Emerging Developments In Arbitration - Current Trends And Where The Action Is Likely To Be When The Music Stops

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I. General

The landscape of the securities industry has been changing over the last several years. Such change has given rise to a new array of cases and claims. Among the significant developments has been the consolidation of and reduction in number of the major retail wire houses, which continues to evolve through the present time. Another particularly significant development has been the entry of major banking institutions into the financial services marketplace. For example, Bankers Trust just announced that it plans to buy the 197-year-old securities firm Alex Brown, Inc.

The reduction in the number of major wire houses has precipitated the dramatic expansion in the number of smaller, thinly capitalized broker/dealers that clear their trades through the major clearing firms. Similarly, there has been a significant increase in the number of persons involved in the financial planning end of the business. Unfortunately, there has also been an increase in a less desirable element in the securities industry - namely, the "organized crime" element.

As a result of these events and the increased competition for investor dollars, an array of new trends can been seen in the securities industry. First, there has been a significant increase in the variety of products offered to investors. Second, there has been a tremendous increase in the number of mutual funds offered and the amount of investor dollars put into mutual funds. Whereas five or six years ago there were 1000 or so mutual funds, today there are over 5000 mutual funds from which to choose. Just about every conceivable investment product is being packaged in mutual funds today, including complex derivatives, commodities, and foreign stocks and bonds, among other things. Moreover, investors have poured billions of dollars into mutual funds. As recently noted by SEC Chairman Arthur Levitt, "Investors today have far more money in mutual funds - $3 1/2 trillion - than in commercial bank deposits - which total some $2 1/2 trillion." *See* Witmer, "SEC Proposes Revisions to Overhaul Mutual Fund Disclosure", *Sec. Reg. & L. Rep*. (BNA) Vol. 29, No. 9, at 253, (February 28, 1997). According to Levitt, over 30 million U.S. households - about 1 in every 3 families - own mutual funds.

The long-running bull market has helped mask many of the potential problem areas in the investment arena. Investors who have been making at least some money are less likely to question what sort of investments they have made.

II. Current Trends

A. Chop Shops & Stock Manipulation

Over the past several years, claimants' attorneys have seen a significant increase in so-called “chop shop” cases. Chop shop cases are essentially those involving penny stock firms. The “chop” refers to the spread between bid and ask prices for certain securities. As one might expect, there has been a proliferation of penny stock firms in recent years. While these firms may have repackaged their products at higher price levels to avoid recent regulations to curb past abuses by penny stock firms, many still engage in boiler-room tactics, such as cold-calling, to sell their securities to unsuspecting investors.

Closely related to claims arising out of “chop shops” are claims that involve stock manipulation. Stock manipulation generally is more prevalent among low-priced, thinly traded penny stocks and is a practice most often associated with smaller brokerage firms which serve as market makers for such stocks and which tend to engage in boiler-room activities.

Notwithstanding movements such as the Penny Stock Reform Act enacted by Congress in 1990, penny stock firms are alive and well and investors are continuing to invest large sums of money with such firms. As such, arbitrations involving penny stock firms have not subsided.

One “trick” often used by penny stock brokers to attract investors is recommending a listed security as the first purchase an investor should make. Penny stock firms often use this tactic for two reasons: first, to give customers the false impression that the customer is not dealing with a penny stock firm, and second, to avoid certain regulatory requirements imposed by the Penny Stock Reform Act.

Typical claims that are pursued in arbitration by penny stock investors are misrepresentation claims and suitability claims. Other claims often involve stock manipulation and violations of the mark-up rules. In addition, investors may have claims for failure to execute sell orders. Often firms involved in stock manipulation will refuse to enter a customer's sell order because they want to keep the stock prices artificially inflated (often referred to as a “no net sales policy.”)

Unfortunately for investors, many of these penny stock firms do not stay in business long enough for investors to file arbitration claims to attempt to recoup some of their losses. For example, numerous investors had claims against Stratton Oakmont when it declared bankruptcy in late 1996. Even states that had arranged for a reparations process for investors who had been defrauded by Stratton were left empty-handed. On December 5, 1996, the NASD expelled Stratton from the securities industry. The NASD found that Stratton had charged excessive and/or fraudulent markups to certain of its customers.

In July 1996 another brokerage firm, A.R. Baron & Co., filed bankruptcy as well. In an article in *Forbes* earlier this year, much was written about Baron and its many problems.

