CONCENTRATION:
TOO MUCH OF A GOOD THING?

The brokerage firm puts out a strong buy on a particular stock. The broker begins recommending it to the majority of his clients. The stock goes down and the broker increases his sales efforts in the guise of an averaging down strategy. The broker does some of his own research on the stock and buys some for himself and for some of his family members. The stock continues to go down. Adding fuel to the fire, the firm's analyst keeps a "strong buy" on the stock, which makes the broker feel comfortable in continuing to recommend it. The broker reasons that if he liked the stock at $40, he certainly loves it at $20. The broker throws caution to the wind and buys larger blocks for all of his clients. The stock continues to plummet. Finally, the broker's initial optimism transforms into a sort of frenetic desperation. The broker feels handcuffed. He's got the majority of his book in the stock in far too high a percentage, and he has loaded up himself and his family on it. A recommendation to sell is not a viable option in his eyes, because of the negative impact not only on his clients but on his business. About this time, investor complaints and arbitration claims mount.

The above scenario shows how many investors ended up highly concentrated in securities that may have been totally unsuitable for them.

I. The Explosion in Concentration Cases

While complaints regarding concentration and lack of diversification have always existed, we have seen a surge in such complaints over the last few years. One of the reasons for so many concentration cases is that one portion of the market became significantly hotter than others. In the late nineties, the NASDAQ and more speculative technology stocks started to significantly outperform other markets and sectors. Far too many brokerage firms, analysts and stockbrokers chased that trend. What exacerbated the concentration problem was that as these stocks started to correct, stockbrokers continued to recommend that their clients average down and add more to these stocks.

A concentration problem is not something that rears its ugly head only in chop shops. Concentration cases have been brought against all the major firms, as well. With the bust of dot.coms, telecoms and tech, many firms and their brokers got a rude reminder of the principles of proper diversification. Diversification's nemesis, of course, is concentration. Not since the early eighties when all energy related stocks took it on the chin have we seen such a broad decline across industry sectors. Despite being required to know, younger brokers who had not previously experienced such a debacle were blindsided when they witnessed their clients' accounts plunge in value.

The investigation by the New York Attorney General Eliot Spitzer and other state regulators into analyst recommendations, to some degree, was a byproduct of the concentration problem. If Merrill Lynch and other firms had put only a very small percentage of each of their clients' portfolios in the telecom and technology industries, then the damages sustained by investors may not have warranted such high-profile investigations.

II. How to Plead a Concentration Case

Concentration, or overconcentration as many like to say (though we wonder if that is redundant), falls under two primary causes of action – negligence and fraud related claims (common law and statutory). Negligence is the easier to prove and easier for the arbitrators to grasp. Stockbrokers have a myriad of duties, one of which is the duty to recommend only suitable investments. When an account is overconcentrated, it is de facto unsuitable. The duty has been breached, and the stockbroker and firm (through respondeat superior) are negligent. If you are in a state where you can establish a fiduciary duty on the part of the stockbroker, then the broker's negligence is most certainly a breach of fiduciary duty, as well.

Invariably, if you can blame the stockbroker for concentrating the account, you can likewise blame management for allowing it to happen. The firm would be negligent in failing to adequately supervise the broker and the account. Allege in your claim that management failed to spot the concentration problem, because the firm had no or inadequate procedures to detect concentration, or because the supervisor failed to take reasonable steps once the problem was red flagged. Through discovery, you will learn which one it was. Either way, it is a violation.

Making this allegation will set you up for a specific discovery request requesting documents evidencing how the firm supervised for concentration. Some firm manuals state that supervisors should monitor for concentration when reviewing monthly statements. However, our experience is that it is not uncommon for firms to fail to produce anything responsive to such a request. Some firm compliance and supervisory manuals are vague or devoid of the concentration issue. The firm's lack of evidence, however, should be the claimant's strength.

The NASD sanctions firms with deficient written supervisory procedures, and the NASD has imposed sanctions where procedures failed to outline the methodology for supervision of concentration. See the NASD's January 1999 sanction of Securities America, Inc. below. And the NASD has a Sanction Guideline for this precise type of misconduct. The NASD Sanction Guidelines are available from the NASDR website. The Guidelines allow for a complete suspension of the responsible individual for up to a year. The NASD considers the following two factors in assessing sanctions for deficient written supervisory procedures:

1. Whether deficiencies allowed violative conduct to occur or to escape detection.

2. Whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance.

Be sure and ask for the identity of the individual responsible for monitoring and supervising for concentration. Although many brokerage firms have abused requests for information and gone far beyond asking for "identification of individuals, entities, and time periods related to the dispute," as set forth in the NASD Discovery Guide, we feel that this is a proper request.

