved deceptive practices by STC and the Hedge Funds. ICA Rule 22c-1 was found to have been applicable to STC but inapplicable to the two hedge funds. STC violated ICA Rule 22c-l with its late trading. However, the court held that Flynn was not aware of and did not substantially assist or cause STC's or the hedge funds' primary violations.

(J) ***SEC v. Gann*, 2006 U.S. Dist. LEXIS 9955; Fed. Sec. L. Rep. (CCH) P93, 836 (N.D. Tex 2006)**

Facts:

Defendants Gann and Fasciano were brokers at Southwest Securities and executed approximately 2,000 market timing trades in approximately 56 mutual fund families in an aggregate amount of at least $650 million on behalf of a hedge fund in New York. Representatives continued market timing trades even after receiving block notices from mutual funds. They concealed their trades by (i) concealing their own identities and the identity of the hedge fund; (ii) creating multiple accounts for the hedge fund and using several broker identification numbers to process market timing trades; (iii) dividing trades into amounts designed to evade detection; and (iv) using different branch identification numbers to disguise their trading activity.

Cause of Action:

The matter before the court was defendants' motion to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6) and 9(b) and the fact that market timing is not illegal per se. The SEC claims defendants violated Section 10(b) of the Exchange Act and Rule 10b-5 and aided and abetted the hedge fund in uncharged violations of securities laws.

Holding: Motion to dismiss denied for failure to state a claim; aiding and abetting charge dismissed.

The SEC met the particularity requirements under Rule 9(b) and adequately pleaded scienter. The court noted that while market timing is not illegal, it may violate the antifraud provisions. However, the claim that defendants aided and abetted the hedge fund in uncharged violations of securities laws failed because the SEC did not sufficiently plead a primary violation by the hedge fund.

(K) ***In re Deutsche Bank Securities*, 2006 SEC LEXIS 2966, Securities Exchange Act of 1934 Release No. 54993; Investment Company Act of 1940 Release No. 27607 (Dec. 31, 2006)**

Facts:

DBSI, a registered broker-dealer and a subsidiary of Deutsche Bank AG ("Deutsche Bank"), and a registered representative ("RR") defrauded mutual funds by misleading mutual funds as to the identity of his customers, many of which were market timers. In addition, the DBSI entered late trades--on more than 55 occasions, the RR

and DBSI received substitute orders after 4:00 p.m. ET, but treated them as though they had been received at the time of the original, rejected orders. DBSI had no procedures and systems to prevent and detect the RR's fraudulent conduct.

Cause of Action:

The RR violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. DBSI violated Rule 22c-1, as adopted under Section 22(c) of the Investment Company Act, and the RR aided and abetted DBSI's violations of Rule 22c-l. In addition, DBSI failed reasonably to supervise the RR, with a view to preventing his violations of the antifraud provisions and Rule 22c-1 of the federal securities laws, pursuant to Section 15(b)(4) of the Exchange Act.

Holding: Settlement Accepted.

DBSI censured and cease and desist; DBSI shall pay $202,835 in disgorgement and $37,284 in prejudgment interest, civil money penalty of $202,835.

(L) ***In re Fred Alger Management, Inc.*, 2007 SEC LEXIS 100, Securities Exchange Act of 1934 Release No. 55118; Investment Advisers Act of 1940 Release No. 2580, Investment Company Act of 1940 Release No. 27663 (Jan. 18, 2007)**

Facts:

Alger Management, the investment adviser to mutual funds in the Alger Fund Group, and Alger Inc., a broker-dealer that serves as the principal underwriter and distributor of Alger Fund Group mutual funds, permitted numerous select investors to market time the Alger Fund. Additionally, Alger Management failed to disclose that Alger Inc. had entered into numerous arrangements with select investors, including "sticky asset" arrangements, to permit them to time the Alger Fund. Alger Inc. required sales employees to negotiate a buy and hold investment equal to 20% of an investor's funds within the Alger Fund Group mutual fund complex in return for new market timing capacity. Also, Alger Inc. permitted one hedge fund customer, Veras Investment Partners, to engage in late trading of Alger Fund portfolios.

Cause of Action:

Alger Management violated and Alger Inc. aided and abetted violations of Sections 206(1) and 206(2) of the Advisers Act. Together, they also violated Section 17(d) of the Investment Company Act and Rule 17d-l thereunder, section 34(b) of the Investment Company Act, and section 15(c) of the Exchange Act and Rule 22c-l of the Investment Company Act.

Holding: Accepted Settlement.

Accepted cease and desist and censure, $30,000,000 in disgorgement, $10,000,000 civil monetary penalty; Respondents have accepted the requirements to retain an independent compliance consultant, undergo a compliance review, retain an independent distribution consultant, get an independent certification, and preserve records for 6 years.

(M) ***SEC v. Fife*, Lit. Rel. No. 19972, 2007 SEC LEXIS 107 (Jan. 19, 2007)**

Facts:

John M. Fife and Clarion Management, LLC engaged in a fraudulent scheme to purchase variable annuity contracts in order to engage in market timing. Clarion Capital was a Chicago hedge fund formed to market time international mutual funds available through variable annuities. To do this, they used trusts and limited liability companies as nominee contract owners and beneficiaries to conceal Clarion Capital's financial interest in the variable annuity contracts. After the

purchase of each contract, they engaged in market timing.

Cause of Action:

The SEC alleged Fife and Clarion violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 and Sections 20(a) of the Exchange Act.

Holding:

SEC seeks disgorgement of ill-gotten gains plus pre-judgment interest and civil monetary penalties.

(N) ***In re Sassano*, 2007 SEC LEXIS 213, 1933 Release No. 8778; Securities Exchange Act of 1934 Release No. 55208; Investment Advisers Act of 1940 Release No. 2587, Investment Company Act of 1940 Release No. 27692 (Jan. 31, 2007)**

Facts:

Michael Sassano and Dogan Baruh collaborated with numerous hedge fund customers to deceptively market time mutual funds. They used the following strategies to help their hedge fund customers deceive the mutual funds: (a) multiple accounts; (b) multiple RR numbers; (c) different branch numbers; (d) trades in smaller dollar amounts; (e) accounts at Charles Schwab & Co.. Inc. and FMR Corp. to continue market timing funds that had blocked their customers trading through CIBC World Markets (a New York based broker-dealer subsidiary of Canadian Imperial Bank of Commerce-CIBC); and (f) variable annuities. Additionally, Baruh knowingly accepted numerous mutual fund orders after 4 p.m. and processed them as though they had been placed prior to 4 p.m. so that they received the same day's NAV. Robert Okin and R. Scott Abry supervised, knew of, and assisted these practices.

Sassano requested and Okin approved the creation of an electronic trading platform at World Markets to facilitate Sassano's market timing business called the Mutual Fund Exchange System ("MFES"). Some mutual funds discovered the late trading and notified World Markets and Fahnestock that they disapproved of the practice. Despite World Markets' assurances that they would stop, their practices continued.

Cause of Action:

The SEC alleged that 1) Sassano and Baruh willfully violated the antifraud provisions -- Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5; 2) Sassano and Baruh willfully aided and abetted and caused CIBC World Markets to violate Section 15(c) of the Exchange Act and Rule 10b-3; 3) Baruh willfully aided and abetted and caused CIBC World Market's violations of Rule 22c-1; and 4) Okin and Abry willfully aided and abetted and caused violations of the antifraud provisions (among other provisions) and failed reasonably to supervise Sassano and Baruh.

Holding: The Division of Enforcement sought cease-and-desist orders, disgorgement, civil penalties, prejudgment interest, and all other remedial sanctions that are appropriate and in the public interest. A hearing had yet to be scheduled with an Administrative law judge at the time of this release.

(O) ***In re Dornfeld*, 2007 LEXIS 214, Securities Exchange Act of 1934 Release No. 55209 (Jan. 31, 2007)**

Facts:

Michael Dornfeld, a managing director at CIBC World Markets, failed to reasonably supervise CIBC brokers who defrauded hundreds of mutual funds and their shareholders by utilizing deceptive practices (market timing) on behalf of their clients (market timing hedge funds).

Cause of Action:

The SEC alleged Dornfeld failed to supervise under Section 15(b)(4)(E) and Section 15(b)(6)(A)(i) of the Exchange Act.

Holding: Accepted Settlement.

Dornfeld accepted suspension from association in supervisory capacity with a broker or dealer for a period of 12 months; pay disgorgement of $1 and civil money penalty of $100,000 to the SEC.

(P) ***In re Mutual Funds Investment Lit.,* 2007 U.S. Dist. LEXIS 37923, (D. MD 2007)**

Facts:

Janus Capital Group, Inc., whose mutual funds were known as Janus fund, permitted certain hedge funds to engage in market timing even though their prospectuses stated that they prohibit such trades. Plaintiffs claim that in exchange for the ability to engage in market timing, the hedge funds parked "sticky assets" in certain Janus funds, distorting the assets under management.

Cause of Action:

This was a class action asserting that Janus violated Section 10(b) and Rule 10b-5. Plaintiffs also asserted a control person claim against Janus under Section 20(a) of the Exchange Act. The matter before the court was a motion to dismiss by Janus.

Holding: Defendant's motion to dismiss granted.

The Supreme Court held that there is no aiding and abetting liability in private securities fraud actions. The plaintiffs' complaint failed to allege that Janus actually made or prepared the prospectuses. Disseminating a misleading document is not the same as making the misstatement for securities fraud purposes. Thus, the plaintiffs did not allege facts sufficient to support their conclusion that Janus made a material misstatement or omission. Also, absent a primary violation of Section 10(b), the control person claim fails.

(Q) ***U.S. v. Beacon Rock Capital, LLC*, Lit. Rel. No. 20051, 2007 SEC LEXIS 552 (Mar. 22, 2007) (Complaint synopsis only)**

Facts:

Beacon Rock (a hedge fund in Portland) and Thomas J. Gerbasio were criminally charged in connection with a scheme to defraud mutual funds with deceptive market timing. Gerbasio, while associated with two registered brokers, assisted in concealing the identity of Beacon Rock and its trading activity in over 26,000 market timing trades.

A civil injunctive action was filed by the SEC in the Eastern District of Pennsylvania on April 21, 2005, resulting in a permanent injunction and disgorgement of $540,000, and later, a permanent bar.

Cause of Action:

The U.S. Attorney charged Beacon Rock and Gerbasio with violation of 10(b) of the Securities Exchange Act and Rule 10b-5.

Holding: Criminal penalties sought.

(R) ***In re Sacco*, 2007 SEC LEXIS 887, Securities Act of 1933 Release No. 8795; Securities Exchange Act of 1934 Release No. 55693; Investment Company Act of 1940 Release No. 27816 (May 2, 2007)**

Facts:

Charles A. Sacco, former representative at A.G. Edwards, used deceptive techniques to market time mutual fund shares for 2 large hedge funds. Sacco placed more than 35,000 trades on behalf of his hedge fund customers. He received at least 180 canceled trade notices from mutual funds

objecting to his market timing but ignored them. In order to evade detection, he opened 142 separate accounts for his 2 hedge fund customers and used several different FC identification numbers.

Cause of Action:

The SEC alleged Respondents violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

Holding: Accepted Offer of Settlement

Cease and Desist; barred from association with any broker, dealer, or investment adviser with the right to reapply for association in 2 years; disgorgement of $215,892 and $56,978 in prejudgment interest. (All but $15,000 waived due to Sacco's financial condition.)

(S) ***In re Zurich Capital Markets* ("ZCM"), 2007 SEC LEXIS 943, Securities Exchange Act of 1934 Release No. 55711; Investment Company Act of 1940 Release No. 27819 (May 7, 2007)**

Facts:

ZCM, an entity that provided financing, aided and abetted four hedge funds that were carrying out schemes to defraud mutual funds that prohibited market timing. ZCM came to learn that the hedge funds were utilizing deceptive practices to market time mutual funds, and nonetheless ZCM provided financing to them and took administrative steps that substantially assisted them.

Cause of Action:

By providing assistance to the hedge funds, ZCM aided and abetted the hedge funds' violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Holding: Settlement Accepted.

ZCM will continue to cooperate and distribute $11 million in disgorgement, pre-judgment interest of $1,809,354 and civil money penalty of $4 million.

(T) ***In re Fasciano*, 2007 SEC LEXIS 1023, Securities Exchange Act of 1934 Release No. 55763; Investment Advisers Act of 1940 Release No. 2603 (May 15, 2007)**

Facts:

George B. Fasciano was a registered representative at Southwest Securities. He was permanently enjoined in the civil action *SEC v. Gann* and ordered to pay disgorgement and a civil penalty when it was discovered that he engaged in deceptive market timing practices on behalf of his client, a hedge fund.

Cause of Action:

This case appears to arise out of an earlier action, *SEC v. Gann*, and the violations contained therein relating to market timing.

Holding: Settlement Accepted.

Fasciano was barred from association with any broker, dealer or investment adviser with a right to reapply in 2 years.

(U) ***SEC v. Simpson Capital Management et. al.*, Lit. Rel. No. 20168, 2007 SEC LEXIS 1373 (Jun. 27, 2007) (Complaint synopsis only)**

Facts:

Robert A. Simpson, president and owner of Simpson Capital, John C. Dowling, head trader of Simpson Capital, and Simpson Capital (investment adviser to 2 hedge funds - Simpson Partners and Simpson Offshore) defrauded mutual funds of approximately $57 million by placing trades after the close of the

market while obtaining prices in effect before the market closed.

Cause of Action:

The SEC alleged Simpson Capital and Simpson and Dowling violated Section 10(b) of the Securities Exchange Act and Rule 10b-5.

Holding: SEC sought to enjoin, disgorge of ill-gotten gains plus pre-judgment interest and civil monetary penalties.

(V) ***In re Haidar Capital Management*, 2007 SEC LEXIS 1462, Securities Act of 1933 Release No. 8820; Investment Advisers Act of 1940 Release No. 2617, Investment Company Act of 1940 Release No. 27883 (Jul. 6, 2007)**

Facts:

Haidar Advisors traded an average of approximately $143 million in US mutual funds and annuities through a market timing strategy that Haidar Advisors' traders executed on behalf of two parent hedge funds. Deceptive tactics included using multiple accounts, utilizing broker-dealers who used multiple registered representative numbers and purchasing variable annuities, to hide Haidar Advisors' identity from mutual funds, and otherwise facilitate Haidar Advisors' market timing strategies.

Cause of Action:

Haidar Advisors and Haidar violated Section 17(a)(3) of the Securities Act.

Holding: Accepted Offer of Settlement

Accepted cease and desist and censure, $3,300,000 in disgorgement, $1,180,000 in prejudgment interest, $100,000 civil monetary penalty; Respondents accepted the requirements to retain an independent compliance consultant and retain an independent distribution.

II. Other Enforcement Actions Against Investment Advisers

The SEC has continued to consider the appropriateness of various trading practices, including situations where investment advisers, such as advisers to mutual funds, favor one or more clients over other clients in the allocation of trades.

(1) *In the Matter of John McStay Investment Counsel L.P.*, Advisers Act Release No. 2153 (July 31, 2003) - A registered investment adviser implemented a new IPO allocation procedure that was not disclosed to all clients and favored a registered investment company advised by the investment adviser.

(2) *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III, and Jon C. Baker*, Advisers Act Release No. 2154 (July 31, 2003) – A registered investment adviser allegedly disproportionately allocated IPOs to a small start-up registered investment company it advised and a hedge fund that paid performance fees. In addition, the investment adviser did not disclose the impact of IPOs on the performance of the registered investment company.

(3) *In the Matter of Monetta Financial Services, Inc.*, Advisers Act Release No. 2136 (June 9, 2003) – The president of an investment adviser made undisclosed hot IPOs allocations to directors of a fund it managed (including one independent director).

(4) *In the Matter of Zion Capital Management LLC and Ricky A. Lang*, Initial Decision No. 220 (January 29, 2003) and Advisers Act Release No. 2003 (December 20, 2001) – An investment adviser allocated more profitable trades to an entity in which an adviser had a financial interest and less profitable trades to an advisory client.

(5) *In the Matter of Brian R. Cassidy*, Advisers Act Release No. 2158 (August 15, 2003) and *In the Matter of Millennium Capital Advisors of Pennsylvania, Inc. and Louis J. Sozio*, Advisers Act Release No. 2092 (December 13, 2002) – A portfolio manager of a registered investment adviser incurred losses in a client account through unauthorized trading. The investment adviser's compliance was effectively vested in the portfolio manager and the investment adviser's procedures did not provide for any independent verification or review of the portfolio manager's reports.

The SEC continues to examine undisclosed conflicts of interest by investment advisers.

(1) *In the Matter of Deutsche Asset Management, Inc.*, Advisers Act Release No. 2160 (August 19, 2003) – A registered investment adviser voted client proxies for a merger without disclosing that its investment banking affiliate was hired by one of the parties to the merger and intervened in the investment adviser's voting process.

(2) *In the Matter of Marshall E. Melton and Asset Management & Research, Inc.*, Advisers Act Release No. 2151 (July 25, 2003) – A principal of a registered investment adviser commingled money among three limited partnerships and used investor funds to operate other entities he controlled.

(3) *In the Matter of Schwendiman Partners, LLC*, Advisers Act Release Nos. 2083 (November 21, 2002) and 2043 (July 11, 2002) – A registered investment adviser, through its principal, took for itself an investment opportunity from a fund it advised, gave preferential treatment to certain advisory clients, and distributed proceeds from liquidation of a fund's assets so as to confer a benefit on the principal.

The SEC continues to bring enforcement actions concerning the best execution practices of investment advisers.

(1) *In the Matter of Jamison, Eaton & Wood, Inc.*, Advisers Act Release No. 2129 (May 15, 2003) – An investment adviser had an undisclosed practice of leaving a client's brokerage with the firm of the registered representative that referred the client, even though the investment adviser could have obtained more favorable execution terms.