> According to the Securities & Exchange Commission, since its very first days A.R. Baron had engaged in egregious sales practice abuses, including rampant unauthorized trading in customer accounts, and abusive sales practices involving stocks that it underwrote. In industry parlance, Baron was a firm that employed a ‘no net sales' policy. That meant Baron's brokers would allow their clients to sell a position in one of their so-called house stocks only if another of the firm's clients

> placed orders to buy the shares. In short, a Baron stock couldn't drop because the broker wouldn't permit trades at lower prices. This had the effect of propping up Baron's special stocks, for a while at least.

See G. Morgenson, “Sleazy Doings on Wall Street,” *Forbes*, February 24, 1997.

The most prevalent form of stock manipulation involves initial public offerings (“IPOs”). Penny stock firms get numerous customers to invest in the IPOs which the firm has underwritten. On the first day of trading, the price invariably rises because these firms have already lined up customers to buy shares once the trading opens in order to create a “demand” for the stock. Keeping the price of the stock inflated after the IPO closes gives insiders a chance to get out of the IPO at a profit. Subsequently, the price of the stock plummets and investors who bought on the IPO or shortly thereafter are left with nearly worthless securities.

In the last year, much has also been written about whether organized crime (i.e. the “Mob”) has infiltrated the securities industry. *See* “The Mob on Wall Street,” *Business Week*, December 16, 1996. According to *Business Week's* findings, the “Mob” is involved in stock manipulation schemes through a network of stock promoters, broker/dealers, and boiler-rooms that sell stocks by cold-calling investors throughout the United States.

In accepting, structuring, and filing claims on behalf of investors who have lost money through investments with chop shops or through stock manipulation schemes, an attorney must exercise caution. With these penny stock firms, significant doubt may exist as to whether the claimant would be able to collect an award should he win his arbitration. While the claimant may have excellent claims, he may ultimately be unable to find a “deep pocket” from which to collect his award. With stock manipulation schemes, the claimant may be able to pursue claims against a firm's principals for their involvement in the manipulation scheme; however, the pursuit of claims against the principals could involve significant time and expense and thus, may not be economically feasible for claimants with smaller claims.

B. Selling Away

“Selling Away” cases have also become more prevalent in recent years. Selling away is the practice whereby a broker invests his client's money without doing so at or through the brokerage house at which he is employed. Selling away can involve investments in private limited partnerships, stock of privately held companies, promissory notes, or real estate, among other things. The practice is known as “selling away” because the broker is selling an investment to his client away from the firm at which he is employed.

The main concern with selling away situations is supervision. If a broker is selling investments to his clients away from his firm, the firm may have no mechanism for supervising such sales. In addition, the firm may have no procedure for determining the suitability of investments made for clients outside the firm. The investments are not being purchased through the firm's normal order entry system and thus, in some cases, the firm may have no knowledge of such sales. However, in other cases, the firm may have full knowledge (at least at the local branch level) of the broker's activities and may even be encouraging such activity. In some situations, the client may even be led to believe that he is investing in a product recommended by the firm.

For example, in a recent arbitration, *Dobison v. Josephthal, Lyon & Ross and Rodney Sailor*, NASD Arbitration No. 96-00963, the Claimant, through his broker at Josephthal, Lyon & Ross, invested funds with two entities and, in exchange, received a convertible note with an option to purchase stock and warrants from one entity and shares of stock in the other entity. The Claimant introduced evidence at the hearing that showed that Respondent's branch managers were aware that the Claimant's broker, as well as other brokers in the branch office, were soliciting Josephthal clients to make such investments as “bridge financing” for at least one of the entities because the branch managers were hoping that Josephthal would do an initial public offering for the entity. The Claimant also introduced evidence at the hearing to support his claim for lack of supervision. Josephthal, Lyon & Ross argued in defense of the Claimant's claims that these investments were made away from their firm and that Josephthal's only connection to the transactions was the fact that the Claimant voluntarily withdrew funds from his Josephthal account to make the investments at issue. The Claimant asked for damages in excess of $500,000. The arbitrators entered an award in favor of the Claimant in excess of $900,000 against Respondent Josephthal, Lyon & Ross representing actual damages, interest and attorneys' fees and for $1,000,000 against the Claimant's broker for punitive damages. The arbitrators found that Josephthal, Lyon and Ross was guilty of negligent supervision, fraud and conversion. The arbitrators also granted Respondent Josephthal an award in excess of $900,000 on its cross-claim against the broker.