Support for concentration as a negligent act can be found in NASD Rule 2310(a) which requires that a member "have reasonable grounds for believing that the recommendation is suitable for each customer…" and in NASD IM-2310-2(a)(1) which imposes on stockbrokers "the fundamental responsibility for fair dealing."

In order to avoid page after page of a brokerage firm's answer devoted to the proposition that there is no private cause of action for a violation of NASD or NYSE rules, it is advisable to structure your claim so that all of your violations of such rules, including failure to supervise, are a subset of your negligence claim. Include language to the effect that "The industry standards of care are set forth by the rules of the NASD (including its Notice to Members), the NYSE, and the SEC; the regulators' interpretations of their rules, federal and state statutes, including the [state] Securities Act; the Securities and Exchange Act; and compliance manuals of the Respondent firm, as well as other firms. Respondents are obligated to provide Claimants and Claimants are entitled to rely upon Respondents for competent, professional securities services in accordance with those industry rules, regulations, customs and practices."

If a brokerage firm should be so bold as to try to attach meaning to the fact that concentration is not specifically referred to in the NASD or NYSE rules, as is the case with unauthorized trading (IM 2310-2(b)(4)(iii) of the NASD Manual and Rule 408 of the NYSE manual) and excessive trading (IM 2310-2(b)(2) of the NASD Manual and Rule 435 of the NYSE manual), there are several ways to counter this argument. First, NASD IM-2310-2(c) makes it clear that the enumerated prohibited practices "are not all inclusive." Therefore, the NASD clearly envisioned violations that it chose not to describe.

If the NASD and NYSE described every conceivable wrong that could be perpetrated on an investor, the respective manuals would easily expand into numerous volumes. For example, the rules do not set forth every aspect of proper supervision, but rather require firms to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association." NASD Rule 3010.

Second, compliance and supervisory manual references to concentration issues should be referred to in the Statement of Claim where possible. Your expert should opine that when a stockbroker violates sales practice guidelines set forth in the firm's compliance manual, it is as serious as violating an NASD or NYSE rule. Ask for production of the firm's training manuals, as this elementary precept of investing should be spelled out there.

Third, the concept of diversifying is so basic that it simply "goes without saying." Morgan Stanley's May 2002 Perspectives document states:

> When something stands the test of time, proving its worth again and again, we call it a classic. In the investment world there's a classic piece of advice: Diversify.

However, the most compelling evidence of the seriousness of concentrating a client's account consists of regulatory decisions evidencing suspensions and fines on brokers for overconcentration. It is important to educate your panel early by incorporating such decisions into your Statement of Claim or attaching them as exhibits. The NASD, the NYSE and the SEC offer search capabilities on their websites that allow you to pull up such decisions. You might find a regulatory decision that involves very similar concentration facts and levels as the facts in your case, which would be very persuasive to the arbitration panel.

For years, the NASD has routinely fined and sanctioned brokers for concentrating their clients' accounts. Some NASD sanctions are as follows:

<u>October 1998</u>

> Jeffrey L. Salzwedel (Registered Principal, Tualatin, Oregon)…censured, fined $107,000, and suspended from association with any NASD member in any capacity for 30 days…findings that he made unsuitable recommendations for the purchase and/or sale of various securities in the accounts of public customers without having reasonable grounds for believing that such recommendations were suitable for these customers in view of the number of shares purchased and held, the nature of the recommended securities, the **concentration** of securities held in the accounts, and the customers' specific financial situations, circumstances, and needs.

<u>February 1999</u>

> Daniel Richard Howard (Registered Representative, Cambridge, Massachusetts) was named as a respondent in an NASD complaint alleging that he recommended and initiated purchase and sales transactions in the securities account of a public customer without having reasonable grounds for believing that the recommendations and resulting transactions were suitable for the customer in view of the size, frequency, **concentration** of speculative securities; the nature of the recommended transactions; and in light of the customers' financial situation, investment objectives, circumstances, and needs.