(2) *In the Matter of Renberg Capital Management, Inc. and Daniel H. Renberg*, Advisers Act Release No. 2064 (October 1, 2002) – Registered investment adviser engaged in agency cross transactions to implement a "repositioning" strategy for its clients. The practice involved repositioning client portfolios when a stock declined by a certain amount for the purpose of lowering the average basis of the stock and maintaining approximately the same percentage of the stock in a client portfolio.

Fraudulent advertising is a continuing concern of the SEC. The SEC has instituted a number of enforcement actions focusing on the facts behind a fund's performance numbers, and on the timeliness of the disclosure to ensure that it is not misleading.

(1) *Securities and Exchange Commission v. Ryan J. Fontaine and Signature Investments Hedge Fund*, Litigation Rel. No. 17864 (November 26, 2002) – Investment adviser made false and misleading claims about its track record, the amount of assets under management, and its purported affiliation with several well-known financial institutions and professionals.

(2) *In the Matter of Stan D. Kiefer & Associates and Stanley D. Kiefer*, Advisers Act Release No. 2023 (March

22, 2002) – Investment advisers misrepresented that registered investment company's performance was audited in compliance with an industry standard and disseminated false advertisements concerning the registered investment company's performance.

III. CFTC

The Commodity Futures Trading Commission ("CFTC") is an independent federal agency created in 1974 that administers the Commodity Exchange Act. The CFTC's mission is to oversee the futures and options markets in the United States and to ensure that these exchanges provide safe, sound, and transparent markets for risk management and price discovery for a variety of commodities, including agricultural, financial, metals, and energy products. The CFTC is responsible for regulating the following futures industry participants: designated contract markets – futures exchanges; derivatives clearing organizations – clearing houses; futures commission merchants ("FCMs"); introducing brokers; and floor traders and floor brokers. In addition, it is jointly responsible for regulating security futures products ("SFPs") with the SEC. SFPs are futures on individual stocks and narrow based securities indices. This new authority was part of the Commodity Futures Modernization Act of 2000 ("CFMA").

In addition to those futures industry participants mentioned above, the CFTC is also responsible for commodity pool operators ("CPOs") and the commodity pools which they sponsor, operate, or advise, as well as commodity trading advisers ("CTAs"). CPOs and CTAs are very similar to the investment company/mutual fund complexes and investment advisers in the securities industry.

The number of CFTC-registered CPOs at the end of 2003 was 2,059. These CPOs sponsored, operated, or advised approximately 3,244 commodity pools at the end of 2003. Based on the financial statements for 2,995 commodity pools which were filed for the calendar year ended 2002, commodity pools held approximately $424 billion in net assets. The vast majority of commodity pools are relatively small, but there were 789 (26%) commodity pools with over $100 million in net assets. These 789 "large" commodity pools had $372 billion in net assets – or approximately 80% of all the net assets in commodity pools.

The amount of net assets held by the commodity pool sector is quite small relative to SEC registered investment companies. SEC registered investment companies – open end mutual funds, unit investment trusts, closed end funds, and exchange traded funds – hold approximately $7.6 trillion in assets. Commodity pools – with just $424 billion in net assets – have only 5% of the assets which SEC registered investment companies hold. The vast majority of commodity pools – approximately 98% - are private placements, which are marketed and sold almost exclusively to institutions, corporations, pension plans, endowments, and other sophisticated investors. Only 43 of the 2,995 commodity pools are SEC registered public offerings. This is in contrast to the more than 8,000 SEC registered investment companies, which are marketed and sold to retail investors in public offerings.

According to testimony of the General Counsel of the CFTC, Patrick J. McCarty, on July 15, 2004, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, four points should be made related to hedge funds:

(1) Many large "hedge funds" are commodity pools. Well over 50% of the largest hedge fund complexes – those with over $1 billion in assets – have commodity pool registration or reporting requirements with the CFTC.

(2) There has been very little fraud in the hedge fund arena. In the last 5 years, less than 3% of all enforcement actions

by the CFTC and the SEC (81 out of 3,035) have been against hedge funds and/or their advisers.

(3) The CFTC/National Futures Association ("NFA") oversight program is periodic and risk-based. CPOs, which operate commodity pools, and CTAs are inspected generally on an average of every 2.5 to 3 years for compliance with CFTC recordkeeping, disclosure, and reporting requirements. 100% of all commodity pool annual reports filed with the NFA, the self-regulatory organization of the futures industry, are reviewed.

(4) The CFTC has worked, and will continue to work, cooperatively with the SEC, the New York State Attorney General, and other regulators with respect to sharing information and investigations involving hedge funds which are sponsored, operated, or advised by a CFTC-registered CPO or CTA.

Many large hedge funds – those with more than $100 million in net assets – are commodity pools. A clear majority of the large hedge fund complexes – those with over $1 billion in assets – have hedge funds/commodity pools that are sponsored, operated, or advised by CFTC registered CPOs and/or CTAs. The CFTC believes that over the past 3 years, a clear majority of the 100 largest hedge complexes had hedge funds/commodity pools sponsored, operated, or advised by CFTC registrants. In 2004, 18 of the largest hedge fund complexes (72%) have fund pools with CFTC registrants. 63 of the top 100 hedge fund complexes (63%) have a CFTC-registered CPO and/or CTA. [CFTC statistics]

In the last 5 fiscal years, less than 3% of all enforcement actions by the CFTC and the SEC (81 out of 3,035) have been against hedge funds and their advisers. In the last 12 years, the CFTC has brought 111 enforcement actions against CPOs and commodity pools. In the last 5 years, the CFTC has brought 43 enforcement actions against CPOs and commodity pools. [CFTC statistics]

The CFTC has investigated, and taken enforcement action where appropriate, in many of the most publicized hedge fund frauds in the past five years. In April 2004, for example, the CFTC sued the operator of the Shasta Fund for allegedly fraudulently soliciting at least $5.7 million from 29 or more investors – a mere two weeks after an independent website featured Shasta as the "hedge fund of the week." (CFTC Enforcement Press Release #4908 [April 6, 2004]) In June 2004, a federal court in Florida ordered the operator of the Orca Funds (Donald O'Neill and affiliated entities) to pay $12 million in restitution and civil monetary penalties totaling $10.6 million for fraudulent solicitation and misappropriating the investments of hedge fund participants. (*CFTC v. Donald O'Neill, et al.,* No. 02CV61307 [S.D. Fla. Order June 15, 2004]) The CFTC also has a pending federal injunctive action (as does the SEC) filed in early 2000 against the operator of the Maricopa Funds (David Mobley and affiliated entities) alleging a $59 million fraud, including misappropriating funds to support a lavish lifestyle for Mobley and his family and associates. (CFTC Enforcement Press Release #4368-00 [February 22, 2000])

In actions against CFTC registrants, in 2003 the CFTC filed an administrative statutory disqualification proceeding against Beacon Hill Asset Management, LLC (a registered CPO and CTA) to restrict its ability to participate in the futures and options industry based on alleged valuation and reporting misconduct regarding certain hedge funds it managed. (CFTC Enforcement Press Release #4734-03 [January 7, 2003]) The NFA also has proceeded against registrants in such situations, as in 2002 when it discovered that Integral Investment Management LP (a registered CPO and CTA) and its managing partner, Conrad Seghers, engaged in false advertising and false

statements to investors concerning the performance of several hedge funds. The Art Institute of Chicago was one of the investors. NFA coordinated with government authorities to take appropriate action. (NFA Business Conduct Committee, #02-BCC-003 [April 12, 2002])

One other case involving a pooled investment vehicle is the pending CFTC and SEC litigation (filed in 1999) against Martin Armstrong and Princeton Global Management, Ltd. (CFTC Enforcement Press Release No. 4312-99 [September 14, 1999]) The CFTC alleges that Armstrong arranged for an FCM (a commodities broker) to issue over 200 letters inflating the net asset values of fund assets, and then transmitted those letters to customers in Japan. The court has ordered Mr. Armstrong jailed for more than four years, held in civil contempt for continuing to refuse to turn over nearly $15 million in corporate assets to a court-appointed receiver. When the FCM settled criminal, CFTC, and SEC charges in 2001 based on its role, $606 million in restitution was awarded to defrauded investors in the criminal proceeding, and the CFTC ordered the FCM to pay $5 million as a civil money penalty. (CFTC Enforcement Press Release No. 4590-01 [December 17, 2001])

IV. NASD

On January 24, 2003, the National Association of Securities Dealers, Inc. ("NASD") advised in a *NASD Notice to Members Number 03-07*, that it was concerned about the sales practices of some of its members who sell direct interests in hedge funds and indirect interests through funds of hedge funds. Mary L. Schapiro, NASD Vice Chairman and President of Regulatory Policy and Oversight, stated "brokerage firms must fulfill their investor protection obligations when selling hedge funds, including suitability and disclosure. Although we are not charged with regulating hedge funds, we will scrutinize carefully the activities of broker-dealers when they sell these products."

As a result of a review of members that sell hedge funds and registered products (closed-end funds) that invest in hedge funds, the NASD has become concerned that some members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers. Obligations of members when selling hedge funds and funds of hedge funds, include:

(1) Providing balanced disclosure in promotional efforts;

(2) Performing a reasonable-basis suitability determination;

(3) Performing a customer-specific suitability determination;

(4) Supervising associated persons selling hedge funds and funds of hedge funds; and

(5) Training associated persons regarding the features, risks, and suitability of hedge funds.

On April 22, 2003, the NASD censured and fined Altegris Investments, Inc. of La Jolla, California, $175,000 for failing to disclose the risks associated with hedge funds. Some of the firm's sales literature also contained exaggerated and unwarranted statements about hedge funds. The NASD also censured and fined the firm's Chief Compliance Officer $20,000 for failing to adequately supervise the firm's advertising practices.

The NASD found that between October 2002 and February 2003, Altegris distributed 26 different pieces of hedge fund sales literature to its customers. Each of these marketing pieces failed to include important disclosures regarding specific risks of investing in hedge funds and made unbalanced presentations about particular hedge funds that failed to provide investors with a sound basis for

evaluating whether to invest in these hedge fund products.

Among the items that Altegris failed to disclose about the specific hedge funds were the following:

(1) The fund is speculative and involves a high degree of risk;

(2) The fund may be leveraged;

(3) The fund's performance can be volatile;

(4) An investor could lose all or a substantial amount of his or her investment;

(5) The fund manager has total trading authority over the fund. The use of a single adviser applying generally similar trading programs could mean lack of diversification and, consequentially, higher risk;

(6) There is no secondary market for the investor's interest in the fund and none is expected to develop;

(7) There may be restrictions on transferring interests in the fund;

(8) The fund's high fees and expenses may offset the fund's trading profits; and

(9) A substantial portion of the trades executed for the fund takes place on foreign exchanges.

Although some or all of these risks may have been described in offering documents to investors, such disclosure did not cure these violations of NASD's advertising rules. These rules require that each piece of sales literature independently comply with the rules' standards.

Two of the pieces of sales literature distributed by Altegris were research reports on specific hedge funds that were written by a registered representative at another member firm. These research reports contained several exaggerated and unwarranted statements and claims. For example:

(1) The first research report characterized the hedge fund as "an ideal fund for conservative investors." However, the Offering Memorandum indicated that the fund had a limited operating history, is speculative and involves a high degree of risk.

(2) In the second research report, the author made the following unwarranted projection of future performance: "Is he likely to continue to give us 12-14% years over the next 4-5 years? In my opinion, I think it is likely he will."

(3) The second research report inaccurately stated that the hedge fund was "subject to NASD inspection" and that "the NASD will audit the fund as well." The research report went on to say, "[f]or some, this layer of regulatory oversight is comforting." The statement is false since NASD did not and was not going to audit the hedge fund.

On August 18, 2003, the NASD announced three separate enforcement actions alleging multi-million dollar fraudulent hedge fund offerings:

(1) Win Capital Corp., Long Island, New York. NASD charged Win Capital Corp; Steven J. Bayern, the firm's Chairman; and Patrick M. Kolenik, its President, with securities fraud in connection with a hedge fund offering. In July 2002, Bayern and Kolenik formed Huntington Laurel Partners, L.P., a hedge fund, and were the principals of Huntington Laurel Capital Management, LLC, the general partner of the hedge fund. Bayern and Kolenik, through Win Capital, sold limited partnership interests in the hedge fund to 12 investors and raised approximately $1 million.

NASD charged that Bayern and Kolenik assisted in the preparation of the documents for the private placement, including a Confidential Private Offering Memorandum provided to investors in the hedge fund. Win Capital, acting through Bayern and Kolenik, failed to disclose material facts to investors relating to the use of $700,000 of the $1 million raised. Bayern and Kolenik failed to disclose that in September 2002, they used $300,000 of the $1 million to buy a note from a company they jointly controlled, Cyndel & Co. They had previously used Cyndel & Co. to lend $300,000 to a friend and business colleague. Separately, Bayern and Kolenik used $400,000 more of the funds raised from investors in the hedge fund to provide an additional loan to this same friend and colleague. Bayern and Kolenik did not disclose in the Offering Memorandum, or by any other means, this use of proceeds or their self-dealing through the hedge fund's purchase of the note from Cyndel & Co.

(2) Shelman Securities Corp., Dallas, Texas. NASD charged Shelman Securities Corp. and Mark C. Parman, the firm's Chairman, with securities fraud in connection with an unregistered hedge fund offering. The complaint alleged that from 1998 through 2000, Shelman and Parman made fraudulent offers and sales of more than $2 million of unregistered securities in the form of limited partnership interests to at least 104 investors located throughout the United States. Of that amount, approximately 30%, or more than $600,000, was paid to Shelman, the exclusive underwriter of the offerings, and Prism Independent Consulting, Inc., an entity owned by Parman, for purported expenses, fees, and commissions.

The complaint further charged that Parman, in his capacity as the President and sole owner of Prism, drafted private placement memoranda provided to investors in the offerings that were inaccurate and incomplete. For example, the memoranda falsely stated that funds from the offerings would not be commingled when, in fact, they were. The complaint also charged that none of the securities were registered with the SEC or any other regulatory authority and that no exemption from registration was available. Investors who purchased these securities lost at least $1.7 million.

(3) Neil W. Brooks. In his settlement with the NASD, Brooks, a registered representative formerly associated with Allstate Financial Services, agreed to a bar from the securities industry for conducting a fraudulent hedge fund offering. Brooks, who neither admitted nor denied the allegations, consented to NASD charges that, during the period from February 2002 through April 2002, he offered and sold securities in the form of limited partnership interests and promissory notes. The NASD found that Brooks provided sales materials to investors that contained materially false and misleading information. Among other things, the materials represented that investments would be secured with certificates of deposit in an FDIC-insured financial institution when, in fact, no such certificates of deposit existed.

The NASD also found that Brooks engaged in private securities transactions, by failing to provide prior written notice to, and obtain approval from, his employer regarding his activities and that Brooks was not properly licensed to offer and sell securities.

State Street Research

In 2004, the NASD had been active in the market timing and late trading enforcement area. On February 19, 2004, the NASD announced that it fined State Street Research Investment Services, Inc. ("SSR") $1 million for failing to prevent market timing of State Street Research mutual funds due to its inadequate supervisory systems. SSR also agreed to pay more than $500,000 in restitution to the individual State Street Research mutual funds to compensate for the losses attributed to the market timing activity. SSR, located in Boston, Massachusetts, distributes State Street Research mutual funds to NASD-regulated broker-dealers for sale to their customers.

The NASD found that, from 2001 through August 2003, SSR's inadequate supervisory system improperly permitted the customers of at least one other securities firm, Prudential Equity Group, Inc., formerly known as Prudential Securities, Inc., to exchange (alternatively buy and sell) shares of State Street Research funds beyond the annual limits set forth in the prospectuses. The annual limits, typically six exchanges per year, were designed to limit market timing in the funds.

In its investigation, the NASD found that by November 2001, SSR's operations personnel had reason to believe that the Boston office of Prudential Securities was engaged in market timing activities on behalf of its clients and that, among others, certain Prudential Securities customers had been able to exchange shares of State Street Research funds beyond the annual limits described in the applicable prospectus.

SSR was aware that a number of Prudential Securities' registered representatives engaged in deceptive conduct so that their customers could exchange funds in excess of prospectus limits. For example, if SSR sent "block letters" prohibiting customers from making future fund exchanges in an account because the customer had exceeded a fund's annual exchange limit, Prudential Securities' registered representatives would use a different account number for that customer in order to evade the block. This ensured the "blocked" customer would be able to continue to buy and sell shares of that fund.

The NASD found that SSR's supervisory procedures and systems were not adequate to prevent and detect customers' circumventing the block restrictions. The firm's written supervisory procedures and systems failed to provide for adequate follow-up to the "block letters" it sent to brokerage firms. Some customers of these firms were able, through the establishment of new customer accounts, to continue trading in SSR funds even after one of their accounts had been blocked. Moreover, SSR's systems and procedures were not able to ensure that accounts were blocked in a timely manner. In several instances, SSR sent "block letters" after the customer had already exceeded the fund exchange limits. The firm did not have an effective system for tracking and enforcing compliance with the "block letters."

In addition to fining the firm, the NASD also required SSR to certify that it had disclosed all instances of fund trading that was inconsistent with the prospectus exchange limits and that it had implemented appropriate systems and controls with respect to market timing.

During its investigation, the NASD also found that SSR failed to preserve and maintain internal e-mail communications relating to the firm's business as required by the federal securities laws and NASD rules. For example, the firm failed to retain all e-mails that were sent but later deleted by its employees.

In addition to paying a $1 million fine, SSR was ordered to pay more than $500,000 to the State Street Research funds to compensate them for losses resulting from the prohibited market timing during the 3-year period ending December 31, 2003.