See also U.S. v. Zandford, 1997 U.S. App. Lexis 6327, 4th Cir., April 3, 1997 (The court refused to overturn a broker's convictions for wire fraud resulting from his mishandling of the account of a 71 year old disabled man and his mentally ill daughter. In this case, the client gave the broker over $400,000 to invest conservatively for him. Instead of investing the money through his firm, the broker converted the funds for personal use. When confronted, the broker claimed that he had entered into three agreements with the client - one for $100,000 for personal services he rendered to the client and his daughter as the overseer of their personal and medical needs; another for $150,000 to operate a business to restore vintage cars; and a third for $140,000 as a personal loan. The court found that the broker failed to disclose these agreements to his employer and that there was ample evidence to show that he had engaged in a scheme to defraud these investors.)

C. ERISA

One area of securities arbitration which observers are seeing more often is ERISA (Employee Retirement Income Security Act) cases. With the aging of the baby boomer generation, the increased concern about retirement planning and the rampant bull market over the past seven years, more and more pension funds have been invested in the securities market. Certain abuses in handling these funds, coupled with the bar's increased awareness of the sweeping liability imposed by ERISA, have given rise to a significant number of “new” cases in this arena.

The broadest liability imposed by ERISA arises when the broker is a fiduciary to the ERISA plan. A broker becomes a fiduciary of a plan under ERISA if he makes investment recommendations to an ERISA plan on a regular basis with the understanding that his recommendations will be the primary basis for the plan's investment decisions. *See* ERISA § 3(21)(A)(ii) [29 U.S.C. § 1002(21)(A)(ii)]. The Department of Labor regulations under ERISA provide:

> A person shall be deemed to be rendering “investment advice” ...only if:
> (i) Such person renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; and
> (ii) Such person either directly or indirectly --
> (A) Has discretionary authority or control, whether pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or property for the plan; or
> (B) Renders the advice described in (c)(1)(i) of this section on a regular basis to the plan pursuant to a mutual agreement, or arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for the investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

29 C.F.R. § 2510.3-21(c). *See generally Farm King Supply, Inc. Integrated PSP & Trust v. Edward D. Jones & Co.*, 884 F.2d 288, 293 (7th Cir. 1989). *See also Glaziers and Glassworkers Union Local No. 252 v. Newbridge Securities, Inc.*, *et al.*, 93 F.3d 1171 (3d. Cir. 1996)(Claimant, various employee benefit funds (the “Funds”), alleged that a brokerage firm failed to disclose to it that its broker had been investigated by the firm and by the SEC due to suspected improprieties in personal investments. The Funds subsequently transferred its account with the broker when the broker left the brokerage firm and set up his own firm. The Funds later learned that the broker was under investigation again by the SEC at his new firm. Unfortunately by that time, the broker had stolen over $500,000 of Fund assets and had wasted Fund assets in excess of $2,000,000. The Funds alleged that the first brokerage firm was a fiduciary under ERISA and that it breached its fiduciary duty by failing to disclose to the Funds the events surrounding the broker's departure from the brokerage firm. The Funds asserted that if it had known of the SEC and internal investigations, it never would have agreed to transfer its accounts to the broker's new firm. The court held that if the previous brokerage firm is found to be an ERISA fiduciary, then it “had a duty to disclose to the Funds any material information which it knew, and which the Funds did not know, but needed to know for its protection.” *Id*. at 1182.)

A broker who breaches the fiduciary duties he owes to an ERISA plan is liable for the losses sustained by the plan and must also return all commissions, fees or other revenue. 29 U.S.C. § 1109(a).

At least one court has held that the six-year rule applied by most securities industry arbitration forums is not applicable in ERISA cases. In *Kramer v. Smith Barney, Inc*. 80 F.3d 1080, (5th Cir. 1996), the court held that the AMEX's six year rule could not be applied to claims arising from a doctor's employee benefit plan accounts. “Because application of Rule 605 to render Kramer's ERISA claims ineligible for arbitration would impair his substantive rights, we hold it void with respect to those claims.” *Id*. at 1085. The court reasoned that

> [u]nder section 410 [of ERISA], 'any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under [ERISA] shall be void as against public policy.' 29 U.S.C. § 1110(a)(1982). To the extent the AMEX rule renders ineligible for arbitration ERISA claims more than six years old which could otherwise be enforced on proof of fraud or concealment, it 'relieve[s] a fiduciary from...liability.'