<u>October 2000</u>

> John Robert Van (CRD #2102824, Registered Principal, Corinth, New York) and Michael Edward Murphy (CRD #1528815, Registered Principal, Clifton Park, New York) - fined $10,000 and suspended from association with any NASD member for 15 business days…findings that they recommended unsuitable trading to public customers that resulted in excessive and inappropriate use of margin. The findings also stated that Van and Murphy recommended transactions in which the customers borrowed against existing stock positions to purchase additional shares of, among other things, "high-risk" over-the-counter stocks. The NASD found that Van and Murphy acted in disregard of their customers' interests when they disregarded the impact of use of margin and the **concentration** levels of certain securities, excessive trading, and the risks incurred in their

recommendations that resulted in a total loss of approximately $211,000 and margin interest of approximately $15,300.

April 2001

William Joseph Shaughnessy (CRD #870259, Registered Representative, Tucson, Arizona) submitted an Offer of Settlement in which he was censured and fined $10,000. Without admitting or denying the allegations, Shaughnessy consented to the described sanctions and to the entry of findings that he made unsuitable recommendations for the joint securities account of public customers that resulted in an over-**concentration** of precious metals-related investments in the account. The findings also stated that Shaughnessy completed a new account form for the customers' securities account that contained material inaccuracies. (NASD Case #C3A000036)

February 2002

John Richard Coleman (CRD #600684, Registered Principal, Orange, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined $7,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Coleman consented to the described sanctions and to the entry of findings that he recommended transactions of a speculative and high-risk stock, and recommended a covered call strategy, which involved writing options against highly volatile and speculative stocks for the trust account of a public customer without having reasonable grounds for believing that such recommendations were suitable for the customer in light of the size and nature of the transactions, the **concentration** of speculative securities, and the facts disclosed concerning the customer's other securities holdings, financial situation, investment objectives, circumstances, and needs.

The NYSE also has a history of sanctioning brokers for concentration. The NYSE has fewer on point decisions generally, because there are fewer brokerage firms that are NYSE members. Every brokerage dealer must register with the NASD, however.

In Re Fulton Gregory Cook, NYSE 99-170 (1999)("Cook over-concentrated the C Account in XYZ and UVW, which constituted approximately 78% and approximately 16.8%, respectively, of the market value of the account portfolio… the highly margined over-concentration in two speculative securities was unsuitable, in light of the investment objectives, financial resources and investment experience of AC and his wife.")

In Re William Kerber, NYSE 00-221 (2000)(overconcentration of aggressive high risk growth stocks).

In addition, regulators have fined brokerage firms for not having in place supervisory procedures designed to catch over concentration and for failing to implement those procedures:

> January 1999
>
> Securities America, Inc. (Omaha, Nebraska) submitted a Letter of Acceptance, Waiver, and Consent to the NASD pursuant to which the firm was censured and fined $10,000…The findings also stated that the firm's supervisory procedures failed to include procedures for all the types of business in which the firm engaged, failed to designate the principal responsible for the supervision of registered representatives and principals in the firm's Offices of Supervisory Jurisdiction, and failed to identify the individual responsible for the updating of the written procedures. Moreover, the procedures failed to outline the methodology for supervision of account activity, **concentration**, and use of margin in connection with accounts located in single person Offices of Supervisory Jurisdiction and branch offices.
>
> In the Matter of PaineWebber, SEC Administrative Proceeding File No. 3-8928 (1996)("The Branch Office Manager…failed reasonably to supervise the RR's activities…by failing to take reasonable measures to investigate clear signs of **overconcentration** in accounts of the RR's customers…")

Finally, in addition to negligence, concentration in unsuitable securities operates a fraud on the investor when there is a failure to disclose the concentration and its attendant risks. The NYSE has opined as follows in a case involving concentration:

> Moreover, for all these customers, Mr. Faragalli owed a duty, under these circumstances, to inform them of the extraordinary **concentration** of this particular stock among his customers. We believe that failure to disclose this information constituted a material misrepresentation, necessarily misleading such customers into accepting his recommendations to purchase still more of the stock without regard to potential illiquidity. The failure to disclose was particularly outrageous when, after the market downturn, the stock's potential for illiquidity was fully realized, and yet he recommended more of the stock to customers.