On June 24, 2004, the NASD announced that it censured and fined five brokerage firms a total of $625,000 for failing to implement adequate supervisory systems and written procedures reasonably designed to detect and prevent "late trading" of mutual funds. The firms and their respective fines are:

- D.A. Davidson & Co. ($150,000)
- TD Waterhouse Investor Services, Inc. ($150,000)
- Stifel Nicolaus & Company ($125,000)
- National Planning Corp. ($100,000)
- SII Investments, Inc. ($100,000)

"Late trading" refers to the practice of placing mutual fund orders after the fund has calculated its daily net asset value – typically 4 p.m. EST – but receiving the price based upon that earlier, 4 p.m. calculation. Firms that permit late trades can provide customers with an information advantage, allowing them to trade based on news that breaks after the market close that could affect the value of the mutual fund's holdings, but which is not reflected in the net asset value ("NAV") for that day.

Each of the aforementioned firms permitted its registered representatives to process mutual fund orders after the close of the market, but none of the firms had adequate systems in place to ensure that only orders received prior to that day's market's close received that day's NAV. One firm, D.A. Davidson & Co., was also cited for failing to comply with a new record-keeping rule that went into effect in May 2003 requiring firms to record the time of receipt of orders to buy or sell mutual fund shares.

While there may be situations where firms legitimately receive orders prior to the close of trading but enter such orders after the market's close, firms bear the burden of demonstrating that they have procedures designed to prevent the occurrence of late trading.

National Securities Corp.

On August 19, 2004, the NASD for the first time prohibited a regulated firm, National Securities Corp., from opening mutual fund accounts for new clients for 30 days for facilitating deceptive market timing practices and for failing to have an adequate supervisory system to prevent deceptive market timing and late trading. National Securities Corp. ("National"), based in Seattle, Washington, was also fined $300,000 and ordered to pay almost $300,000 in restitution to the funds that were affected by the deceptive market timing. In addition, National was ordered to revise its supervisory systems to correct supervisory and e-mail retention deficiencies. National's president, Michael A. Bresner, was fined $25,000 and received a 1-month supervisory suspension for the firm's supervisory failures. David M. Williams, the firm's former chief operating officer, was also fined $25,000 and received a 4-month supervisory suspension.

The NASD found that from January 2001 through August 2002, National helped four hedge fund clients engage in deceptive market timing practices aimed at 13 mutual funds that had restrictions and prohibitions against these practices. The hedge fund clients transacted at least 1,000 mutual fund trades, totaling nearly $400 million, after National had received notices that the fund companies considered the timing strategy of the clients to be disruptive and contrary to the interests of long-term investors. These notices were ignored as the hedge fund clients reaped profits of approximately $300,000 at the expense of long-term investors.

Despite the issuance of multiple notices by the mutual funds demanding that the hedge fund clients stop market timing their funds, National failed to prevent them from continuing to trade the funds through deceptive means. For example, after an account was restricted by a fund for market timing, the hedge fund client would evade subsequent detection by shifting the

prohibited activity to another brokerage account that it controlled. In a few instances, the hedge fund client continued to time the fund through the very same account that had been restricted by the fund company. This resulted in the issuance of additional notices or warnings until the account finally complied with the market timing restriction.

At least two of National's senior officers, Bresner and Williams, failed to ensure that the firm had an adequate supervisory system designed to prevent and detect deceptive market timing practices. They also failed to respond to red flags that pointed to the deceptive practices. Bresner, Williams, and other supervisors received multiple notices from the affected funds directing that the hedge fund clients stop the market timing activity. Additionally, prospectuses and selling agreements for the mutual funds contained explicit restrictions or limitations on market timing. Instead of placing limitations on the evasive activities of the hedge fund clients, however, National assumed a hands-off approach with respect to their deceptive practices.

During its investigation, the NASD also found that National failed to preserve and maintain internal e-mail communications relating to the firm's business, as required by the federal securities laws and NASD rules.

Citigroup Global Markets, Inc.

Finally, on October 25, 2004, the NASD censured and fined Citigroup Global Markets, Inc. $250,000 for disseminating inappropriate sales literature. More than 100 pieces of sales literature distributed between July 1, 2002, and June 30, 2003, cited a targeted rate of return without providing a sound basis for evaluating the target, improperly used hypothetical returns in charts or graphs, and/or failed to include adequate risk disclosure. "As hedge funds and 'funds of hedge funds' are marketed more and more aggressively to individual investors, ensuring that those investors receive full and accurate information is critical," said NASD Vice Chairman Mary L. Schapiro. "This enforcement action underscores our commitment to making certain that firms provide the investing public with a sound basis for evaluating hedge fund investments, and adequately disclose all of the risks." Among the objectionable statements relating to targeted rates of return:

- "The Portfolio seeks to earn an annualized return of 15% or more, net of all fees, over a three- to five-year investment horizon, while maintaining volatility below that of world equities."
- "…targets a 12-14% annual net return…"
- "The portfolio seeks to earn an annualized return of LIBOR + 500 basis points."

Twenty-eight of the sales pieces for recently started funds of hedge funds improperly presented hypothetical performance for these funds. This hypothetical performance showed results for the funds before they had begun operating and, therefore, did not reflect the actual performance of the funds of hedge funds. Instead, these hypothetical results were calculated by selecting a portfolio of individual advisers with whom the fund of hedge funds intended to or had recently begun to invest, and then combining the historic performance results of these selected advisers, using a hypothetical allocation of assets.

Because it reflected the selection of potential advisers and asset allocations made after the performance of those advisers was already known, the hypothetical performance invariably showed positive rates of return. Further, there was no guarantee that the particular fund of the hedge funds being promoted would continue to invest with any or all of the selected advisers – or that allocation of assets to those advisers would be the same as that used in the hypothetical performance.

In addition, in some instances, the sales literature presented hypothetical performance

results in a chart or graph in combination with the actual historical performance of the fund of hedge funds. Such presentations created the misimpression that the particular fund of hedge funds had a longer investment track record than it actually possessed.

Forty-four pieces of sales literature failed to include adequate risk disclosure. Each of these pieces contained some risk disclosure, but not full and complete risk disclosure. Among the disclosures that were not included: that the funds were speculative and involved a high degree of risk; that an investor could lose all or a substantial amount of his or her investment; that there was no secondary market nor was one expected to develop for investments in the funds; that there might be restrictions on transferring fund investments; that the funds may be leveraged; that the funds' performance may be volatile; that the funds had high fees and expenses that would reduce returns, and other specific risks as to the particular funds' investments and strategies.

V. New SEC Rule 206(4)-8

In August 2007, the SEC adopted a new Rule 206(4)-8 that prohibits advisers to pooled investment vehicles from making false and misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles. The rule was designed to clarify, in light of a recent court of appeals decision, the SEC's ability to bring enforcement actions under the Investment Advisers Act against investment advisers who defraud investors or prospective investors in a hedge fund or other pooled investment vehicle.

The rule applies to both registered and unregistered advisers. The rule makes it a fraudulent, deceptive or manipulative act in violation of the Advisers Act for an adviser to a pooled investment vehicle to:

- Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
- Otherwise engage in any act, practice or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

For purposes of the rule, a "pooled investment vehicle" includes any investment company, as defined under the Investment Company Act, and any company that would be an investment company but for the exclusions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act (e.g., hedge funds, private equity funds, venture capital funds, and other types of privately offered vehicles that invest in securities). The rule does not distinguish between pooled investment vehicles based on their investment strategies, type of fund or any lock up period. Moreover, the rule is not limited to fraud in connection with the purchase or sale of interests in a pooled investment vehicle. Finally, the rule does not create a private right of action and, therefore, does not alter the standard of liability to investors.

VI. Conclusion

Enforcement action against hedge funds and their advisers has been and will continue to be a high priority for the three federal regulators. With the ongoing retalization of hedge fund products, the globalization of the capital markets, and the increasing complexity of derivative products, fraud involving hedge funds will continue to be front-page news.

Variable annuities are sold more aggressively than fake Gucci handbags on the streets of New York City. – SmartMoney.com[1]

Is a Variable Annuity a "Security"?: Making Sense of Inconsistent State and Federal Securities Statutes

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I. Introduction

Sales of variable annuities have grown at an enormous rate during the last decade. Despite the tremendous increase in sales, a growing consensus among experts in the financial industry finds that variable annuities are suitable for only a small percentage of the investing public. It should come as no surprise, then, that as variable annuity sales have increased, so too have reports of investor abuse involving such products. Regulators have identified abuse in the sale of variable annuities as a growing problem in the industry, and continually send warnings to the investing public to beware of fraud and other misconduct by brokers looking to enrich themselves at the expense of the unwary investor.

Variable annuities are a unique investment vehicle from a regulatory perspective. Because these products have both an insurance component and securities component, the states have been left to themselves to decide the best manner in which to regulate their purchase and sale. Some states consider variable annuities to fall within the definition of "security" as provided in the state's respective securities statutes. The majority of states, however, do not consider a variable annuity to be a "security." The resulting patchwork of state security statutes may leave the multi-jurisdictional practitioner in a quandary as to the appropriateness of invoking a particular state's securities act in cases involving annuity sales. The applicability of securities statutes is important because most provide injured investors with remedies such as attorneys' fees, interest, costs and other equitable relief. These remedies might not otherwise be available to claimants bringing claims under common law causes of action.

The purposes of this article are to: (1) briefly introduce the reader to the variable annuity as an investment product; (2) identify common abuses often perpetrated by those selling variable annuities; (3) provide guidance for determining whether or not a particular state's securities laws apply to variable annuities; and (4) suggest alternative causes of action for cases arising in jurisdictions in which variable annuities are not considered to be "securities."

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[1] *What's Wrong with Variable Annuities*, SmartMoney.com, *at* http:www.smartmoney.com/retirement/investing/index.cfm?story=wrongannuities (updated September 10, 2007).

II. What is a Variable Annuity?

A variable annuity, also commonly referred to as a variable life insurance contract, is a hybrid investment product containing both securities and insurance components.[2] The dual nature of this type of investment product has created a patchwork of confusing regulatory efforts. As noted in one variable annuity prospectus:

> Our products are subject to a complex and extensive array of state and federal tax, securities and insurance laws, and regulations, which are administered and enforced by a number of governmental and self-regulatory authorities.[3]

A. The Securities Component.

The securities component of a variable annuity provides the purchaser with the potential to obtain capital appreciation and earn income through investments in various securities products (such as mutual funds, stocks or bonds). As a result, the purchaser bears the risk of the market as long as he or she owns the annuity. When a variable annuity is purchased, the amount paid is invested in securities held within the annuity's "sub-account." In most cases, the purchaser is offered a list of available securities to populate the sub-account, and may choose to diversify the portfolio in the same manner as any other brokerage account. The value of the annuity will fluctuate as the value of the assets held in the sub-account rises or falls over time. Sub-accounts overconcentrated in any particular security or asset class may be disproportionately affected by volatility in the market. The time period during which the annuity sub-account holds securities is commonly referred to as the "accumulation phase."

B. The Insurance Component.

The insurance component of a variable annuity provides the purchaser with the means to mitigate market risk. For example, the purchaser may elect to "annuitize" the investment, meaning that at the end of the accumulation phase the insurance company will provide the purchaser with a series of periodic payments over time (the payment amount is determined, in part, by the value of the investment at the time it is annuitized). In addition, the insurance company may offer a "death benefit" to the purchaser's beneficiary, meaning that if the purchaser dies during the accumulation phase and the account balance is less than a certain, predetermined benchmark (often times the beginning balance amount), the insurance company will pay an amount equal to the deficiency to the beneficiary. The variable annuity's insurance features aren't free. The purchaser is subjected to management fees in much the same manner as owners of mutual funds in traditional brokerage accounts. The insurance company levies fees for "mortality and expense" charges, which are comparable to 12b-1 fees assessed by load mutual fund companies. Other fees include charges for riders or other special features (such as enhanced death benefits or guaranteed minimum income benefits), front end or back end loads, administrative fees, advisory fees, and other underlying fund expenses.[4] One study by Morningstar found that the average annual expense on variable annuity sub-accounts stands at 2.3% of assets.[5] By

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[2] *Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*, Securities Exchange Commission and National Association of Securities Dealers, at 2 (June 9, 2004), *at* http://www.sec.gov/news/studies/secnasdvip.pdf (referred to hereinafter as the "JOINT REPORT").

[3] Prospectus, ING GoldenSelect Premium Plus® Deferred Combination Variable and Fixed Annuity Contract, at 7 (April 30, 2007).

[4] JOINT REPORT, *supra* note 2, at 6-7.

[5] *Id.* at 6.

comparison, the average mutual fund charges just 1.44%.[6]

Variable annuities are intended to be long term investments. The insurance company will charge a significant "surrender penalty" to the purchaser if he or she attempts to liquidate the sub-account during the first few years of the accumulation phase (usually between five to ten years, depending on the individual contract). The amount of the surrender penalty should be clearly set forth in the annuity's prospectus, and usually decreases with time. According to Morningstar, the average surrender penalty is 7.2%. Not coincidentally, the surrender penalty usually bears a striking similarity to the commission paid by the insurance company to the salesman.

C. Tax Considerations.

Variable annuities are entitled to favorable tax treatment under the Internal Revenue Code.[7] The tax-deferral features of the variable annuity allow for growth during the accumulation phase without triggering income or capital gains taxes. Further, the tax-deferral feature permits owners to make changes in the sub-account portfolio without incurring any tax liability. Note, however, that withdrawals made before age 59 ½ may be subjected to a 10% early withdrawal tax penalty.

Gains in the sub-accounts are taxed at ordinary income tax rates, which may be as high as 35%, as opposed to capital gains tax rates, which may be 15% or lower.[8] In the event of the purchaser's death during the accumulation phase, the beneficiary may receive the proceeds of the death benefit tax free, but any gains in the sub-account are taxed as ordinary income. This is in sharp contrast to the tax treatment of ordinary securities, which are generally inherited at the stepped-up basis at the time of owner's death.

III. Unsuitable Sales Practices Relating to Variable Annuities.

In 2005, the North American Securities Administrators Association ("NASAA") published its annual top ten list of "Threats to Investors."[9] Variable annuity sales practice ranked number 9 on the list. That same year, California's Department of Corporations (the state's securities regulator) published its annual "'Dirty Dozen' Investment Scams" notice to investors.[10] Variable annuities sales ranked number 2 on the list. The SEC/NASD Joint Report of 2004 identified a host of abusive sales practices perpetrated by brokers and brokerage firms, although the report euphemistically referred to them as "weak practices."[11] The commissions available to those who sell variable annuities are steep, "typically above 5%,"[12] and provide a powerful incentive to aggressively market such products to customers for whom they are unsuited. According to the JOINT REPORT, brokers routinely recommend variable annuities without regard to customers' age, investment objectives, risk tolerance, need for liquidity, eligibility for the

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[6] *Id.*

[7] *Id.* at 7.

[8] *Id.*

[9] NASAA's 2005 Top 10 Threats to Investors, North American Securities Administrators Association (March 24, 2005), *at* http://www.nasaa.org/nasaa_newsroom/current_nasaa_headlines/2719.cfm#.

[10] California Issues "Dirty Dozen" Investment Scams for 2005, William P. Wood, Commissioner, California Department of Corporations, News Release 05-03 (February 2, 2005), *at* http://www.corp.ca.gov/pressrel/05/corp/nr0503.htm.

[11] JOINT REPORT, *supra* note 2, at 9.

[12] *Id.* at 2.

investment and other critical factors.[13] Further, brokerage firms have inadequately supervised their registered representatives, and failed to control inappropriate sales practices.[14] These types of warnings to the public paint a grim picture of the brokerage industry's practice of selling variable annuities to unwary investors.

A. Variable Annuities are Subject to Industry Rules Regarding Suitability.

As noted by the former NASD (n/k/a FINRA) Chairman and CEO Robert R. Glauber, "Variable insurance products have always been subject to the suitability, disclosure and other requirements that apply to all securities."[15] In other words, the sale of variable annuities is subject to the suitability rules of the NASD as set forth in NASD Conduct Rule 2310.[16] In 1986, the NASD issued a Notice to Members that outlines factors in determining whether a variable annuity is suitable for a given client.[17] Those factors include, but are not limited to, "the customer's need for liquidity", "the customer's need for retirement income," and "the customer's willingness to invest a set amount on a yearly basis."[18]

For retired investors needing immediate income, variable annuities are rarely suitable. Liquidity problems, ongoing fees and expenses, volatility in the values of mutual funds in the sub-accounts, and the fact that withdrawals for income during the investor's lifetime could ultimately diminish the death benefit may make variable annuities unsuitable for retirees. Such investments do very little for the living who need retirement income, and even less for their heirs should withdrawals be necessary. Also, the tax-deferred feature of a variable annuity is wasted on an IRA, which is already tax-deferred.

The sale of variable annuities has been under intense scrutiny by the NASD. In a notice to members in 2000,[19] the NASD reminded members of their supervisory obligations with respect to the sale of variable annuities, and reported on recent disciplinary actions against brokers who sold variable annuities. One common factor in the NASD's disciplinary decisions was the fact that the variable annuity had been sold to a retiree.[20]

Considering the comparatively high fees, lack of liquidity, adverse tax consequences upon death, and crushing surrender penalties, it is safe to say that variable annuities are only suitable for a small group of investors. This would include investors who are relatively young (under age 40), maximize their annual IRA and/or 401(k) contributions, and have little-to-no need for liquidity.

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[13] *Id.* at 9.

[14] *Id.* at 10.

[15] Press Release, U.S. Securities and Exchange Commission, SEC and NASD Release Joint Staff Report on Broker-Dealer Sales of Variable Insurance Products, 2004-80 (June 9, 2004), *available at* http://www.sec.gov/news/press/2004-80.htm.

[16] Section 2310 of the NASD's Conduct Rules provides: In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer on the basis of facts, if any, disclosed by such customer as to his other security holdings and to his financial situation and needs.

[17] NASD NTM 96-86.