Id. The court noted that the arbitrators could decide whether the ERISA statute of limitations barred any of the Claimant's claims. *Id*.

D. Employment Law Claims

Over the last several years there has also been a proliferation of cases arising out of employment abuses within the securities industry. Whereas in the past most employment claims revolved around contract, compensation or confidential information disputes, today claims for sexual harassment, gender discrimination, racial and age discrimination, among others, have increased in number. The Americans with Disabilities Act also opens up firms to possible litigation.

There has been an ongoing debate whether employment discrimination claims should be arbitrated or if employees should be permitted to pursue such claims in court. In *Gilmer v. Interstate Johnson Lane Corp.*, 500 U.S. 20 (1991), the United States Supreme Court ruled that arbitration agreements, which cover employment-related claims of individuals in the securities industry, are enforceable. The Court also held that issues regarding the arbitrability of disputes should be resolved in favor of arbitration. The following test was established to determine if a claim is arbitrable:

1. whether there is an agreement to arbitrate;
2. whether the claim falls within the scope of the agreement; and
3. whether there has been a waiver of the right to arbitrate.

Gilmer, 500 U.S. at 20-34.

The Supreme Court in *Gilmer* held that there was no absolute right of access to the court system to pursue a claim based on the Age Discrimination in Employment Act. Numerous cases rely on *Gilmer* in extending the enforcement of arbitration agreements in employer-employee agreements in other situations. *See Pritzker v. Merrill Lynch*, 7 F.3d 1110 (3d Cir. 1993) (ERISA); *Bender v. A.G. Edwards & Sons, Inc.*, 971 F.2d 698 (11th Cir. 1992) (Title VII); *Saari v. Smith Barney, Harris Upham & Co., Inc.*, 968 F.2d 877 (9th Cir.), *cert. denied*, 113 S.Ct. 494 (1992) (Federal Employee Polygraph Protection Act); *Willis v. Dean Witter Reynolds Inc.*, 948 F.2d 305 (6th Cir. 1991) (Title VII).

Recently, much has been written about arbitrating employment discrimination claims. On March 24, 1997, SEC Chairman Isaac Hunt stated that "securities industry-dominated panels are...uniquely unqualified to arbitrate employment discrimination claims, particularly when those claims involve gender or race discrimination." Witmer, "Special Report - Industry Panels Unfit to Handle Discrimination Claims, Hunt Says," *Sec. Reg. & L. Rep*. (BNA), Vol. 29, No. 13, at 426 (March 28, 1997). Citing that the makeup of the securities industry is not particularly diverse, Chairman Hunt found that industry panels do not have enough experience in employment discrimination law and therefore, a better system of handling discrimination claims needs to be devised. *Id*. Although the Securities Industry Association ("SIA") has supported mandatory arbitration of discrimination claims, many have criticized the practice, including the Equal Employment Opportunity Commission ("EEOC") on the grounds that mandatory arbitration of employment discrimination claims violates an employee's civil rights.

Last year, a group of women sued Smith Barney in a class action suit for sexual harassment and sex discrimination. *See Martens, Thomann, and Mione v. Smith Barney, Inc.*, ___ (S.D.N.Y.May 20, 1996). These woman also named in their suit the NASD and the NYSE, among others, alleging that the regulators are in error for supporting and enforcing a system which forces them to pursue their claims in arbitration in exchange for getting licensed. These claimants filed their suit as a class action on behalf of all woman at Smith Barney. By filing as a class action, the claimants are hoping to avoid arbitration since neither the NASD and NYSE will hear class action cases.

Apparently the Form U-4 is not the only manner in which securities firms are forcing employees to pursue their disputes in arbitration. Smith Barney purportedly makes employees sign a document called "Principles of Employment" on their first day on the job. Employees who sign this form give up their right to pursue claims in court and submit to a narrowing of the powers of securities arbitrators. *See Securities Regulators Keep Sex Bias Cases Under Wraps*, The Tampa Tribune, June 23, 1996.