In the Matter of Henry James Faragalli, NYSE Hearing Panel Decision, 94-61, page 25 (1995)(the broker was suspended for 9 years).

III. What is Concentration and How to Spot It

Classically, people think of concentration as putting a large percentage of an investor's assets in one stock. But if an investor had numerous stocks in the telecommunications industry, for example, the diversification in numerous securities provided no protection due to the concentration within a particular industry. Generally, diversification requires investment in securities that are not affected by the same variables. "For example, an investor would not want to combine large investment positions in airlines, trucking, and automobile manufacturing because each industry is significantly affected by oil prices and interest rates." See David L. Scott, Wall Street Words, 1998. Also, Barron's Dictionary of Finance and Investment Terms, 1985, defines diversification as the "spreading of risk by putting assets in several categories of investments – stocks, bonds, money market instruments, and precious metals, for instance, or several industries, or a mutual fund, with its broad range of stocks in one portfolio."

As of late, investors found themselves not only invested technology stocks but in technology filled mutual funds. The concentration problem was exacerbated by many firms, like Merrill, that created mutual funds heavily weighted in technology. Brokers will sometimes mislead clients into believing they are diversified simply because they are in mutual funds.

When discussing the issue of concentration and lack of diversification, realize that there are two different aspects to it. The first is what percentage of the investor's portfolio should be in stocks - versus cash, bonds or other investments. The second is what percentage of only the stock portion of the investor's portfolio should be in certain types of stocks, industries or sectors of the market. The following pronouncements deal with the first aspect.

Concentration is relatively easy to spot when a single security comprises a significant portion of a client's portfolio. It's also easy to spot when you are able to obtain the firm's guidelines regarding concentration. Merrill Lynch counseled its brokers through its training program books in the early 1980s as follows:

> As a general rule, high-risk money should not exceed 10 – 20% of the client's investment funds, unless high risk is suitable.

More recently, the following is what Merrill Lynch states to clients in its Financial Foundation Reports:

> <u>Managing a Diversified Portfolio</u>
>
> Allocating assets among the three investment classes (equity, fixed income and cash) helps to protect investors against adverse market conditions affecting any one class. In addition, you should consider diversifying your investments within each asset class.
>
> Portfolio theory has statistically shown that a diversified portfolio typically reduces overall risk without necessarily reducing the expected return on that portfolio. This is typically achieved with a mix of different classes of securities representing a wide range of industry sectors that respond differently to various economic forces.

It is also helpful to utilize guidelines that are "sponsored" or attributable to certain firms. In the prospectus for the Equity Investor Fund - Focus Series - Broadband Portfolio 2000 (A Unit Investment Trust) which the prospectus specifically states is sponsored by Merrill Lynch, PaineWebber, and Morgan Stanley, in the section entitled "The Risks You Take", it states:

When stocks in a particular industry or country make up 25% or more of the Portfolio, it is said to be 'concentrated' in that industry, which makes the Portfolio less diversified.

At the CNN Money Website, there are a multitude of tools designed to assist investors in making their own financial decisions. The site offers a variety of calculators, such as a mutual funds screener, a retirement planner, a savings calculator and a mortgage refinance calculator where the user answers questions to which the output is tailored. Among them is an asset allocator calculator that presents the viewer with various allocation plans depending on the answers to the following questions.

When do you need the money?

a) 3 – 5 years
b) 5 – 10 years
c) 10+ years

How much risk can you handle?

a) Not much at all
b) A reasonable amount
c) As much as possible

How much wiggle room do you have?

a) I can't afford to miss my target.
b) If I miss my goal by a year or two, I'll still be okay.

As the market downdraft intensified in 2001, did you:

a) Sell stocks thinking things would only get worse
b) Do nothing
c) See an opportunity to buy more stocks

Interesting, if one selects the answers that would be given by the least conservative type of investor (answers a[1], c, b, and c), the suggested allocation has 60% of that investor's account in bonds, as shown below![2]

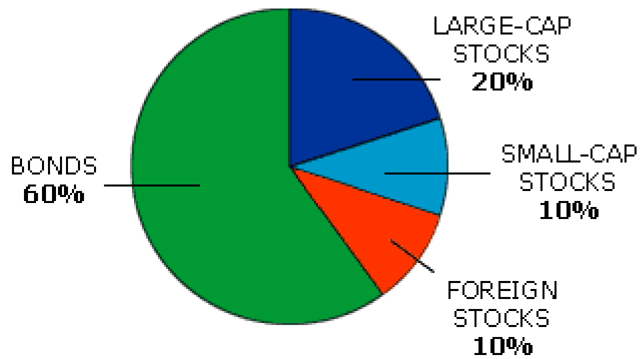
[1] An argument could be made that the least conservative investor would choose c), however, our rationale was that the risk taker is a mover and shaker and needs access to his funds for risky ventures.