[18] *Id.*

[19] NASD NTM 00-44.

B. Common Unsuitable Sales Practices

The concept of suitability extends not only to the recommendation to purchase the variable annuity itself, but also to the activity within the annuity sub-accounts as well. The sales practices listed below have been recognized as abusive and violative of the industry's

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[20] A sampling of additional relevant NASD guidance and criticism is as follows:

- NASD NTM 97-27 (Reminding its members of their compliance obligations with respect to the sale of group variable contracts).
- NASD NTM 99-35 (Establishing best practice guidelines for the supervision of the sale of variable annuities).
- NASD NTM 04-45 (Setting forth a proposed rule governing the purchase, sale, or exchange of variable annuities and stating that the "NASD has become increasingly concerned about some members' unsuitable recommendations and inadequate supervision of transactions in deferred variable annuities").
- NASD Press Release dated February 15, 2001: "NASD Regulations files Six Enforcement Actions Involving Marketing and Sales of Variable Annuities."
- NASD Press Release dated December 5, 2001: "NASD Regulation Announces Two Enforcement Actions Involving Sales of Variable Annuity and Life Insurance Contracts."
- NASD Press Release dated December 4, 2002: "NASD Fines American Express Financial Advisors $350,000 for Improper Sales of Variable Annuities and Life Insurance."
- NASD Press Release dated May 27, 2003: "NASD Takes Disciplinary Actions for Variable Annuity Abuses and Issues Investor Alert on Variable Products" ("[i]nvesting in a variable annuity within a tax-deferred account, such as an individual retirement account may not be a good idea. Since IRAs are already tax-advantaged, a variable annuity will provide no additional tax savings. It will, however, increase the expense of the IRA, while generating fees and commissions for the broker or salesperson.")
- NASD Press Release dated July 30, 2003: "NASD Charges Louisiana Broker with Unsuitable Sales of Variable Annuities and Mutual Funds of More than $6 Million."
- NASD Press Release dated January 12, 2004: "NASD Bars Louisiana Broker and Orders Restitution for Unsuitable Sales of Variable Annuities and Mutual Funds."
- NASD Press Release dated January 14, 2004: "NASD Charges Waddell & Reed with Suitability Violations Relating to Thousands of Variable Annuity Exchanges and Seeks Customer Compensation; Two Senior Execs Also Charged."
- NASD Press Release dated January 29, 2004: "NASD Fines Prudential $2 Million; Orders $9.5 Million to Customers for Annuity Sales in Violation of NY Insurance Regs."
- NASD Press Release dated April 26, 2004: "NASD Proposes Specific Requirements for Deferred Variable Annuity Sales; Concerns Over Suitability, Disclosure, Supervision Cited."
- NASD Press Release dated May 20, 2004: "NASD Disciplines Three Firms, Three Brokers for Variable Annuity Abuses; Total Fines Exceed $500,000, With Two Brokers Permanently Barred."
- NASD Press Release dated June 9, 2004: "SEC and NASD Release Joint Staff Report On Broker-Dealer Sales of Variable Insurance Products."
- NASD Press Release dated November 29, 2004: "NASD Bars Former AmSouth Broker for Fraud in the Sale of Variable Annuities."
- NASD Press Release dated April 29, 2005: "Waddell & Reed, Inc. Agrees to Pay $5 Million Fine, up to $11 Million in Restitution to Settle NASD Charges Relating to Variable Annuity Switching."

suitability rules.

i. Unsuitable Recommendation to Purchase a Variable Annuity.

Unsuitable variable product recommendations are made when the broker has no reasonable basis in light of information the broker may have had regarding the customer's age, financial or tax status, investment objectives, investment sophistication, low risk tolerance, need for liquidity, lack of or need for life insurance, ineligibility under the terms of the prospectus and other relevant information. Brokers who adopt a "one-size-fits-all" strategy in which every customer gets a variable annuity are likely ignoring their suitability duties.

ii. Commission Churning and Product Switching.

As explained above, brokers are entitled to a substantial commission for selling variable annuities. Churning occurs when a broker uses unfounded, false or misleading justifications as a basis for recommending that a customer switch variable annuities. Such switching may trigger significant surrender penalties, a fact often not disclosed to the customer, and provide enormous commissions to the broker. It is worth noting that many salespersons use the "bonus credit" offered by many insurance companies to justify an unsuitable switch, often characterizing the bonus as "free money." A bonus credit provides the annuity purchaser with a small addition to the contract's beginning account value (typically between 1% to 5% of the amount invested). While this may provide the investor with a higher initial principal, the bonus almost always comes with costly strings attached. Increased surrender penalties, longer surrender periods, and inflated expenses are just some of the ways the purchaser may be disadvantaged by electing to take the bonus credit. In many cases the costs of a bonus credit may actually far exceed the benefits.

iii. Failure to Disclose Material Information.

Brokers have a duty to disclose all fees, costs, and risks associated with the purchase of a variable annuity, as well as to explain the lack of liquidity of variable products, guaranteed death benefit, tax implications and the potential consequences of financing variable products. In cases of switching variable products, the broker must disclose whether or not the transaction will lead to a surrender penalty or loss of bonus credit.

iv. Unsuitable Asset Allocation of the Annuity Sub-Account.

Even if the variable product is suitable for the customer, the broker must adhere to principles of suitability when making investment recommendations for the annuity sub-accounts. For example, sub-accounts overconcentrated in high-risk securities may be unsuitable for a customer with a low risk tolerance and conservative investment objective.

IV. Is a Variable Annuity a "Security"?

Victims of variable annuity sales abuse have many choices when it comes to selecting appropriate causes of action. In many jurisdictions, the claimant may be able to invoke the applicable securities act in order to take advantage of statutorily provided remedies, such as attorneys' fees, costs, interest, etc. However, only a minority of states recognize variable annuities as securities, notwithstanding the fact that the annuity sub-accounts consist entirely of stocks and bonds (by way of mutual funds). This section will attempt to provide guidance for determining whether or not a particular jurisdiction's securities statutes provide investors with protection in cases of unsuitable variable annuity sales.

A. Variable Annuities Are Considered "Securities" Under Federal Law

In *S.E.C. v. Variable Annuity Co.*,[21] the United States Supreme Court held that a variable annuity is a "security," as the term is defined in the Securities Act of 1933.[22] In *Variable Annuity Life*, the Court was tasked with determining whether or not insurance companies that issued variable annuities were required to register such products with the Securities and Exchange Commission. The insurance companies argued that the Securities Act's exemption for insurance products applied to variable annuities, and therefore such products were excluded from the definition of "security." The SEC had attempted to enjoin the insurance companies from offering their variable annuity contracts without properly registering them with the Commission. The Court sided with the SEC, and found that the Act's definition of "security" was broad enough to include variable annuity contracts, and therefore, the Court held, such products must be registered in accordance with the Securities Act. The Court's holding has never been overturned.

In reaching its conclusion, the Court explained that the insurance component of the variable annuity was not substantial enough to justify nullifying legislative protections provided in the Securities Act. The Court stated:

> [A]bsent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interests reflects--which may be a lot, a little, or nothing....But we conclude that the concept of "insurance" involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense....The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities [footnote omitted]--an interest that has a ceiling but no floor.[footnote omitted] There is no true underwriting of risks, [footnote omitted] the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.[23]

As a result of the Court's decision, investors victimized by abusive or unsuitable sales practices relating to variable annuities may choose to plead causes of action arising under federal securities laws. Whether or not this is advisable is outside the scope of this article, as there are strong arguments both for and against invoking the anti-fraud provisions of the various federal securities statutes.

B. Variable Annuities *May* Be Considered "Securities" Under State Law

The Securities Act of 1933 preserves the right of the individual states to regulate securities fraud.[24] As a result, each state is free to establish the scope of protection afforded to investors, and define the term "security" in a manner which may or may not include variable annuities. It should come as no surprise that there are significant differences in the states' treatment of variable products. Only a minority of states consider variable annuities to fall within the definition of "security" as provided in the state's respective

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[21] *S.E.C. v. Variable Annuity Life Insurance Co. of America*, 359 U.S. 65 (1959).

[22] 15 U.S.C. § 77b (a)(1).

[23] *Variable Annuity Life Ins. Co. of America*, 359 U.S. at 69-73.

[24] 15 U.S.C. § 77r (c)(1).

securities statutes. The majority of states, however, have declined to do so.

In 2006, the Hawaii Legislature published an exhaustive study of state securities statutes relating to variable annuity contracts.[25] The HAWAII REPORT included an ambitious survey of the fifty states' securities statutes' definitions of "security," and whether or not the definitions excluded variable annuities. The results of the HAWAII REPORT, as well as the methodology employed in the study, are explained below.

i. Statutory Construction and Interpretation

The first step in determining whether or not a particular state's securities act applies to variable annuities is to analyze the text of the provision defining the term "security." The vast majority of such statutes exclude certain annuities from the definition of "security." At first blush it is difficult to determine whether fixed and variable annuities are treated equally under such statutes. For states that have adopted some version of the Uniform Securities Act ("USA"),[26] the official code comments provide guidance for statutory interpretation.

a. 1956 Version of the Uniform Securities Act

The 1956 version of the USA provides in Section 401(1) that:

> "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay **[a fixed sum of]** money either in a lump sum or periodically for life or for some other specified period. (emphasis added)

The official comments applicable to Section 401(1) provides that:

> The last sentence has been explicitly phrased so as not to exclude from the definition the so-called "variable annuities" which have been recently developed. …If it is desired to exclude variable annuities along with orthodox annuities on the ground that the former are sufficiently regulated by the insurance authorities in the particular state, **the bracketed language should be deleted**.[27]

Simply stated, if the text of the definitions statute retains the phrase "a fixed sum of," then the definition of "security" includes variable annuities. If the phrase has been removed, then the term "security" does not include variable annuities.

Using Washington as an example, the state's statutory definition of "security" specifically excludes an "annuity contract under which an insurance company promises to pay ***a fixed sum*** of money either in a lump sum or periodically for life or some other specified period."[28] Note the phrase "a fixed sum" has not been deleted. Accordingly, the term "security" includes variable annuities under Washington's Securities Act.

The HAWAII REPORT indicates that the following states have adopted the 1956

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[25] Dean Sugano, *Variable Annuity Contracts Under State Statutes Relating to Securities and to Insurance*, Legislative Reference Bureau, December 2006, *at* http://hawaii.gov/lrb/rpts06/annuity.pdf (hereinafter referred to as the "HAWAII REPORT").

[26] The Uniform Securities Act first appeared in 1956, and was updated in 1985 and 2002.

[27] HAWAII REPORT, *supra* note 25, at 29 (citing Uniform Securities Act (1956), as Amended, page 37, official code comment on section 401(1). National Conference of Commissioners on Uniform State Laws, *at* http://www.nasaa.org) (emphasis added).

[28] WASH. REV. CODE § 21.20.005(12)(b) (2002).

version of the USA: Alabama, Alaska, Arkansas, Connecticut, Delaware, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Montana, New Hampshire, New Jersey, North Carolina, Oregon, Pennsylvania, Utah, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

b. 1985 Version of the Uniform Securities Act

The 1985 version of the USA appears to have been drafted with the assumption that variable annuities are securities. Section 101(16) of the 1985 version of the USA provides:

> The term [security] does not include…an insurance or endowment policy or annuity contract under which an insurance company promises to pay **a fixed sum** of money either in a lump sum or periodically for life or some other specified period. (emphasis added)

The official comment for this section provides that:

> Similarly, insurance products providing for the payment of **a fixed sum** of money are excluded from the definition. **Variable annuities and similar products are treated as securities under this definition**, but are exempted from registration under Section 401(4).[29]

Accordingly, under the 1985 version of the USA, variable annuities are considered to be "securities" by default. The exclusion of annuities from the definition of "security" is therefore limited only to fixed annuities. Like the 1956 version of the USA, if the term "a fixed sum" is deleted from the statute, the definition of "security" will not include variable annuities. The HAWAII REPORT indicates that the following states have adopted the 1985 version of the USA: Colorado, Montana, Nevada, New Mexico, and Rhode Island.

c. 2002 Version of the Uniform Securities Act

The 2002 version of the USA provides a third framework for analysis. Under Section 102(28), the term "security"

> does not include an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed **[or variable]** sum or money either in a lump sum or periodically for life or other specified period; (emphasis added)

The official code comment to Section 102(28) provides:

> The Drafting Committee recognized that the decision whether to exclude variable annuities from the definition of security will be made on a state-by-state basis. **Those states which intend to exclude variable products from the definition of security should add the words "*or variable*"**…[30]

Therefore, if the definitions statute retains the phrase "or variable" then the term "security" does not include variable annuity contracts. If the phrase "or variable" has been deleted, then the term "security" includes variable annuity contracts.

In the case of Minnesota, for example, the term "security" excludes an "an annuity contract under which an insurance company

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[29] HAWAII REPORT, *supra* note 25, at 30 (citing Uniform Securities Act (1985), with 1988 Amendments, page 15, official code comment on section 101(16), National Conference of Commissioners on Uniform State Laws, *at* http://www.uniformsecuritiesact.org).

[30] HAWAII REPORT, *supra* note 25, at 30-31 (citing Uniform Securities Act (Last Revised or Amended in 2005), pages 32-34, official code comment on section 102(28), National Conference of Commissioners on Uniform State Laws, *at* http://www.uniformsecuritiesact.org) (emphasis added).

promises to pay a fixed **or variable** sum of money either in a lump sum or periodically for life or other specified period."[31] Note that the term "or variable" has not been deleted from the text. Accordingly, variable annuities are not included in the definition of "security." The HAWAII REPORT indicates that the following states have adopted the 2002 version of the USA: Hawaii, Idaho, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, South Carolina, South Dakota, and Vermont.

d. Non-Uniform Securities Act States

Many states have not chosen to adopt any of the three versions of the Uniform Securities Act described above, including: Arizona, California, Florida, Georgia, Illinois, Louisiana, New York, North Dakota, Ohio, Tennessee, and Texas. In these jurisdictions, the text of the definitions statutes must be interpreted without the benefit of the USA's official comments. Fortunately, many of these states have specifically addressed the issue of variable annuities in the statutory text. For example, in California, the definition of "security" excludes an "annuity contract under which an insurance company admitted to this state promises to pay a sum of money **(whether or not based upon the investment performance of a segregated fund)** either in a lump sum or periodically for life or some other specified period."[32] Georgia[33] and Louisiana[34] similarly provides an exclusion for "any variable annuity contract." States such as Tennessee[35] and Texas[36] simply exclude all annuity contracts, without distinguishing between fixed and variable annuities.

ii. Jurisdictions in Which Variable Annuities Are "Securities"

In addition to the methodology of statutory construction and interpretation explained above, the researchers for the HAWAII REPORT used additional means to form the Report's conclusions. Researchers contacted the securities administrators of many states to inquire about their respective interpretations of their securities acts. Further, they compiled evidence of enforcement actions relating to variable annuity contracts, brought under the various states' securities acts. This permitted them to infer that in states such as Massachusetts and Missouri, variable annuities are considered to be "securities."[37] Ultimately, the HAWAII REPORT concludes that the securities acts of the following states apply to variable annuities: Arizona, Florida, Hawaii, Kentucky, Massachusetts, Missouri, Montana, Nevada, New York, North Dakota, Rhode Island, South Dakota, Vermont, and Washington.[38]

iii. Jurisdictions in Which Variable Annuities Are Not "Securities"

The HAWAII REPORT concludes that the securities statutes of the following states do not apply to variable annuities: Alabama, Alaska, Arkansas, California, Colorado,

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[31] MINN. STAT. § 75-71-105(n).

[32] CAL. CORP. CODE § 25019 (2001).

[33] GA. CODE ANN. § 10-5-2(a)(26) (2002).

[34] LA. REV. STAT. ANN. § 51:702(15)(b) (2006).

[35] TENN. CODE ANN. § 48-2-102(16) (2002).

[36] TEX. REV. ANN. 581-4(A).

[37] See HAWAII REPORT, *supra* note 25, at 28 (providing several enforcement actions and consent orders initiated by Massachusetts' and Missouri's securities administrators).

[38] See HAWAII REPORT, *supra* note 25, at Table 4.

Connecticut, Delaware, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Virginia, West Virginia, Wisconsin and Wyoming.[39]

V. Alternative Causes of Action in Jurisdictions Where the Securities Act Does Not Include Variable Annuities.

In those jurisdictions in which an injured investor is precluded from invoking the state's securities act, several common law causes of action may be available to provide the claimant with the desired relief. This section will provide examples of potentially viable causes of action from several jurisdictions that may be pled in variable annuity cases.

A. Breach of Contract

An investor subjected to abusive and unsuitable sales practices may have a viable cause of action for breach of contract. When a brokerage firm has agreed to abide by regulatory laws and rules, such rules are deemed incorporated into the customer/ broker agreement and a violation of those laws and rules constitutes a breach of contract, as noted in *Brumm v. McDonald & Co.*[40] As the *Brumm* court explains,

> "[a]dditionally we note a number of cases in which customers of stockbrokers are deemed to have contemplated and authorized a course of dealing in accordance with the rules and customs of the stock exchanges. *See, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc.* (1966), 90 N.J.Super. 565, 570, 218 A.2d 655. 657-658; *Lynch v. Maw* (1955), 3 Utah 2d 271, 274, 282 P.2d 841, 843; *Korns v. Thomson & McKinnon* (D.Minn.1938), 22 F.Supp. 442, 447. **Thus the exchange rules are deemed incorporated into any agreement between customer and broker**. *Thomson McKinnon Securities, Inc. V. Clark* (C.A.11 1990), 901 F.2d 1568, 1570-1571."[41]

The *Brumm* court is not alone in its holding, and it is well established that where a brokerage firm agrees to comply with regulatory requirements, a violation of suitability rules is a breach of contract.[42] In *Komanoff v. Mabon, Nugent & Co.*, the Court explained that regardless of whether an investor could assert a private cause of action based directly on the violation of an SRO rule, the investor had a viable breach of contract cause of action based on the same violation.[43] Accordingly, in addition to

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[39] See HAWAII REPORT, *supra* note 25, at Table 4.