For other cases in which courts have been asked to decide whether securities industry employees must arbitrate their discrimination claims *see: Prudential Insurance Co. of America v. Lai*, 42 F.3d 1299 (9th Cir.), *cert. denied*, 116 S.Ct. 61 (1994): The U.S. Court of Appeals for the Ninth Circuit reversed a district court's order compelling arbitration of statutory sexual harassment and gender discrimination claims under the FAA. It held that, despite execution of U-4 agreements, two female sales representatives did not "knowingly" enter into an agreement to arbitrate employment disputes. The Court reasoned Congress intended there to be a knowing agreement to arbitrate certain employment disputes, such as sexual discrimination claims. However, this dispute arose before the 1993 amendment to the NASD Code (in which the NASD provided for arbitration of any dispute arising out of the employment or termination of employment), and involves a situation where the agreement did not specify that it encompassed employment claims, the employees were not advised of the arbitration clause, and the employees were not given an opportunity to read the agreement.

See Degaetano v. Smith Barney, Inc., 70 Fair Empl. Prac. Cas. (BNA) 401 (Feb 5, 1996): Ms. Degaetano, a former analyst with Smith Barney, sued Smith Barney for sexual harassment. Ms. Degaetano had not signed a form U-4. However, the court held that an arbitration agreement contained in an employee handbook and signed by Ms. Degaetano on her first day of employment was enforceable. When Ms. Degaetano was hired by Smith Barney, she signed an agreement which stated "You must observe the policies which we publish from time to time for employees. These expectations are included in the Dispute Resolution Procedure, the Arbitration Policy and the Employee Handbook, all of which are available for your review prior to your acceptance of employment, if you choose to review them. Remember, it is your responsibility to read and understand these policies and expectations." Pursuant to the agreement Ms. Degaetano waived her right not only to file her claim in court, but also her right to attorneys' fees, punitive damages and injunctive relief. The court rejected Ms. Degaetano's arguments that arbitration agreements should not be enforced because they are inherently at odds with Title VII, they are not knowingly and voluntarily entered into by employees, and they are unfair because they restrict the types of damages that may be awarded by the arbitrators.

See Nieminski v. John Nuveen & Co., 1997 U.S. Dist. Lexis 764 (N.D. Ill. January 16, 1997): A former municipal housing analyst sued her former employer for sexual harassment, age discrimination and retaliation for filing a complaint. Ms. Nieminski's attorneys sought declaratory relief to prevent the respondents from compelling her claim to arbitration before the NASD or NYSE. The court granted Respondent's motion to dismiss and to compel arbitration even though Ms. Nieminski signed a U-4 before the NASD amended its Code of Arbitration Procedure to include arbitration of employment disputes. The court found that at least some of the acts of which Ms. Nieminski complained had occurred after 1993 when the NASD amended its Arbitration Code.

III. Time Bombs in the Bull Market

A. Product Cases

While cases involving the mishandling of an individual's account by a particular broker are still quite prevalent, in recent years there have been more "product cases" filed in arbitration and in court. Product cases are those cases in which the particular product is the focus of the case, such as limited partnerships, mutual funds, or collateralized mortgage obligations ("CMOs") or other derivative securities, instead of the "bad broker." Oftentimes in product cases, not only is the broker not named as a defendant, he may even be a favorable witness for the claimant, particularly if the broker is no longer employed by the brokerage firm from which the claimant purchased the product at issue.

While limited partnerships cases were commonplace in the early 1990s, today cases involving mutual funds, derivatives, and even variable annuities have taken their place.

1. Mutual Funds

Over the last ten years, more and more investors have invested significant sums of money in mutual funds. In fact, as stated above, investors have more money invested in mutual funds than in commercial bank deposits. Investors are buying mutual funds not just from brokerage firms, but instead through a variety of sources including the securities departments of major banking institutions. In the last several years, various mutual funds have suffered large losses and, as a result, investors have begun filing class action lawsuits and arbitration claims in an attempt to recoup their losses.

Claims involving mutual funds often include claims for suitability and misrepresentation. Investors have also pursued claims for excessive fees charged by mutual funds and for misrepresentation based upon the fund's failure to disclose certain conflicts of interest.

Another area of concern is "in-house" mutual funds. Brokers are often encouraged to sell in-house mutual funds because these funds have higher commissions or because the broker may have a sales quota for such funds. However, the in-house fund may not be the best fund available to satisfy the client's investment objective. A broker then has to decide what his obligations are to his client versus his firm.

The SEC has proposed changes to mutual fund disclosure. The new rules would allow investors to purchase mutual funds based on summary or profile prospectuses. Also, mutual funds would be required to invest at least 80% of their funds in the investments suggested by their names, and there would be restrictions on use of misleading terms such as "government," "guaranteed" and "tax-exempt".