[2] This result was obtained on June 30, 2002 by going to www.cnnfn.com, clicking on calculators and then selecting asset allocator, answering the questions and clicking on "get allocation."

Fix Your Mix

You selected:	
Time horizon:	3-5 years
Risk tolerance:	high
Wiggle room:	some
In a selloff, you:	buy

Suggested allocation:



Try a different scenario

Also, be sure to explore the websites of the brokerage firm at issue to see what they are currently advising folks about. At Merrill Lynch's website, we recently found the following Investor Profile Models[3]:

Investor Profile Models

The grid below illustrates the trade-offs that must be considered when designing an investment plan. Your Merrill Lynch Financial Advisor can help you find a balance between risk and return potential to create an investment plan tailored to your specific goals.

Model Name	Risk Potential Less ← → More	Return Potential Less ← → More	Asset Allocation
Capital Preservation			Stocks 15% Bonds 55% Cash 30%
Income			Stocks 30% Bonds 45% Cash 25%
Income/Growth			Stocks 45% Bonds 40% Cash 15%
Growth			Stocks 60% Bonds 25% Cash 15%
Aggressive Growth			Stocks 75% Bonds 10% Cash 15%

Merrill Lynch has changed the allocations for each model in the past and might change the allocations in the future, depending upon research and investment strategy recommendations.

The second aspect of concentration is focused solely on the stock portion of the account. Brokerage firms have likewise provided documentation to their clients and the public on this issue, as well.

Morgan Stanley's May 2002 Perspectives document states:

<u>Looking to Reduce Risk? Diversification is Key</u>

Suppose you own just one stock and it declines 20%. The value of your "portfolio" has fallen 20%. Now suppose you have two stocks, and while one drops 20%, the other stays flat. The value of your portfolio, in this case, has declined by just 10%. If you own 20 stocks, a 20% decline in one reduces the

[3] This chart was obtained on June 30, 2002 at http://askmerrill.ml.com/example/display/1,,534,00.pdf

> value reduces the value of your portfolio by just 1%! That's how diversification can help to reduce risk and optimize your overall return.

In a document entitled, "Five Strategies for Diversifying a Concentrated Position," which was available on Merrill Lynch's website, Merrill Lynch wrote:

> A concentrated position is a double-edge sword. When the stock's price is rising, the position can boost the value of an investor's overall portfolio. However, when the price falls, the portfolio value will suffer proportionately.

The long held investment norm is that for a stock portfolio to be considered diversified, the stock portion of the account should hold at least 20 (5%) to 30 (3.3%) different stocks. This standard is supported by numerous documents. A November 5, 1997 A.G. Edwards Compliance Note refers to 5% or more in a speculative security as a "concentrated" position.

Even mutual funds, which are professionally managed, must follow certain guidelines under the Investment Company Act of 1940 (ICA) to be considered "diversified." The guideline states that with respect to at least 75% of the fund, the securities of any single issuer do not account for (a) more than 5% of the investment company's assets, or (b) more than 10% of the outstanding voting securities of that issuer. ICA §5(b)(1).

Concentration definitions and levels vary among firms and companies. This makes it all the more important to determine the standards at the respondent firm during the time period at issue – standards for the entire portfolio and standards for the equity investments. However, just because the firm had a standard in effect, does not mean that it was an appropriate standard. If the firm had no standards at the time in question, then look to more recent guidelines by the firm, as well as guidelines from other firms, all of which can serve to establish the standard of care that was breached. Do not hesitate to incorporate standards that you find at respectable websites, like the CNNFN example above, either.