[40] *See, e.g., Brumm v. McDonald & Co.*, 603 N.E.2d 1141 (Ohio 1942).

[41] *Id.* (Emphasis added).

[42] *Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848, 859-60 (S.D.N.Y. 1995).

[43] *Id.* Accord, *Hofmayer v. Dean Witter & Co.*, 459 F. Supp. 733, 739 (N.D. Cal.1978) (where plaintiff alleged violations by defendant of certain rules of the Chicago Board of Trade and the Chicago Mercantile Exchange, plaintiff's claim "should properly have been separated into two counts, for it allege[d] both a breach of contract requiring [defendant] to abide by the rules of any exchange or market where transactions are executed, and an independent claim arising from the violation of the rules."); *Iowa Grain v. Farmers Grain and Feed Co.*, 293 N.W.2d 22, 25 (Iowa 1980) ("A broker's covenant with its customer that it will follow exchange rules and customs establishes a contractual duty to the customer."); *Index Futures Group, Inc. v. Ross*, 199 App.3d 468, 145 Ill. Dec 574, 557 N.E.2d 344, 347 (Ill App. 1990), *cert. denied*, 133 Il.2d 557, 561 N.E.2d 692 (1990). See also, *Geyer v. Paine, Webber, Jackson & Curtis, Inc.*, 389 F.Supp. 678 (D. Wyo. 1975); *Avern Trust v. Clarke*, 415 F.2d 1238 (7th Cir. 1969); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 410 F.2d 135, 141 (7th Cir. 1969) (Claimant is entitled to assert causes of action, including but not limited to breach of contract, for violations of NASD and NYSE Rules).

breaching the express agreements and assurances made to the customer by the broker or firm that they would carefully and prudently invest the customer's assets, the broker and firm, by violating SRO rules, may have breached the contract(s) they made with the customer.

B. Negligence

Violation of securities industry rules may give rise to a claim of negligence. The underlying theory of a negligence claim is that the broker and/or firm owed the customer a duty of care, they breached that duty through their failure to abide by industry rules, and as a result, caused the customer to incur losses. In Texas, at least two federal courts have held that NASD rules may be used as evidence of the appropriate standard of care owed to brokerage customers.[44] Evidence tending to establish a variance between conduct called for by a firm's procedures and the actions actually undertaken by an employee of the firm may support a finding of liability.[45] Also, a violation of internal procedures may support a punitive damages award.[46] Finally, "a court [or other arbiter] may consider evidence of [a] brokerage firm's internal rules as evidence of the proper standard of care."[47]

C. Negligent Misrepresentation

A claim for negligent misrepresentation may be appropriate in cases in which fraud may be difficult to prove because of the requirement to demonstrate scienter on the part of the wrongdoer. The California Supreme Court in *Small v. Fritz* explains that the elements of a negligent misrepresentation claim require demonstrating "'[t]he assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true' ([Cal.] Civ. Code, § 1710, subd. (2)), and '[t]he positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true' ([Cal.] Civ. Code, § 1572, subd. (2))."[48] In Illinois, to state a claim for negligent misrepresentation, a claimant must allege:

> (1) a false statement of material fact; (2) carelessness or negligence in ascertaining the truth of the statement by the party making it; (3) an intention to induce the other party to act; (4) action by the other party in reliance on the truth of the statement; (5) damage to the other party resulting from such reliance; and (6) a duty on the party making the statement to communicate accurate information.[49]

D. Fraudulent Misrepresentation

Claims involving churning and unsuitable annuity switching may lend themselves to a claim of fraud. The large commissions "earned" by the broker in such transactions,

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[44] Nelson S. Ebaugh and Grace D. O'Malley, A Guide to Selecting Causes of Action Under Texas Law to Recover for Suitability Violations, 12 PIABA BAR J. 43, 49 (Spring 2005) (citing *Lange v. H. Hentz & Co.*, 418 F.Supp 1376 (N.D. Tex. 1976) and *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F.Supp 1160 (S.D. Tex. 1969)).

[45] *Rupert v. Clayton Brokerage Co. of St. Louis, Inc.*, 737 P.2d 1106 (Colo. 1987).

[46] *Aldrich v. Thomson McKinnon Securities, Inc.,* 589 F.Supp. 683, 685 (S.D.N.Y. 1984).

[47] *Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817, 820 (6th Cir. 1981). See also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 697 F.Supp. 1224, 1227 (D.D.C. 1986) (violation of NASD rule was evidence of broker's negligence).

[48] *Small v. Fritz Companies, Inc.*, 65 P.3d 1255 (Cal. 2003) (citing *Fox v. Pollack,* 181 Cal.App.3d 954, 962 (Cal. 1986) [describing elements of the tort]).

[49] *Bd. of Educ. of Chicago v. A, C & S, Inc.*, 131 Ill. 2d 428, 452 (1989). *See also Fox Assoc., Inc. v. Robert Half Int'l, Inc.*, 334 Ill. App. 3d 90, 94 (Ill. App. Ct. 2002); *Neptuno Treuhand-Und Verwaltungsgesellschaft Mbh v. Arbor*, 295 Ill. App. 3d 567, 572-74 (Ill. App. Ct. 1998).

coupled with the lack of any reasonable basis for such a costly transaction may allow the arbitration panel to find scienter on the part of the salesman.[50] In Florida, the elements of fraudulent misrepresentation are "(1) a false statement concerning a material fact; (2) the representor's knowledge that the representation is false; (3) an intention that the representation induce another to act on it; and, (4) consequent injury by the party acting in reliance on the representation."[51]

E. Elder Abuse

Several states provide statutory protection for the elderly that cover financial abuse. In California, for example, one such statute defines "elder financial abuse" as when a person or entity does any of the following: 1) takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both; or 2) assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.[52] Remedies under this statute include attorneys' and costs.[53]

VI. Conclusion

Sales abuse relating to the sale of variable annuities is likely to continue until both the brokerage firms that sell them and the authorities that regulate them succeed in adequately addressing the "weak practices" that exist in the industry. While the local state's securities statutes may not always be available for the injured investor in variable annuity cases, he or she may be able to seek protection or redress by pleading several other powerful common law or statutory claims.

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[50] *See Franks v. Cavanaugh*, 711 F. Supp. 1186 (S.D.N.Y. 1989) (scienter element of churning may be inferred by evidence of excessive trading).

[51] *Johnson v. Davis*, 480 So.2d 625, 627 (Fla. 1985).

[52] CAL. WELF. & INST. CODE § 15610.30 (2001).

[53] CAL. WELF. & INST. CODE § 15657(a) (2001).

The Fallacy of “Customer-Described” Risk Profiles

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Prologue:

Referring to “Recommendations to Customers,” (Suitability), NASDR Conduct Rule 2310 (b) says, “ a member shall make reasonable efforts to obtain information … **used or considered to be reasonable by such member or registered representative in making recommendations to the customer.”** There is no specific mention of “risk profile” in the NASD regulatory language yet every NASD member’s new account form has a section on “Risk Level”; normally categorized as conservative, moderate, aggressive or speculative. It is standard and customary in the securities industry for members to utilize this information in establishing suitability parameters for customers to whom they make equity based investment recommendations. Other important data, such as the customer’s “financial objectives” are specifically noted in NASD 2310(b)(4).

Utilizing risk profile information is assumedly “reasonable” (by NASD standards) when making a recommendation to a non-institutional customer; and rightly so. Given the risk profile assessment is elicited from the customer, *is it reasonable* for a member to depend upon this “self-described” or “stated” risk profile information as accurate? This article will argue that *a customer’s self-described risk profile is not reliable* and should not be “reasonably considered”.

This article ponders the question,” Shouldn’t establishing risk tolerance be treated in the same fashion as financial objectives, *as a duty of the member to establish*; given that risk profile should be “reasonably” considered in making a recommendation?

Part One

The first issue to consider is whether or not a non-institutional investor understands the concept of “risk,” to the extent necessary to provide an accurate assessment. This is not as simple a question as it may seem; especially to those outside the securities industry. Does a non-institutional customer have the same “cognitive” perception and comprehension of risk that an institutional customer has?

Looking first at cognitive perceptions, it is empirically known that institutional investors have very different perceptions of risk than “retail” customers. Professionals understand risk, risk components (such as market risk versus company risk, interest rate risk, event risk, currency risk, headline risk, etc.) and can measure risk using a variety of statistical tools and benchmarks.

Professionals understand "the Greeks;" alpha, beta, what can be diversified and what cannot, portfolio tracking error, R-squared, standard deviation, linear regression, regression to the mean, Sharpe ratios, Bollinger Bands as well as other volatility measures (such as the .VIX). Compared to the professional investor or asset manager, non-institutional customers are more inclined to say "It's all Greek to me," when asked to characterize risk in a definitive fashion.

As a matter of experience, to those of us who have worked or managed within the retail distribution channel, we know that customer's generally don't understand risk. In fact, one component of risk, upside volatility, is actually "invisible" to the retail customer; due to the lack of comprehension.

To the mainstream customer, positive capital gains are not interpreted within the framework of risk (or risk-reward factors) but of financial objective. A customer experiencing a positive investment result ("upside capture") is happy because they are fulfilling their financial objective of growth of capital or capital appreciation. They have not considered any downside risk because they have yet to experience it, making the risk "invisible" to the retail customer. Another way to express this thought is to say that a customer achieving a capital gain is correlating their experience to their financial objective (of growth) and not to any perceptions of volatility. Because upside risk (a positive total return) is not correlated in their understanding, the risk is deemed "invisible."

Part Two

In what context does the customer recognize risk, if not to the upside? The mainstream customer becomes conscious of risk when the downside element of the risk-reward equation is experienced. In other words, risk is perceived when the customer "emotionally experiences" the market value of an investment dropping below the cost basis or entry price. **"Risk" becomes visible below cost basis when the investment return is interpreted against a customer's financial objective.**

Keep in mind that emotional experience and understanding are not correlated. In the event of an emotional reaction, the customer is gaining no real insight or understanding relative to the concept of risk. Again, there is a negative emotional reaction to the failure to attain the financial objective. The negative performance (relative to the cost basis) is in conflict with the customer's financial objective of capital appreciation, the decision criteria for the investment in the first place.

This dissonance between the stated investment objective (capital appreciation) and the result (an unrealized loss) is expressed as "emotional intolerance" in contrast to what a professional would understand as the downside volatility of the investment. To the customer, this risk is not understood in the same way but is experienced emotionally as a fear response.

Emotion is related to instinct. When confronted with a "threat" (in this example a threat to principal), there are two basic instincts; fight or flight. One segment of the customer population instinctively takes flight; they sell out taking a loss. Another segment, despite their emotional intolerance to the first "loss of principal," adds to the position. This customer sub-group is still committed to their initial intention of achieving their financial objective of capital appreciation.

A third sub-group, caught in a state of psycho-emotional ambivalence, takes no action despite a high level of anxiety (risk intolerance). This is the "deer in the headlights" syndrome, another type of stress related behavior.

All three examples have one element in common. The variable is instinctive behavior, which by definition is not "rational."

Looking closer at the three generically defined sub-groups of customers, we can infer that the first subgroup has a very low risk tolerance and cannot tolerate any or very little loss below cost basis. They instinctually sell out to remove the anxiety (the risk intolerance) they feel.

In the second sub-group of customers, the investor exhibits a non-rational, maladaptive behavior (an attempt to lower their anxiety level by lowering their cost basis) in order to increase the chances of "getting out even" at a lower basis than their original entry.

The third subgroup, exhibiting emotional and behavioral ambivalence under stress produces no behavior.

Empirical observations show that the customer's behavior is not founded upon a cognitive understanding of risk, nor upon an acceptance of risk, but rather upon emotional intolerance to downside risk (which was not anticipated) and reflects some degree of actual "risk aversion."

Part Three

How can we use this hypothesis to explain investor behavior? Let's examine the following hypothetical trading behavior.

A customer purchases 100 shares of ABC stock at $50.00 per share, and purchases 100 shares of XYZ stock at $25.00 per share. Over the next several months, in an orderly fashion, ABC moves from $50.00 to $75.00 per share. At the same time, XYZ appreciates from $25.00 to $35.00 per share in incremental price moves.

The customer is pleased. The share price growth is consistent with the customer's financial objective of capital appreciation. Because they have not experienced any volatility near their cost basis, the customer has no emotional experience of "risk" and as such, the risk is invisible to the customer.

The following month, the customer notices that ABC stock has pulled back to $55.00 per share (a $20.00 negative change from the previous high) and stock XYZ has pulled back to $20.00 per share (a $15.00 negative change from the previous high).

The next month, the customer sees that ABC is still at the $55.00 per share price level but stock XYZ has moved back up to $25.00 per share. The customer sells stock XYZ at $25.00; and takes no action with respect to stock ABC.

How do we explain the fact that the investor sold the stock, XYZ, that pulled back LESS in dollars per share? ($15.00 versus $20.00). Wouldn't we expect the customer to sell the stock with the LARGEST dollar pullback from the high?

The behavioral theory proposed by this article suggests that the explanation is found in what can be describes as the "Total Risk Profile." The "Total Risk Profile" comprises two distinct elements. The first is cognitive comprehension of risk. The second element is "emotional tolerance to risk," which is not the customer's emotional response to volatility per se, but to volatility around the cost basis price point.

One rational explanation for the customer selling the stock with the lesser dollar loss is that the move back up to break even provided an opportunity to eliminate the emotional tension experienced by a risk averse customer. Given a failure to achieve the financial objective of capital appreciation, the customer can effectively revoke the failed trade.

Technical analysts know the definition of "resistance," a situation in which supply exceeds demand at a certain price level. Technical analysts refer to this imbalance as "overhead supply," which results commonly in some degree of customer selling at this price level. Previous buyers can get out "break even." This explanation provides the

behavioral model to explain this technical phenomenon.

The theory further suggests that the financial objective (in this example of capital appreciation) and the "emotional risk tolerance" of the customer were not in synch with each other. Given that risk was not intellectually comprehended or correlated with performance (to the upside), there was no inconsistency with the financial objective. The investor didn't understand the inherent or implied negative volatility of their investment. Only when the stock dropped below the cost basis did the risk become visible, creating an intolerable emotional stress. The investor still didn't comprehend the risk components involved. Instinct, given the customer's "emotional risk tolerance" (or intolerance), is the basis of the behavior.

On the other hand, why didn't the customer sell the ABC stock that pulled back more, measured in dollars per share? Based on the analysis above, the answer lies in the fact that the ABC stock was still above the cost basis of $50.00, and therefore, the "risk" remained "invisible" to the customer as we have explained.

Conclusions

Ultimately, this analysis of cognitive risk versus emotional risk tolerance suggests that when a non-institutional customer is asked to self-define their personal risk "profile", they may in fact be describing their financial objectives; omitting their actual understanding of risk as well as their emotional tolerance to risk.

In the circumstance of a member (or registered representative) making a recommendation based upon the suitability criteria of NASD 2310, it is therefore *NOT REASONABLE* for the member to rely upon self-described risk evaluation by customers. To do so makes the recommendation faulty because it is partially based upon inaccurate or uninformed customer opinion.

Given the unreliability in a customer self-describing their risk tolerance, the argument can be made that it is the further duty of the member to establish risk tolerance by gathering information that is accurately descriptive of the customer. This seems to be even further supported in NYSE Rule 405 (Diligence to Accounts, which requires the member to (1)"**Use due diligence to learn the essential facts relative to every customer…."**

Even in a situation in which a customer is sent a form by the member firm asking the customer to "confirm" a risk profile, the validity of the customer's signature (if provided) is void given the customer's lack of comprehension and understanding of the risk related question.

In addition, issues such as how long the customer has "been in the market", trading or investing in different asset classes, is not necessarily correlated with acknowledgement or comprehension of risk. They may simply have experienced a history of random gains and losses.

The fact that an investor believes themselves to be "sophisticated" and/or has owned "sophisticated" investments upon the recommendation of a member firm does not necessarily mean the customer is cognitively sophisticated.

Further, many customers have simply learned to avoid certain types of investments based solely on adverse experience. Again, this only suggests behavior that is reinforced by a failure to achieve their financial objective, not any understanding of risk as an investment or suitability factor.

Finally, the legal theory is often made in Statute of Limitations argument(s) that given the "obvious volatility" of the customer's account market value, the customer "…knew or should have known" the inherent risks of their investments. This argument is rebutted by our assertion that volatility above cost basis is "invisible" and the customer did not

"know" – in a cognitive fashion – the risks being taken in their account.

Summary of Analysis

A reasonable person should concur that risk tolerance is an essential fact, and "due diligence" goes beyond a simple inquiry of a customer regarding their self-described risk profile or tolerance. For brokerage firms to continue to rely merely on the customer's uninformed explanation of risk is not sufficient and will result in more customers being placed in unsuitable investments for their true risk tolerance.

Selling Deep-in-the-Money Calls as an Option Writing Strategy: The Good, the Bad and the Ugly

Martin Dirks

Option writing strategies are common investment vehicles. These strategies are generally classified as a low risk strategy and often used if a client states that they are a conservative, risk-adverse investor with an objective of preservation of capital or income. However, these strategies, especially the sale of deep-in-the-money calls can evolve into a high-risk nightmare for an unknowing investor.

I. Basic Call and Put Strategies: The Good and the Bad

A. Selling Cover Calls: The Good

Call options are common and traded on most public stocks. If an investor has owned a stock for some time and does not want to realize the taxable gains from selling it, a broker may suggest that they sell calls on the stock "to provide income." This is especially the case when the stock has not been going up and the investor is disappointed that the stock is not generating returns, yet they are reluctant to realize the tax gain when selling the stock.