See Langner v. Brown, et al. [1995-1996 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 99072 (January 30, 1996) (Shareholder brought claim against directors of closed-end fund for mismanagement and self-dealing. Shareholder claimed, among other things, that the directors caused the fund to incur total net investment losses in excess of $5.1 million from 1989 through 1994, while the executive officers received in excess of $3.8 million in compensation.)

See Krouner v. American Heritage Fund [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99082 (September 11, 1995) (Class action in which it was alleged that certain risks were not disclosed in a mutual fund's registration statement and prospectus. "Although the fund did not disclose that it invested in poorly capitalized companies and companies without any operating history, it did disclose that it invested in bankrupt companies and junk bonds, and that it engaged in leveraging, short selling and other speculative investment techniques." The court found that the omitted information could not have affected a reasonable investor's decision to invest.)

See In Re Speaker [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,901 (January 13, 1997) (A mutual fund portfolio manager settled an SEC administrative proceeding which resulted from the fund's manager trading debentures which created a conflict of interest with the fund. The fund's manager could have purchased certain debentures for the fund and sold them the same day at a profit, but chose instead to buy the debentures for his personal account so that he personally could reap the profits.)

See Blatt v. Merrill, Lynch, Pierce, Fenner & Smith, 916 F.Supp. 1343 (D. N.J. 1996)(the court found that mutual fund investors had sufficiently alleged a cause of action for material misrepresentations and omissions and securities fraud. Investors alleged that Merrill Lynch failed to disclose the risks associated with the funds which were invested in derivative securities.)

See In Re TCW/DW North American Gov't Income Trust Securities Litigation, 941 F.Supp. 326 (S.D.N.Y. 1996)(Mutual fund investors filed class action based upon misrepresentations of risk in the fund prospectus. Investors have also claimed that the fund breached its fiduciary duties by charging the investors excessive management and advisory fees. Defendants moved to dismiss, but the court did not grant the motion.) *See also In Re TCW/DW North American Gov't Income Trust Securities Litigation* [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,320 (August 28, 1996).

2. Derivatives

With derivatives, which are very complex investments, claimants often pursue claims for suitability and misrepresentation. For example, in the case *ABF Capital Management v. Askin Capital Management, L.P.*, 1997 U.S. Dist. Lexis 621, January 22, 1997, investors in three hedge funds (the “Funds”) brought claims against the Funds' manager, Askin Capital (“ACM”), and the broker-dealers who sold risky CMO investments to the Funds. The investors contend that the broker-dealers aided and abetted the Funds' manager in committing fraud and in breaching its fiduciary duties to the Funds by selling risky CMO investments to the Funds which they knew were not appropriate for the Funds. The court refused to dismiss the claimants' claims against the brokerage firms. The court held that “[u]nlike the typical relationship between brokers and customers, ACM and the Funds relied on the Brokers to create new CMOs, to finance CMO purchases and to maintain a general market for such securities. In turn, many Brokers relied on the Funds -- which were among their largest and most important CMO customers -- to purchase a large proportion of the Brokers' most ‘toxic,’ ‘deal-driving’ CMO tranches....The allegations that the Brokers engaged in these activities and did so to prop up ACM and their multi-billion dollar market in CMOs...adequately supports the claim that the Brokers substantially assisted ACM's fraud.” *Id*. at 62.

Several mutual funds have been attacked for having invested in derivatives. In one instance a brokerage firm, PaineWebber, put $33 million of its own money into a government bond fund, the Short-Term US Government Income Fund, to help “repay” investors for losses the fund incurred as a result of investments in derivatives. Piper Jaffray also injected $10 million into its Piper Jaffray Institutional Government Income Portfolio which had suffered losses from mortgage derivatives. Although investors in the Hyperion 1999 Term Trust filed an action under §§ 11 and 12 of the 1933 Act, the suit was dismissed. The court held that the prospectuses contained sufficient warnings regarding the risks involved in the fund's purchases of interest only strips of mortgage-backed securities. *See Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2 (2nd Cir. 1996).

See also Hahn et al v. Investors Trust Government Fund, et al., No. 94-1455B (PQR) (SD CA) (Class action suit filed against Investors Trust Government Fund and other defendants including the Fund's adviser and sub-adviser. Defendants settled for $7.3 million to pay investors for losses from mortgage-backed derivatives.)