IV. The Impact of Margin in Concentration Cases

The use of margin plays a significant role in concentration cases. Stockbrokers have been known to portray margin to clients as a way to diversify the account, and thereby lessen the risks when, in reality, margin increases the risks. An investor on margin is much more susceptible to price swings in the stocks owned and, accordingly, risks having to liquidate either the core holding or the new stocks purchased using margin. The investor not on margin, on the other hand, has the ability to weather price drops without being forced to take action. Even Olde Discount's 1993 Compliance Manual stated "Investing in one security, a few securities, or securities in the same industry exposes the customer to greater risk, especially in a **margin** account."

With more frequency, we have seen the situation where an employee of a publicly traded company opens a brokerage account with a deposit of a huge amount of his company stock acquired through employee stock options. Brokers may mislead clients into believing that there is no need to sell the company stock and that, instead, diversification can be accomplished by using margin and purchasing additional securities. The problem is that the broker has not lessened that client's risk in the concentrated position. The client has the same exposure – in terms of risk of loss if the stock nosedives – as he did when he came to the firm. For this reason, margin is not an effective tool to lessen the risk in a concentrated position.

Diversification works in the absence of margin, because in order to diversify, the client has to sell some of the underlying security, which in turn lessens the risk of the concentrated position.

Ask your clients if the broker brought up margin as a way to diversify. Explore the broker's financial incentives to utilize margin. In a commission based account, margin increases the account's buying power and the broker's ability to generate commissions. Establish that what the broker made in subsequent margin purchases was greater than what he would have made if he had sold some of the concentrated security. If the broker was compensated on a percentage or flat fee basis, show that the broker made money by margining the account, since such compensation is based on the market value of the account, as opposed to the equity.[4] Compare this to what the broker would have made if he had recommended that a portion of the underlying security be sold - nothing.

Margin almost never decreases the risks, and almost always increases the risks. If the broker or brokerage firm argues that the use of margin diversified the account and thus lessened the risks, it will be clear that the firm not only misled your client, it is trying to mislead your arbitration panel.

V. Brokerage Firm Defenses to Concentration Cases

Brokerage firms utilize a variety of tactics to defend concentration cases. First, they often paint a picture that your client is a speculator, and so the concentration was not unsuitable. Second, they may attempt to show that there was no concentration by, what we call, "diversification by hindsight." Third, they almost always blame the investor for loving the stock or the industry and wanting to load up on it. Where possible, the firm will support that claim with evidence that the broker marked the order tickets "unsolicited". And finally, if your client came to the firm with the concentrated position, they will claim "no duty." Each of these defenses can be dealt with as follows:

A. Your Client Was A Speculator

The classic defense to almost any claim that hints of unsuitability is that the client had speculation as an investment objective and, hence, the firm had carte blanche to recommend anything and everything. The problem with such a premise is that it presupposes two things that undermine the premise. The first is that even stupid recommendations are suitable and the second is that historical precepts for investing no longer have any validity.

[4] Some firms also pay their brokers a percentage of the margin interest paid by the client.

A true speculator, be he in real estate or stocks, takes calculated risks by conducting research and using historical data to measure and evaluate the potential risk and return. The true speculator doesn't make stupid investments. And he doesn't throw out the window the historical precepts regarding investing. He probably makes rather intelligent investment decision; they just happen to be higher risk. It has been written that "the speculator is the advance agent of the investor…the road to success in speculation is the study of values."[5]

Though you likely dispute the contention that your client was a speculator, you may be able to show that the conduct in question failed to meet the investment objectives of speculation, assuming for the sake of argument, their validity.

B. Diversification Through Hindsight

In determining the percentage of concentration, the top number – or numerator in the equation - is the dollar value of the concentrated position, whether that is a single security, a group of "high risk" securities, or a particular industry. There is usually little dispute about that figure.

However, in one of Mr. Schulz's recent cases, where the registered investment advisor had placed roughly 80% of the investor's account in technology stocks, at the arbitration the advisor attempted to dispel the concentration by fiddling with the numerator. The advisor contended that the "technology" stocks were not really technology stocks per se, but rather could be broken down into the following different and diversified industries: hardware, software, communications, micro-chips, etc. Do not let your arbitration panel be fooled by this unsupportable argument. There are roughly 10 accepted "sectors," and not all of them are technology.[6]

More commonly, brokerage firms muddy the water by attempting to increase the denominator. Doing so results in a lower percentage of the concentrated position, perhaps so much so that it enables the firm to argue that there was no concentration.