So how would this work? A call option is the right to buy an underlying security (stock, commodity, bond, etc.) at a set price and within a set time frame, in the future. As an analogy, think of a lease contract with option to buy a house. The lessee owns a call option in their lease contract on the purchase of the house. If the housing market increases while he is renting, he exercises the right to purchase at a set purchase price (with options called the strike price) and within a set time frame (referred to as the expiration date) in the future. If property values have fallen, the renter allows the purchase option to expire worthless.

Similarly, the owner of the house who agrees to the lease-purchase contract on the house has sold a call option. If the value of the house climbs dramatically, the owner must be ready to sell the house at the set price (strike price) if the renter exercises the purchase (call) option within the set time frame (expiration) of the contract. The homeowner receives a premium, a higher rent, in return for the lease-purchase option, which he keeps if no purchase transpires.

So, for example, an investor who owns IBM trading at $102 may sell a $105 strike call for $1.00 which will expire after 30 days. If IBM is not trading for more than $105 at expiration, the call option sold expires worthless and the investor keeps the $1.00. The investor made $1.00 on an investment of $101 (the stock cost $102, but $1.00 was received from the sale of the call), or 1%, in 30 days.

Martin Dirks is an expert witness and consultant. He is also an adjunct professor of finance at Golden Gate University. He has 20 years of industry experience, primarily in stock and option investing at large hedge funds. For more than five years he was the sole manager of an $800 million technology stock portfolio for Harvard University's endowment. Mr. Dirks can be reached at mdirks@isacm.com

Why should the $105 call be worth $1.00? There is some chance that IBM will move up in price in the next 30 days and the call gives the owner the right to all the IBM value over $105. The $1.00 price for the call option is determined by the buyer's estimation of the probability that IBM will move over $105 in the time available for it to do so – the time to expiration.

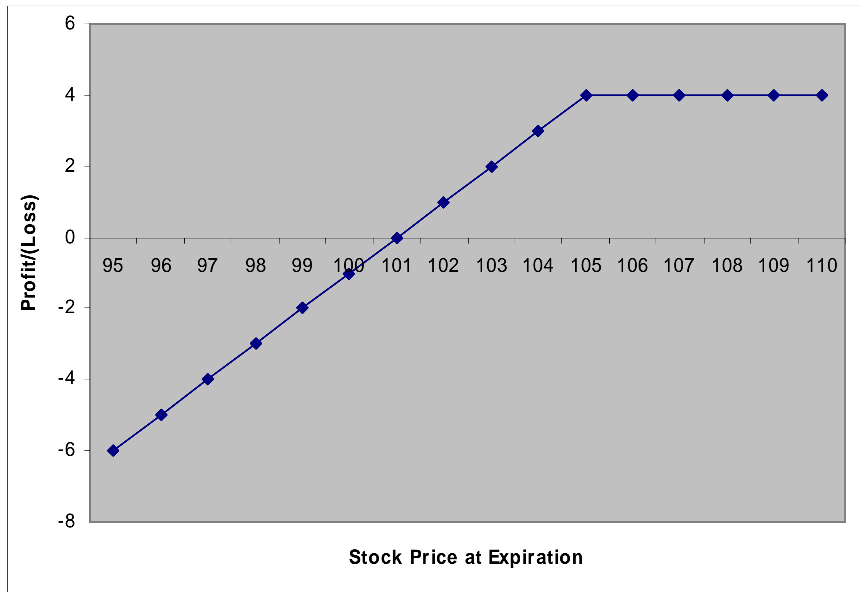
If IBM is trading at over $105/share after 30 days, the owner of the call will exercise the option and the stock will be sold at the agreed upon strike price of $105. The investor profited $3.00 from the sales of the stock for $105 to the owner of the call option and by $1.00 from the proceeds received from the sale of the call. So, the investor profited by $4.00 on an investment of $102or 4%, in a 30 day period.

Should IBM have declined in price to 98 at expiration, the call option sold will expire worthless. The investor will have lost $4.00 due to the stock decline and gained 1.00 from the sale of the call for a total loss of 3.00. This is better position than the investor would be in if they had not sold the call. Without the sale of the call, they would have lost $4.00.

Graphically, the profit loss can be shown as below with the stock price at expiration shown on the horizontal axis and the profit or loss shown on the vertical axis.

Chart A

Stock Price	Profit/(Loss) at expiration
95	-6
96	-5
97	-4
98	-3
99	-2
100	-1
101	0
102	1
103	2
104	3
105	4
106	4
107	4
108	4
109	4
110	4



B. Selling Naked Puts: The bad

Although selling covered calls is relatively low risk, there are other options strategies that are not for the risk adverse. One of the riskiest option strategies is to sell "naked puts."

A Put Option is the right to sell an underlying security (stock, commodity, bond, etc.) at a set price (strike price) and within a set time frame (expiration) in the future. To continue the above house analogy, we could use homeowner's insurance as an example of a put option. The homeowner has the right but no obligation to sell his home to the insurance company if it greatly decreases in value by flood, fire, vandalism etc. The insurance company, by selling or writing the policy (selling is also called "being short"), must always be ready to buy the house or pay the cash difference for any loss to the house.

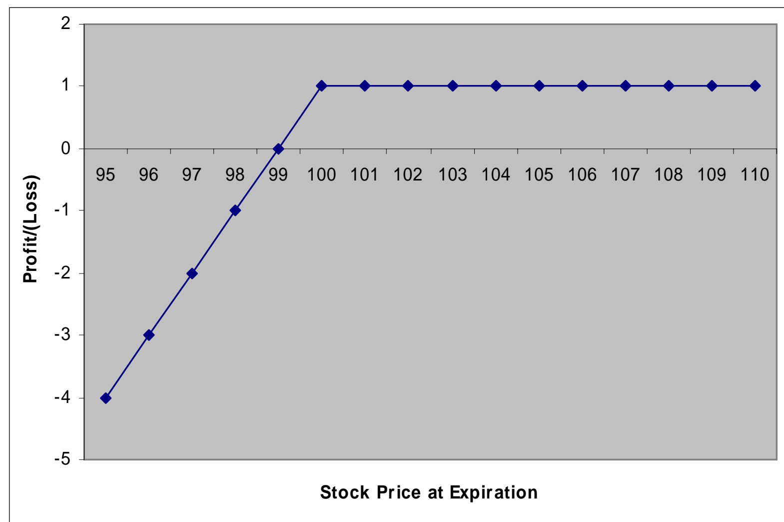
If an investor sells a put without having a position in the underlying stock to "cover" the risk, the position is called "naked." If an investor sells puts in IBM when it is trading at $102, as discussed above, the investor might sell a 100 IBM put with 30 days to expiration for $1.00. As long as IBM does not decline more than 2% in that 30 day period, the investor would keep the $1.00 as a profit.

If something bad happens and the stock declines $10, to $92, by expiration, the investor would be obligated by the option contract to buy the stock at the strike price of $100, even though the current market price is 92. That's a loss of $10. This is offset some by the proceeds from the sale of the put for $1.00, but still leaves a net loss for the 30 day period of $9.00. Selling naked puts is sometimes described as "picking up nickels in front of a steamroller." If something goes wrong, the consequences can be terrible. It is a high-risk strategy and best left to very sophisticated professional investors.

Graphically, the profit loss can be shown as below with the stock price at expiration shown on the horizontal axis and the profit or loss shown on the vertical axis.

Chart B

Stock Price	Profit/(Loss) at expiration
95	-4
96	-3
97	-2
98	-1
99	0
100	1
101	1
102	1
103	1
104	1
105	1
106	1
107	1
108	1
109	1
110	1



II. Selling Deep-in-the-Money Calls: The Ugly

A. Basics

Puts are not the only options strategy with significant risk. Another, less obvious risky strategy, is the sale of calls that are already in the money. For example, what if, using the same $102 IBM share, the investor sells a 100 strike call (called an "in-the-money" call because when the call's strike is less than the current stock price it has "intrinsic" value) instead of the 105 strike out-of-the-money call?

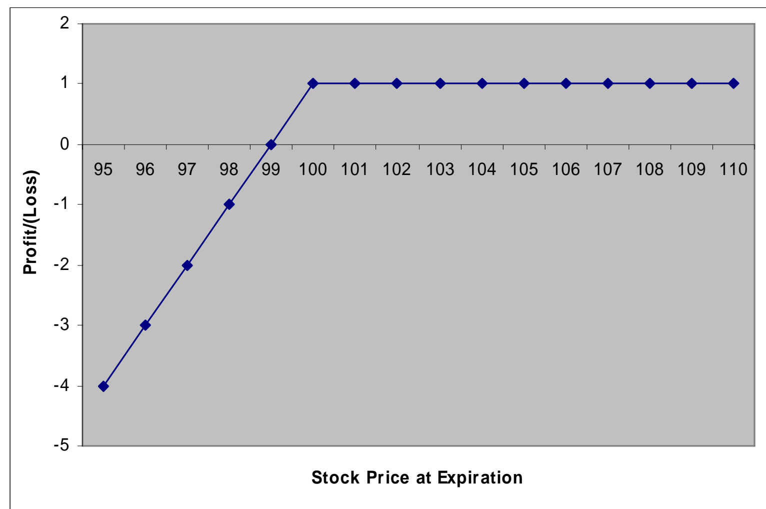
When the investor sells the in-the-money 100 strike call, he would have received $3.00.

(When the stock is at $102, the 100 strike call is "intrinsically" worth $2.00 because if we could buy the call for $2.00 we could be assured that we would not lose money. The purchaser could exercise the call, take possession of the stock and sell it in the market for $102. In addition to the intrinsic value, there is $1.00 of "time value" in the option based in the probability that IBM could increase in value before expiration. The total value of the option is then $3.00)

The risk graph for this position is shown below.

Chart C

Stock Price	Profit/(Loss) at expiration
95	-4
96	-3
97	-2
98	-1
99	0
100	1
101	1
102	1
103	1
104	1
105	1
106	1
107	1
108	1
109	1
110	1



So what has a covered call got to do with a naked put? Look closely at Graphs B and C. Do they look similar? They should. Selling a 100 strike call and owning the underlying stock has *exactly* the same risk and reward as a selling a 100 strike naked put. In finance terms, a covered call is the synthetic equivalent to a naked short put.

B. How does it get ugly?

Let's say the investor was explicit that they did not want to realize a taxable event, but they were advised to use a covered call strategy to "generate income." What happens if the stock goes up a lot before the option expires?

In the IBM example, if IBM went from 102 to 112 at expiration, the broker has a problem. He is short the 105 strike call – now, a deep-in-the-money call. The broker's choices are:

1. Let the stock be called away – the client will not be happy because there is a taxable event generated, or,

2. Buy back the expiring 105 strike call and sell a 115 call, an out-of-the-money call. The problem here is that it cost more to buy back the deep-in-the-money call than the proceeds from the sale of the out-of-the-money call. The broker will have to ask for more money from the client or the broker will need to borrow money on margin, which would be inappropriate for a conservative account. If the client is retired and making monthly withdrawals, it makes the situation worse. The account will be forced into margin more quickly. Eventually, the account will use the maximum margin allowed and be forced to close positions in order to continue to fund monthly withdrawals, or,

3. Sell another deep-in-the-money call. This does not require getting more money from the client or having a taxable event. However, it's a terrible investment strategy.

The broker must buy back the about to expire 105 strike call for $7.00 and sell another 105 strike call with 30 days to expiration for $7.50. He cannot sell the 115 strike call for $1.50, an out-of-the-money strike call, because it won't bring in enough proceeds to allow him to buy back the expiring 105 strike call for $7.00.

What happens in this scenario? The most the investor can make is $0.50 over the next 30 days, a 6% annual return. If there is some terrible market crash, the investor will realize all losses in IBM below a price of $105. If IBM falls to $100, the investor will lose $4.50 ($5.00 in stock losses offset by $0.50 from the time value in the 105 call options sold). So, the best an investor can do is to make 6% annual returns and the worst is a huge loss.

C. Broker incentives

Not surprisingly, there an incentive for a broker to sell deep-in-the-money calls.

When a sold call option is approaching expiration and is deep-in-the-money, it probably won't expire worthless. The call option needs to be bought back or the stock will be called away by the owner of the option.

At each expiration, the broker not only will sell another call, but must buy back the short call. This doubles the number of buy/sell transactions and doubles the broker's commissions. This is a strong enough incentive that the broker might even start selling in-the-money calls at the start of the strategy and try to tell the investor that the total proceeds from the call sales are "income" – which is certainly not the case. The account's value is increasing at about a 6% annual rate, very little on a month-to-month basis.

D. Why does a brokerage firm allow a covered call strategy to be categorized as appropriate for conservative investors?

The covered call strategy is not a risky strategy for the broker. The broker has the collateral to assure that no matter what happens to the stock; the broker will not lose money.

The broker can argue that the risk for a covered call strategy is the same as if the client owned the stock. That may be true, but when owning the stock the potential for upside is unimpaired. With deep-in-the-money calls, the upside is minimal while all the downside is all still there.

III. Summary

A covered call strategy, considered a conservative strategy, has great potential for abuse by an unscrupulous broker who wants to maximize his commissions.

It also has great potential to unwind into a deep-in-the-money covered call situation, especially during a market rally. The broker faces a choice of having a difficult, unhappy conversation with his client or letting the strategy evolve into a deep-in-the-money covered call strategy. Such a strategy will double the broker's commissions, but is an inappropriate investment strategy for any investor with a conservative risk tolerance.

Recent Arbitration Awards

Samuel B. Edwards

Anthony, et al. v. Investors Capital Corporation;
NASD Case No. 06-04080

Thirty claimants collectively brought various causes of action against Respondent relating to a selling away/Ponzi scheme perpetrated by Respondent's registered representative.

Claimants asserted the following causes of action: failure to supervise and selling away; breach of fiduciary duty and respondeat superior; negligence and suitability; negligent misrepresentation; violation of the North Carolina Securities Act; breach of contract; and fraud.

Claimants requested compensatory damages of approximately $5,000,000 including lost profits if their monies had been prudently invested, pre- and post-judgment interest, attorneys' fees, punitive damages, a return of all fees, management charges and commissions, plus interest and costs.

Respondent requested dismissal of the Statement of Claim, costs including forum fees, and attorney's fees.

The panel awarded Claimants the following damages: Compensatory damages (including damages for "lost use interest") totaling $553,498.74; attorneys' fees of $100,000; and reimbursement of costs and expenses totaling $13,619.56.

Claimants' Counsel: Howard B. Prossnitz, Law Offices of Howard Prossnitz, Chicago, Illinois; and Robert M. Birndorf, Birndorf & Birndorf, Chicago, Illinois.

Claimants' Expert: William Collison.

Respondent's Counsel: James A. McGovern, Marshall, Dennehey, Warner, Coleman & Goggin, P.C., Pittsburg, Pennsylvania.

Arbitrators: Zeb E. Barnhardt, Jr. (Chair), Harold G. Koger (Public) and Thomas C. Borthwick (Industry).

This case is significant because it resulted in a recovery for a group of thirty investors – none of whom were Respondent's customers – based on theories of control person liability and negligent supervision. The Claimants were victims of a Ponzi scheme perpetrated by the Respondent's registered representative. The broker sold the Claimants unregistered, bogus securities without the Respondent's knowledge or approval (selling away). Notably, the broker was sentenced to prison for his involvement in the scheme. The panel

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awarded damages to several Claimants who had no out-of-pocket losses, and awarded attorneys' fees and interest pursuant to the North Carolina Securities Act.

Bloom, et al. v. Bear Stearns & Co., Inc. & Jerome Ross;
NASD Case No. 2003-011301

Forty-two claimants brought causes of action against Respondents relating to fraud and manipulating the market for various securities. The broker held a large position in thinly traded stocks in his personal investment accounts. In an attempt to increase the value of his personal holdings, the broker recommended that Claimants invest in these same stocks. The broker attempted to subvert the firm's compliance procedures by advising Claimants to purchase the stocks at other brokerage firms.

Claimants asserted the following causes of action: breach of contract, breach of fiduciary duty, unsuitability, negligence, failure to supervise, RICO violations, State and Federal securities fraud, and common law fraud in the management of investments in equity securities.

Claimants requested compensatory damages of $5,000,000.

Respondent requested dismissal of the case.

The panel awarded Claimants the following damages: $1,734,366.00 in compensatory damages, plus interest at 5% per annum (amounting to over $500,000).

Claimant's Counsel: Steve Buchwalter and Barak Lurie, Steve A. Buckwalter, P.C., Encino, California.

Respondent's Counsel: Michael M. Gless, Keesal, Young & Logan, Long Beach, California.

Respondent's Expert: John Maine.

Arbitrators: Alan Stamm, Ernest S. Gould and Richard B. Bullock.

This case is significant because of the forty-two claimants, only about one-third were actually customers of the brokerage firm. In this case, the broker attempted to circumvent the firm's compliance procedures by advising the Claimants to make their investments at other brokerage firms. The panel found that every claimant that could satisfactorily prove he or she communicated with the broker about the subject investments stated a cognizable cause of action against the brokerage firm. Notably, the successful claimants recovered nearly all – or in some cases in excess of – their out of pocket losses. Many of the claimants were wealthy individuals and successful businessmen. While the broker denied all wrongdoing, and even denied having conversations with many of the Claimants, the Panel believed the consistent testimony provided by dozens of victimized investors. The interest awarded in this case exceeded a half-million dollars. Furthermore, the Panel assessed virtually all of the forum fees against Respondents.

***Edward Almquist and Sally Almquist v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*;**
NASD Case No. 05-03362

Claimants brought causes of action against Respondent relating to unsuitable investments in their accounts. Specifically, Claimants alleged that the broker and his investment team were applying an improper "one-size-fits-all" strategy to their customers' accounts. Claimants were retirement age, yet were invested in an overly aggressive portfolio.