B. Wrap Fees

The future is likely to bring more cases in which the client has not been charged a commission, but has instead paid a wrap fee for the transactions in his account. Oftentimes in addition to the fee, there are other undisclosed methods whereby the broker has made money from the trades done in the wrap fee account. For example, *In the Matter of Portfolio Management Consultants, Inc*. [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶85,826 (June 27, 1996) an investment advisor executed orders for its wrap fee clients at the national best bid and offer. However, the advisor obtained better prices in the third market contemporaneously and did not pass along better prices to its clients. The SEC found that the advisor failed to disclose to its clients that the prices they were paying were not the most favorable and failed to disclose that the advisor also received, in addition to its wrap fees, profits from principal trading. The advisor violated anti-fraud provisions, was ordered to cease and desist, to pay a $25,000 fine, and to disgorge the profits it had received. *Id*.

C. Use of Electronic Media

The growth in popularity of the Internet has brought with it many new opportunities for fraud. Issuers and broker/dealers now have a new method to communicate with potential investors via the Internet. Small investors have access to on-line information that was once available only to institutional clients.

The concern over the potential for fraud on the Internet has prompted the NASD to prepare a brochure to be sent to all NASD member firms. The brochure warns that “[t]he real-time nature of the Internet, combined with its growing base of users, makes it a prime target for stock touting and bashing....Never make investment decisions solely based upon what you read on the Internet. Always consult other resources.” *See* “NASD Regulation Warns Investors of On-line Hype,” Fed. Sec. L. Rep. (CCH) No. 1729, p. 7 (1996). According to a website for the SEC, typical investment frauds conducted via the internet usually fall within one of the following categories: (1) the pyramid scheme; (2) the risk-free fraud; (3) the “pump and dump” scam. *See* SEC website at “http://www.sec.gov/consumer/cyberfr.htm”. With the pyramid scheme, investors try to make money by getting new investors to join the program. According to the SEC, this type of scheme works well on the Internet because so many people can be reached with one on-line message. With the risk free fraud scheme, investors are often told that whatever investment being peddled is “like a CD” or “risk free.” The SEC noted that investment schemes conducted over the Internet included investments in wireless cable projects, prime bank securities, eel farms, and a fictitious coconut plantation in Costa Rica. With the “pump and dump” scam, the SEC says that there is a proliferation of on-line messages urging investors to either buy or sell a particular stock. The message sender usually alludes to the fact that he has inside information regarding these stocks, but in reality, according to the SEC, the message senders are usually insiders who stand to gain if they can pump up the price of the stock or short sellers who will gain if the price of the stock goes down.

The Internet has also made it much easier for brokers to reach investors worldwide. Unfortunately, some unscrupulous brokers prey upon foreign investors, viewing them as nothing more than new opportunities to perpetrate their frauds.

Along with Internet fraud, misuse of the Regulation S (“Reg S”) exemption has also grown in recent years. Reg S, which was originally adopted by the SEC in 1990, provided that the registration provisions of the U.S. securities laws would not apply to placements of securities offshore. Instead the SEC believed that the laws of the foreign jurisdiction where the securities were being offered would govern and protect investors in those jurisdictions. Since its adoption, Reg S has been abused in some instances as a means to distribute unregistered securities in the U.S. As a result of these abuses, in February 1997, the SEC published for comment proposed rules to amend the Reg S safe harbor procedures. *See Offshore Offers and Sales* [Current Transfer

Binder] Fed. Sec. L. Rep. (CCH) § 85,909 (February 20, 1997). Under the proposed amendments, equity securities placed offshore to non-U.S. persons pursuant to Reg S would be treated as restricted securities within the meaning of Rule 144, and thus these securities could not be resold in the U.S. during the restricted period, which has been increased from 40 days to two years under this proposal.

See SEC v. Sellin, D.C. S. Fla., Case No. 96-6825-CIV-Ungaro (7/25/96) (The SEC obtained a temporary restraining order against an individual and two entities in Florida who, according to the SEC, engaged in a fraudulent securities offering via the Internet. According to the SEC, the defendant used newsgroup bulletin board postings and advertisements place through CompuServe to engage in a fraudulent offering.)

See Cody v. Ward, D.C. Conn., Case No. 3:95CV169 (R.N.C.)(2/4/97)(A promoter from California used Prodigy's “MoneyTalk” to send messages about a particular stock to investors. The promoter encouraged people to invest in this particular stock and in doing so, made fraudulent misrepresentations about the stock.)