Claimants asserted the following causes of action: breach of contract, breach of fiduciary duty, unsuitability, negligence, violation of state securities laws, violation of NASD and NYSE rules, and failure to supervise.

Claimants requested unspecified compensatory damages, treble damages not

to exceed an additional $10,000.00 as provided by the Washington Consumer Protection Act, pre-award interest at the legal rate, and attorneys' fees.

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

The panel awarded Claimants compensatory damages of $1,483,723.00.

Claimant's Counsel: Chris R. Youtz, Sirianni Youtz Meier & Spoonemore, Seattle, Washington.

Claimant's Expert: Craig McCann.

Respondent's Counsel: Curt R. Hineline, Dorsey & Whitney, LLP, Seattle, Washington.

Respondent's Expert: Michael Weiner.

Arbitrators: Craig Charles Beles (Chair), James B. Parsons (Public) and Jeanne C. Stilwell (Industry).

This case is notable for the panel's award of damages based on the well-managed account theory. The Claimants, a retired doctor and his wife, actually made money in their accounts and thus had no out-of-pocket damages. Despite this, the panel awarded damages based on the comparatively higher returns that would have been earned if the broker had followed the firm's recommended asset allocation models for retirees. It was clear that the broker's recommendations were far too aggressive and risky when compared with the firm's model portfolios, and therefore unsuitable.

In this case, the Claimants had maintained brokerage accounts with the firm for decades. The original broker of record left the firm around 2000, and was succeeded by his son. The new broker led an investment group that serviced hundreds of accounts and a large customer base. This investment group adopted an aggressive investment strategy that involved picking "hot stocks" and timing the market. When the group identified certain stocks to purchase, they placed the stocks in their customers' accounts without regard to each customer's age, investment objectives, risk tolerance, financial circumstances, etc. The broker thus abrogated his duty to undertake a proper suitability analysis before recommending investment to the Claimants. In addition, the Claimants successfully demonstrated that unauthorized trading had taken place, including during a period in which they were abroad and out of communication with the broker. As a result, the Claimants were awarded money by the panel despite suffering no out-of-pocket losses.

John T. Bell v. Alaron Trading Corporation, Comtrust, Inc., Protrade Futures & Options, Corporate Commodities, Inc., and Mitchell Goldberg; NFA Case No. 06-ARB-61.

The Claimant brought causes of action against the Respondents relating to the improper sale of commodity options contracts. In this case, the Claimant, an elderly man suffering from significant memory loss, entrusted most of his retirement savings to Comtrust. Comtrust and its agents lost almost $800,000 of the Claimant's money through a highly aggressive and costly investment strategy. In just a few months' time, the Claimant was charged over a half-million dollars in commissions and fees, and placed in option positions exceeding $21 million. The level of trading in the Claimant's account was so great as to make the Claimant a major player in the entire U.S. market for January 2006 natural gas contracts. The wrongdoing in this case and several related matters led the NFA to permanently bar the following from the commodities industry: Mitchell Goldberg, Protrade Futures & Options and Corporate Commodities.

Claimant asserted the following causes of action: breach of contract, breach of fiduciary duty, negligent misrepresentation, failure to supervise, fraud, violations of the CEA 7 U.S.C. Sec. 1, *et. seq.*, violation of NFA

Compliance Rules 2-2 and 2-4, and violation of Illinois Consumer Fraud and Deceptive Business Practices Act 815 ILCS 505/2.

Claimants requested unspecified compensatory damages, punitive damages, interest, costs and attorneys' fees.

Respondents requested dismissal of the case and attorneys' fees.

The panel awarded Claimants compensatory damages in the amount of $594,292.

Claimant's Counsel: B. Prossnitz, Law Offices of Howard Prossnitz, Chicago, Illinois

Claimant's Expert: Nuzer Balsara

Respondent's Counsel: James L. Kopecky, Gary Sinclair and Daniel Lazurus.

Arbitrators: Daniel Formeller (Chair), Mark Dunaevsky and Timothy Lankford.

This case is significant in that a clearing firm was found liable and ordered to pay substantial damages. The clearing firm unsuccessfully argued that it was not liable because its role was merely to process orders placed by the introducing brokers. The panel found that the firm ignored red flags, and was in a position to detect and prevent the wrongdoing alleged by the Claimant. For example, in this case the clearing firm shared a building with the introducing brokers. The transactions at issue were so large that the clearing firm should have inquired further into the customer's awareness and assent to the investments. Given the profile of the Claimant – an elderly retiree with significant memory loss – and the exceedingly risky nature of the transactions (which included currency exchange, or ForEx, transactions), the clearing firm acted improperly by blindly executing the orders it received.

Interestingly, after the award was issued, counsel for the Claimant had to petition a federal court to confirm the award and to establish a temporary restraining order to keep the clearing firm from improperly dispersing its assets to avoid compliance with the panel's order.

Sandra L. Crook v. A.G. Edwards & Sons, Inc. and Douglas A. Potter.;
NASD Case No. 05-00771

Claimant, a former broker, brought an action against Respondents related to her employment and subsequent termination.

Claimant asserted the following causes of action: sexual harassment, retaliation, intentional infliction of emotional distress and violation of the California Fair Employment and Housing Act.

Claimant requested compensatory damages of $1,500,000, punitive damages of $4,000,000, pre-judgment interest at the rate of 10% per annum, and costs, including attorney's fees. s.

Respondent denied the allegations made in the Statement of Claim.

The panel awarded Claimant the following damages:

Compensatory damages of $500,000, punitive damages of $3,000,000, attorney's fees of $418,262, additional costs of $26,204.10 and 10% interest if not paid within 30 days.

Claimant's Counsel: Raymond N. Stella Erlach, Esq., Law Offices of Raymond N. Stella Erlach, San Francisco, California.

Respondents' Counsel: Nuviah Shirazi, Esq., A.G. Edwards & Sons, Inc., St. Louis, Missouri and Daryl S. Landy, Morgan Lewis & Bockius, SSP, Palo Alto, California

Arbitrators: Mary Margaret Bush (Chair), Jonathan Holman Hathaway (Public) and Michael Garcia (Industry)

This case is significant because it demonstrates how well wronged industry personnel can do in FINRA arbitration. Although not every member is interested in employment cases, for those who are, this supports taking the case to a hearing unless a truly fair settlement is offered. Here, the case resulted in a large award, including punitive damages, attorney's fees and costs. Specifically, the Panel awarded damages of six times the compensatory damages. To support that award, the Panel cited Commodore Home Systems, Inc. v. Superior Court, 32 Cal. 3d 211 (1982). In addition, the panel cited the California Fair Employment and Housing Act as support for its award of attorney's fees totaling almost $420,000.

Cases & Materials

Timothy A. Canning

Following are summaries of recent cases and other material that may be of interest, from state and federal courts involving arbitration and/or securities, arranged generally by topic.

BEFORE THE ARBITRATION
COMPELLING/RESISTING ARBITRATION

Challenging Arbitration Agreements: Unconscionable

Tillman v. Commercial Credit Loans, Inc.
(N.C. 1/25/2008) 655 S.E.2d 362

An arbitration clause in a consumer credit agreement was unconscionable, because it was one-sided, prohibited joinder of claims and class actions, and exposed consumers to prohibitively high costs in pursuing arbitration.

In this case, plaintiff consumers contended that they did not want or need single premium credit insurance and that defendant Commercial Credit did not tell them that the insurance was optional. In addition, plaintiffs claim that Commercial Credit was the sole beneficiary of the insurance policies. Plaintiffs' complaint specifically alleged that "Commercial Credit violated North Carolina law by failing to provide Plaintiffs with requisite disclosures regarding the credit insurance sold to them and by charging fees that were deceptive, unfair, duplicative, imposed without adequate commercial justification or disclosure, and in excess of the fees permitted by North Carolina law." Plaintiffs sought money damages based on the amount of credit insurance premiums collected by defendants. Defendants sought to compel arbitration.

In finding that the arbitration clause in the consumer agreements was unconscionable, the court observed that there was no mention of credit insurance or the arbitration clause at the loan closings. In addition, defendants admitted that they would have refused to make a loan to the plaintiffs rather than negotiate with them over the terms of the arbitration agreement. Finally, the bargaining power between defendants and plaintiffs was unquestionably unequal in that plaintiffs are relatively unsophisticated consumers contracting with corporate defendants who drafted the arbitration clause and included it as boilerplate language in all of their loan agreements. The court therefore concluded that plaintiffs made a sufficient showing to establish procedural unconscionability.

The court then held that the arbitration clause was substantively unconscionable because (1) the arbitration

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costs borrowers may face are “prohibitively high”; (2) “the arbitration clause is excessively one-sided and lacks mutuality”; and (3) the clause prohibits joinder of claims and class actions. The collective effect of the arbitration provisions is that plaintiffs are precluded from “effectively vindicating [their] ... rights in the arbitral forum.”

Venue

Maronian v. American Communications Network, Inc.
(W.D.N.Y. 1/14/2008) 2008 WL 141753

The venue provisions of section 4 of the Federal Arbitration Act do not apply in actions to stay arbitrations.

In this non-securities case, plaintiff brought an action in New York federal court to stay an arbitration that was being conducted in Michigan, on the grounds that plaintiff did not agree to arbitrate the dispute. The respondents sought to dismiss action on improper venue grounds, or have the action transferred to Michigan.

The court denied the motion, holding that the venue provisions of section 4 of the FAA did not apply to the instant case. Further, because the parties disagreed as to the existence of the alleged contracts, the court could not grant respondent's motion to dismiss or transfer for improper venue, based on an alleged forum selection clause, without first examining, among other things, whether such agreements exist.

Who Can Enforce Arbitration Obligation: Against Successor Broker Dealers

World Group Securities, Inc. v. Allen
(D. Ariz. 11/20/2007) 2007 WL 4168572

A successor broker dealer was obligated to arbitrate claims of successor-liability brought by an investor, on the grounds that the successor broker was bound as a nonparty to the arbitration agreement between the investor and the predecessor broker dealer. The court first held that the successor corporation (WGS) was not obligated to arbitrate these claims under the NASD Code, unless the arbitration claimants could show that WGS is the successor in interest to WMAS (the predecessor corporation). The court acknowledged that its decision in this regard is at odds with two federal district-court decisions, which held that because the arbitration complaint included concededly arbitrable claims, the successor-liability claims were arbitrable as well.

The court went on to hold, however, that the successor corporation (WGS) was bound as a nonparty to the arbitration agreement between the arbitration claimants and the predecessor corporation (WMAS) as a matter of equitable estoppel. This doctrine “‘precludes a party from claiming the benefits of a contract while simultaneously attempting to avoid the burdens that contract imposes.’” WGS conceded that it knowingly received the fees generated from the arbitration claimants’ accounts after becoming their broker of record. The arbitration claimants’ obligation to pay these fees derives directly from the contract containing the arbitration clause.

Having determined that WGS is bound by Defendants' arbitration agreement with WMAS, the court then held that the unconditional and all-inclusive nature of the arbitration agreement left no doubt that the successor-liability claims fell within the parties' arbitration agreement.

Arbitration Required Under NASD Rules: Who Is A Customer

Contemporary Financial Solutions, Inc. v. Miller
(D.Colo. 11/20/07) 2007 WL 4197588

A claim of negligent supervision of a broker against a brokerage firm is sufficient to satisfy the requirement of “arising in connection with the NASD member’s business” to require arbitration. In order to determine whether a person is a “customer” under NASD rules, evidence regarding the nature of the

relationship between the person and the purported broker is required.

An investor's status as a “customer” is determined at the time of the events providing the basis for the allegations. In addition, to be a customer of an “associated person”, the investor need not have any knowledge of the associated person's affiliation with the NASD member, nor need the associated person have been given authority by the NASD member to conduct the particular transaction.

However, to be a “customer” of an “associated person” under NASD Rule 10301, an individual must have received investment or brokerage services, not just financial advice, from the “associated person”. Furthermore, the investment or brokerage services must have been provided during the time that the “associated person” is associated with an NASD member. Finally, the events that give rise to the claims, here negligent supervision, must occur during the period of association and the provision of investment/brokerage services.

If there is a factual dispute as to whether a person satisfies the definition of “customer”, then an evidentiary hearing or trial is required.

Here, the Court believed it lacked sufficient evidence of the nature of the relationship between the claimants and the purported broker to determine whether they were his “customers” while he was associated with the NASD member firm. For instance, the Court could not determine whether the claimants had a relationship with the broker during 2004 which pertained to investment or brokerage services, or whether he merely solicited them with investment advice and sold them insurance.

Arbitration Required Under NASD Rules: Former Members
Galey v. World Marketing Alliance
(5th Cir. 12/12/2007) 510 F.3d 529

Even though an arbitration agreement between a former NASD member and the claimant unambiguously requires arbitration of the claimant’s claim, NASD rules trumped that contractual provision where the firm’s NASD membership had lapsed.

World Marketing Alliance and World Marketing Alliance Securities (collectively “WMAS”) sought to compel arbitration of a claim brought by former customers, as the language of the arbitration agreement between the parties unambiguously required arbitration.

However, as the court noted, the arbitration agreement specifically incorporated NASD rules. WMAS had allowed its membership in the NASD to lapse in 2000, a fact that WMAS could not dispute. This card turned out to be a trump: NASD Rule 10301 provides that a claim involving a member whose membership has been terminated, suspended, cancelled, or revoked shall be ineligible for arbitration under the NASD Code of Arbitration Procedure.

The language of the arbitration agreement at issue, requiring “arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. (NASD),” constitutes a forum selection. Under the arbitration agreement, the parties had agreed that the NASD is the only appropriate forum for this dispute. Here, then, the principal question is whether we should order arbitration before the NASD.

WMAS contended that consideration of its membership status violated the parol

evidence rule. The parol evidence rule is intended to "prohibit the admission of evidence which is offered for the purpose of contradicting the plain unambiguous terms of a writing." Considering WMAS's membership status only serves to apply the referenced NASD rules and so does not in any way vary the terms of the agreement. Accordingly, considering WMAS's NASD membership status does not violate the parol evidence rule.

WMAS also argued that the portion of the arbitration agreement requiring compliance with NASD rules should be severed. A provision of an arbitration agreement is severable if the intent of the parties at the time of the agreement demonstrates that "the essence, the essential term, of the bargain was to arbitrate, while the" provision at issue "was merely a minor consideration." NASD Rule 10301, however, is not a minor consideration of the arbitration agreement at issue. This conclusion is clear from the policy that motivated the adoption of Rule 10301. In approving the rule, the Securities Exchange Commission explained that the rule was designed to protect customers from "terminated, suspended, barred, or otherwise defunct firms [that] have a significantly higher incidence of non-payment of arbitration awards than do active firms."

In the light of this policy, it is apparent that Rule 10301 was adopted to serve a critical purpose and that it is an essential term of the arbitration agreement at issue. Rule 10301 protects customers; it is not simply a minor logistical consideration ancillary to the arbitration agreement; and so it is not severable from the remainder of the arbitration agreement at issue.

DURING THE ARBITRATION

Settlement Issues/ Scope of Release

Barone v. Marone
(S.D.N.Y. 12/14/07) 2007 WL 4458118

An investor's settlement with a brokerage firm which included a broad release also released the individual broker.

In this case, investors obtained default judgment against an investment advisor. The investors subsequently obtained an NASD arbitration award against the brokerage firm with whom the advisor was registered. The firm sought to vacate the award. While that action was pending, the firm and the investors settled their dispute, and the investors executed a general release. The advisor then moved to reduce the default judgment to zero, as the judgment had been satisfied or released. The court granted the motion.

After reviewing the settlement agreement and release, the court concluded that there was no question that the settlement payment from the firm and the judgment against the advisor compensated the plaintiffs for the same injury. The plaintiffs' NASD Arbitration statement of claim against the firm requested compensatory relief in the amount of $4.7 million, the same amount sought by the investors in their default judgment motion against the advisor. Though the investors losses may have been caused by all three "defendants"- the advisor's fraud and the firm's negligence in hiring, retaining and supervising the advisor -there are no factual distinctions between the injuries resulting from their alleged conduct: the $4.7 million loss represents a single, indivisible harm.

Further, the settlement agreement between the investors and the firm included a general release of all existing judgments and defaults entered against the firm and its former agents and representatives. Though plaintiffs acknowledge the breadth of that release, they nonetheless contend that it should not be

read so expansively as to relieve the investment advisor of liability for any conduct outside the scope of his employment with the brokerage firm.

The court held that the release was not so limited. The investors contend in court that the advisor was not acting as an agent while engaged in the illegal conduct, but took the opposite position in the NASD arbitration in order to support their respondeat superior claim.

There was never any basis for the parties to the release to conclude that advisor's fraudulent conduct was necessarily outside the scope of his employment and that the default judgment would be unaffected by the release of the firm's "agents" or "representatives". Indeed, the plaintiffs' failure to include an express reservation of rights against the advisor in his individual capacity, a likely request given the uncertainty surrounding the default judgment, further suggests that the parties did intend to release the advisor.

AFTER THE ARBITRATION
CHALLENGING / CONFIRMING ARBITRATION AWARDS

Vacatur:
Exclusion of Evidence
Attorneys Fees
Sanctions for Seeking Vacatur

Deitchman v. Bear Stearns Securities Corp.
(S.D. Fla. 12/28/2007) 2007 WL 4592238

An arbitration panel's decision to exclude an "AWC" and other investigatory material from the NASD regarding a brokerage firm did not constitute grounds for vacating an award in favor of that brokerage firm, where the investor/claimant failed to demonstrate that no rational basis existed for the arbitrators' decision to exclude the Report and Recommendations and the NASD Investigation Report.

However, since both parties agreed to withdraw the attorneys' fees issue from consideration by the arbitrators, the arbitration panel did not have the authority to enter an order directing that each party was to pay its own attorneys' fees.

The court declined to impose sanctions on the investor/claimant for seeking vacatur, because the improper exclusion of evidence from an arbitration hearing is a valid ground for vacatur, and the investor/claimant identified two items of evidence that were excluded by the arbitrators. While the Court disagreed with the investor/claimant's argument that the exclusion of such evidence was prejudicial to her case (or, for that matter, relevant to her case), the Court "refuses to sanction a party solely for losing their argument in court."

As to the AWC and investigatory reports, the court held that the arbitrators' decision to exclude the evidence could have been based in reason. The Independent Consultant's Report merely summarized Bear Stearns' compliance and internal operating policies for a period of years pursuant to a settlement with the U.S. Government prior to Bear Stearns' relationship with Eastlake. The Recommendations included with the report were non-binding and were not immediately nor collectively adopted. Bear Stearns' counsel reminded the arbitration panel that violation of any of the proposed rule changes in the Report could not give rise to any private cause of action. The arbitrators were thus faced with substantial questions as to the relevance of the proffered evidence.

The arbitrators could have reasonably found that the Report and Recommendations were inappropriate forms of evidence based on the same considerations motivating Federal Rule of Evidence 408, i.e., the policy interest of keeping settlement negotiations and offers of compromise confidential. The arbitrators could have excluded the Report because it was the product of settlement negotiations with the SEC. Allowing admissions Bear Stearns made in one settlement to be used

against it in other, unrelated litigation would discourage settlements.

The panel's decision to exclude the NASD's investigation report of the broker also could not be shown to be "without reason." The relevance of the report is questionable at best. In addition, the arbitration panel had previously excluded the AWAC, and it did not appear irrational to the Court that the arbitration panel would also exclude the very document that led to the execution of the AWAC for the same or similar reasons.

Finally, even if the evidence was relevant, the investor/claimant did not present any persuasive argument that she was prejudiced by the exclusion of the evidence. The Court was unable to conclude that the result of the arbitration would have been different but for the exclusion of the investigative and AWC evidence. The investor/claimant could have, at the very least, attempted to find other evidence and testimony to present at the hearing. According to the court, "Petitioner cannot and should not ask this Court to vacate her arbitration award based on her unsuccessful litigation strategy."

Vacatur: Discovery Abuse

Montane v. Morgan Stanley Dean Witter & Co.
(Cal. App. 12/13/2007) 2007 WL 4348084

Investor claimants who were represented by a non-attorney at an arbitration hearing were adequately represented, the arbitrators' dismissal of the case as a result of discovery violations was not in excess of their authority, and arbitrators were not required to disclose other pending arbitrations in which they were serving as arbitrators.

In this matter, claimants sought to vacate an arbitration award that dismissed their claims against brokerage firm Morgan Stanley.

Claimants were represented by both an attorney and by a non-attorney advocate/ securities consultant. Morgan Stanley challenged the non-attorney's ability to represent claimants in the arbitration on the basis that he would be engaged in the unauthorized practice of law. In accordance with a position taken by NASD in other matters, and as allowed by Code of Civil Procedure section 1282.4, the panel ruled that the non-attorney could represent the claimants.

At a later telephone hearing on several discovery-related issues, and "[d]ue to the disruptive behavior of the Claimants' representative and counsel" during the oral hearing, which lasted nearly five hours, the chair eventually adjourned the hearing. The panel issued its award that granted the motion to dismiss claimants' claims with prejudice, as a result of their repeated failure to pay the sanctions.

The court rejected claimants' arguments that they were substantially prejudiced by the arbitrators' refusal to postpone the hearing on the request of their attorney (who was unavailable for the hearing as a result of a medical problem). Claimants contended that denial of the postponement deprived appellants of their right to assistance of counsel under California Code of Civil Procedure section 1282.4 and NASD Code of Arbitration Procedure, Rule 10316. The court concluded that the non-attorney representative could adequately represent the claimants.

As to the dismissal of the arbitration, according to the court, the claimants' claims were dismissed not simply for their initial failure to timely produce discovery as ordered by the panel, but for their repeated failure to comply with the panel's discovery orders and related sanctions. In these circumstances, dismissal was authorized by NASD rule 10305.

The court also rejected claimants' alternative argument, that the failure of the arbitrators to disclose other pending arbitrations constituted a failure to disclose grounds for disqualification. According to the court, an

examination of this record gives us no concern that disclosure of the pending arbitrations would have revealed the arbitrators were biased in favor of respondents. Most of the other arbitration proceedings were disclosed in the arbitrators' written disclosure reports provided to the parties.

Vacatur: Due Process

Keybanc Capital Markets, Inc. v. Daly Holdings, Inc.
(N.D. Ohio 12/04/2007) 2007 WL 4287852

Whether an arbitration award violates public policy can be considered even after the time to move to vacate the award has expired; however, the NASD as a private actor does not have to satisfy the same due process considerations that a state actor would.

In this matter, an individual was found liable by a panel of NASD arbitrators to a claimant, based on alter ego liability. The individual failed to timely move to vacate the award. In response to a motion to confirm the award, the individual opposed confirmation on the grounds that the award was against public policy, arguing that the individual's due process rights had been violated, in that he was not a signatory to any arbitration agreement.

Arbitrators may exercise jurisdiction over entities or individuals who are not signatories to an arbitration agreement if those entities or individuals are acting as the agents or alter-egos of parties to the arbitration agreement, or if they are subject to corporate veil piercing.

In order to satisfy the public policy exception to confirming an arbitration award, the public policy at issue must be explicit, well defined and dominant, and must be ascertained by reference to laws and legal precedents. The "due process" considerations discussed by the individual did not fulfill this requirement. According to the court, it is true that there is a well established public policy created through the Ohio and Federal Constitutions and through a great deal of legal precedent providing that no state actor shall be allowed to deprive a citizen of due process. However, there is no such well established policy that requires private actors to provide similar rights. In fact, legal precedent supports the dismissal of claims for violation of due process when no state actor is involved. Further, "every court that has considered the question has concluded that NASD is not a governmental actor" for purposes of a due process claim.

The individual also claimed that no state actor was required because he was not basing his claim on a constitutional violation; however, without reference to the state or federal constitution, the court held that he could cite no law or legal precedent supporting a public policy that requires private arbitrators to provide individuals with due process.

Second, even if an explicit, well defined and dominant public policy did exist, the individual did not explicitly and clearly show a conflict between the public policy and the arbitration award. The individual had full notice of every relevant proceeding in the arbitration proceedings. It was not the process that was lacking in this case, the individual simply failed to take advantage of the process and procedures available to him.

Vacatur: Remand to Arbitrators

Raymond James Financial Services, Inc. v. Bishop
(E.D. Va. 12/18/2007) 2007 WL 4531964

Where an arbitration panel's explanation for its award in favor of claimants was convoluted and garbled, the matter should be remanded to the arbitrators for further explanation, so that the court can conduct meaningful judicial review.

According to the court, remand to an arbitrator for clarification is appropriate where

an award is patently ambiguous, the issues submitted were not fully resolved, or when the language of the award has generated a collateral dispute.

The arbitrators in this case issued a written decision with an explanation of reasons for the award they entered. The explanation of reasons was so confusing and difficult to understand, particularly when viewed in perspective of the Statement of Claims and the issues, as framed by the text of the award, and as explained by the explanation of reasons given for the award, that the court found it impossible to conduct meaningful judicial review. Under certain circumstances, the award might be appropriately affirmed. Under other circumstances, the award may exceed the power of the arbitrators because of a disregard of a contractual provision controlling the rights and remedies available to the parties.

The Court needed to understand the basis for the decision made by the arbitrators as to each of the three Claimants before it would be possible for it to conduct meaningful judicial review. Where arbitrators have chosen to explain the reasons for their award, it is necessary that the explanation be sufficient to permit the process of judicial review to be intelligently conducted. As it was not possible for the court to do so in this case, the case was remanded to the arbitrators for a clarification of the basis upon which the award of compensatory damages was made to each of the Claimants.

Vacatur Procedural Issues:
State Time Limit for Seeking Vacatur Not Preempted by FAA

Moscatiello v. Hilliard
(Pa. 12/27/2007) --- A.2d ----, 2007 WL 4553342

Investors in mutual funds filed multiple claims with the NASD against brokers, alleging fraud under the Securities and Exchange Act of 1934, common law fraud and deceit, breach of fiduciary duty, negligent supervision, and violation of the Pennsylvania Unfair Trade Practice and Consumer Protection Law. A three-member NASD arbitration panel dismissed all claims. More than 30 days but within three months after the award was served, the investors filed a petition to vacate. The trial court dismissed the petition as untimely, holding that Pennsylvania's 30-day time limit for challenging arbitration awards was not preempted by the three-month FAA time limit, because the FAA preempts only state substantive law which interferes with the enforcement of an agreement to arbitrate.

The appellate court rejected the investors contention that because they contracted to arbitrate their claims under the FAA, they should be permitted to rely on the entire FAA in asserting their post-arbitration rights. The investors asserted that the FAA is a substantive body of law applicable in federal and state courts, which includes the three-month time limit for filing challenges to arbitration awards, and that the FAA preempts conflicting state law.

Because Pennsylvania's arbitration acts provide for the enforcement of arbitration of contract and other disputes, the state's acts foster the federal policy favoring arbitration enforcement. The 30-day time limit found in both Pennsylvania arbitration acts does not undermine the federal policy or the FAA's goal. There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.

The federal policy favoring arbitration, set forth in the FAA, is limited to Congress's intent to make arbitration agreements enforceable. The FAA does not preempt the procedural rules governing arbitration in state courts, as that is beyond its reach.

Regardless of whether an arbitration agreement provides for arbitration pursuant to the state arbitration act or state common law, application of a 30-day time limit for challenging arbitration awards is appropriate.

As this presented no conflict with the FAA's goal, the court held that Pennsylvania courts should apply its procedural rules for filing arbitration award challenges as it more quickly renders arbitration awards final.

Effect of Arbitration: Collateral Estoppel/Issue Preclusion

IDT Corp. v. Morgan Stanley Dean Witter & Co.,
(N.Y.A.D. 11/20/2007) 45 A.D.3d 419, 846 N.Y.S.2d 116

Plaintiff's arbitration proceeding against one party for breach of contract in connection with an IPO did not collaterally estop plaintiff's court action against Morgan Stanley for tortious interference and unjust enrichment arising out of the same IPO, where the plaintiff did not have the opportunity to take discovery from Morgan Stanley regarding damages in the arbitration.

Morgan Stanley contended that plaintiffs' claims against it were barred by collateral estoppel, which prevents a party from relitigating an issue previously decided against it in a proceeding where there was a fair opportunity to fully litigate the matter. According to Morgan Stanley, in plaintiff's arbitration against Telefonica, the arbitrators decided critical issues that preclude plaintiff's claims against Morgan Stanley. In that arbitration, however, plaintiff never had an opportunity to conduct discovery on the extent of the damages it suffered due to Morgan Stanley's alleged tortious conduct.

The court further held that plaintiff's remaining claims were not time-barred or insufficient to state causes of action. While Telefonica's breach of its memorandum of understanding with IDT was allegedly a result of Morgan Stanley's tortious interference, no cause of action for such interference arose until plaintiff actually suffered damages, and such damages were not necessarily suffered at the time the contract was breached.

Further, plaintiff's equitable breach of fiduciary duty claim seeking disgorgement of $10 million is governed by a six-year limitations period, and should not be dismissed at this stage of the litigation as "duplicative" of the unjust enrichment claim, when it properly serves as an alternative theory for the relief sought.

SUBSTANTIVE ISSUES

Statute of Limitations: Accrual and Discovery

Bentley v. Mutual Benefits Corp.
(5th Cir. 11/5/07) 2007 WL 3251997

Under Mississippi law, the statute of limitations for an investor's claim arising out of an investment in a viatical settlement began to run on the date of the investment, and was not tolled.

In this matter, a salesman (Giltner) mailed plaintiff and prospective investor Bentley information on viatical settlements, a suitability questionnaire, a Purchase Agreement, a Trust Agreement, and other related forms. Two or three days after he received these documents, Bentley decided to invest $25,000 in a three-year MBC viatical settlement, with the expectation that he would reap a 42% return and thus receive $35,500 at or within three years. Bentley only decided to invest $25,000 instead of the full $100,000 he had available because he was "unsure and uneasy about the prospect of investing his money in a 'viatical settlement.'"

On May 27, 1997, Bentley executed the documents required to purchase the viatical settlement from Giltner.

On April 5, 2002, almost five years after purchasing the MBC viatical settlement, Bentley filed suit against Giltner, and others primarily claiming that Giltner had fraudulently induced Bentley to enter into the viatical contract by unconditionally promising him that the viatical settlement was a safe, risk-free investment, which would pay a return of 42%

at or within three years. In addition to fraud, Bentley asserted claims of negligent misrepresentation, gross negligence, breach of fiduciary duties, violation of the Mississippi Securities Act, equitable estoppel, joint venture, and vicarious liability/respondeat superior.

Mississippi state law had a 3 year general limitations period applicable to those claims. The Supreme Court of Mississippi had held in a previous case that "[a] fraud claim accrues upon the completion of the sale induced by false representation, or upon the consummation of the fraud," when a plaintiff is on notice of the terms of the contract that contradict that prior representation.

In this matter, at the time Bentley invested in the viatical, Bentley had copies of the purchase and trust documents, which contradicted Giltner's earlier alleged promises. The terms of the Purchase Agreement dispelled any notion of a guaranteed return and clearly established that Bentley was buying an interest in a life insurance policy of a terminally ill person, that Bentley would receive a payment upon the maturity of the life insurance policy (i.e., when the person died), that returns may vary depending upon the life expectancy of the insured person, that returns were not annual returns but total returns, and that the exact return "cannot be determined until the policy matures." The court held that the causes of action accrued on the date of the investment.

The court then rejected the investor's claim that the statute of limitations were tolled as a result of fraudulent concealment. Bentley had not alleged that Giltner made any misrepresentation to him after he purchased the viatical settlement. Bently only alleged that the misrepresentation occurred concurrently with the initial sale. By Bentley's own account, after Giltner received and forwarded the executed documents and check to MBC, Bentley had no further contact with Giltner until mid-2000, when Bentley inquired about his investment. Other than this initial contact, Bentley did not allege that Giltner had any other involvement with his viatical settlement. Thus, Bentley has not satisfied the "subsequent, affirmative act" prong of the fraudulent concealment test.

Likewise, Bentley failed to present evidence of due diligence in his investigation of facts which gives rise to his claims. Bentley did not investigate the viatical settlement investment, outside of his initial limited conversations with Giltner, even when the clear language of the agreement should have caused him to do so. Because of the provisions previously discussed, Bentley should have investigated the accuracy of Giltner's alleged representation that the viatical settlement would produce a guaranteed return of 42% at or within three years. By Bentley's own admission, he was suspicious of viatical settlements, given that he only invested $25,000 of his $100,000 in insurance proceeds; yet, he did not investigate. Thus, he has also not satisfied the "reasonable diligence" prong of the fraudulent concealment test. Simply making inquiries to Giltner about his investment in 2000 did not suffice.

Because there was no proof of fraudulent concealment by Giltner, the court held that the statute of limitations was not tolled, and Bentley's claims were time-barred.

State Suitability Rules: No Private of Action

Ives v. Ramsden
(Wash App. 01/02/2008) --- P.3d ----, 2008 WL 40071

In this matter, the court held that a breach of the suitability rule – codified in Washington's securities act – did not provide for a private right of action itself, but could be used to establish the existence of a duty and breach of duty. The court also held that in order to conclude that an investment was suitable, the trial was required to make specific findings of fact as to the investors' financial status and financial objectives.

David Ramsden, a registered securities broker, recommended that 75-year-old G. Jerome Ives buy investments that nearly depleted all of his liquid assets. Ramsden also induced Ives to personally loan Ramsden funds to purchase a home for a very low interest rate and then defaulted. Ives passed away and, on July 1, 1999, the Ives Estate sued Ramsden. The trial court found that Ramsden violated his fiduciary duties and duties of good faith and fair dealing, committed securities fraud, violated the CPA, and violated the suitability rule as to most but not all of the investments the broker sold to the investor.

The broker appealed, and the investor cross-appealed the trial court's conclusion that some of the investments were suitable. Because the evidence was not sufficient to support the trial court's finding that the first four limited partnerships did not violate the suitability rule, the court remanded the case for reconsideration by the trial court.

The court first concluded that under Washington's Securities Act, there is no private right of action for violations of the suitability rule. Before the Washington legislature codified the suitability rule in statute, Washington courts followed federal law and held that a private party may not sue a broker for violating the NASD suitability rule. Instead, an aggrieved investor must assert another cause of action, such as breach of fiduciary duty or securities fraud.

The Washington legislature codified the suitability rule, as part of Washington Securities Act. The state securities act expressly allowed individuals to sue investment brokers who allegedly violated certain listed provisions. Omitted from this list is the suitability rule. Also omitted from this list is a violation of which makes it unlawful for a broker "[t]o engage in any dishonest or unethical practice as the director may define by rule," including the recommendation of unsuitable investments.

According to the court, it was clear that the Washington legislature decided that private individuals can sue investment brokers under some provisions of the Securities Act, but cannot sue for violations of the suitability rule. Accordingly, no private cause of action exists for violations of the suitability rule.

However, it was proper for the trial court to consider compliance with the suitability rule as evidence of a duty that the broker/advisor owed his customers. The trial court found that brokers owe clients a common law duty to recommend only suitable investments that comply with the state suitability rule. To determine if a broker-dealer has breached his duty of due care and fair dealing by failing to follow the suitability rule, the trial court must consider both the customer's financial status and objectives.

The blanket statement by the trial court that the investor had "sufficient liquidity" after the purchases was insufficient to base a conclusion that the investments were suitable. The trial court failed to examine whether the limited partnership investments were appropriate given the investor's financial status and his investment objectives.