This is the same tactic used by brokerage firms and their experts in churning cases. In determining the turnover number, brokerage firm experts try to use the market value of the account as the denominator, as opposed to the account equity, which is the accepted way to perform the calculation. It is ironic that firms want to use the account value figure as the denominator – the figure that evidences that the firm margined the account and, by definition, increased the risk – to lower the turnover number, thereby masking the risk level of the account. Fortunately, regulators have rejected these defense arguments. See, In the Matter of Dean Witter, et. al., SEC Administrative Proceeding File No. 3-9686 (2001)(SEC accepted claimant's turnover and concentration calculations).

[5] Philip L. Carret, The Art of Speculation, 1975.

[6] Merrill Lynch, on some of its CMA Account statements, lists the following 10 sectors: Financials, Services, Consumer Staples, Consumer Cyclicals, Capital Goods – Technology, Capital Goods – Industrial, Energy, Basic Industries, Transportation, and Utilities. Morgan Stanley, in its May 2002 Perspectives document, lists the following 10 sectors: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunications Services, and Utilities.

What figure you use for the denominator will depend upon the facts of your case. Again look to any pronouncements by the firm in question. Merrill Lynch states that it does not include "other assets," such as the value of life insurance policies or business interests, in its asset allocation analysis "because this type of asset may not be readily reallocated." Under that theory and generally speaking, the value of assets in a separate IRA account should not be a part of the denominator, nor should other accounts that are earmarked for specific purposes or specific goals, such as a trust fund for a child's education. Additionally, brokerage firm attempts to look to assets in accounts outside the firm to lessen the concentration figure usually fail and are viewed as Monday morning quarterback behavior.

C. It Was The Client's Idea - Confirmations Are Marked Unsolicited

At one end of the spectrum, we have the situation where the broker has marked all of the purchases resulting in the concentrated position unsolicited, meaning it was the client's idea. Yet, your client has told you that none of the transactions were her idea. We have seen numerous cases involving this fact pattern.

In this situation, it is critical that you obtain the broker's unredacted commission runs in discovery, the document that shows all of the broker's transactions in all of his accounts. By unredacted, we mean other customers' account numbers are not fully redacted so that you can see how many different accounts there are. The NASD Discovery Guide speaks to such redaction, however, it is faulty in that it only mentions unredacted commission runs being discoverable in churning cases. This is presumably because the issue of control is an element of churning claim. If the broker had all or many of the same investments in his other clients' accounts, this would be evidence that the broker controlled the client's account.

Unredacted commission runs are equally important in concentration cases. The broker's mismarking of order tickets can be swiftly refuted by showing that the broker was making the same trades in other clients' accounts. When making this argument in the pre-hearing conference, point to language in the respondent's answer claiming that the trades were the claimant's idea – to show that the same issue of control exists in your concentration case.

Even where a claimant affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a broker is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. See, In re Gordon Scott Venters, 51 S.E.C. 292, 294-95 (1993); In re John M. Reynolds, 50 S.E.C. 805, 809 (1992). This is especially true where a brokerage firm's recommendation leads to a high concentration in the customer's account of a particular security or group of securities that are speculative. See, e.g., In re Clinton Hugh Holland, Exchange Act Rel. No. 37991, at 8 (Dec. 21, 1995), aff'd, 105 F.3d 665 (9th Cir. 1997).

Oftentimes brokers, in defense of a concentrated position, will testify that they advised the client against the concentration levels but the client insisted on it. Make sure you find out where the broker and/or his supervisor documented this "unsuitable" activity. Some firms such as A.G. Edwards, Dean Witter, and First Union state in their compliance manuals that their brokers are not required to accept trades that they think are unsuitable but if they do, they must, at a minimum, document the incident. Some require the broker to obtain a signed "unsolicited" letter from the client.

At the other end of the spectrum, do not think you are safe if the purchases that collectively resulted in the concentrated position were "solicited" by the broker (meaning the confirmations do not say "unsolicited"). We have had cases where brokers testified that they did not check "unsolicited" on the order ticket because, for example, the stock was on the firm's recommended list which meant an automatic "solicited" trade. Nonetheless, the broker's testimony was that it was the client who called up begging to load up on more of the stock. Again, ensure you obtain the unredacted commission runs. If there are just a few trades in other clients' accounts in the same security, you may need to make a second request for the order tickets for those trades to actually see how they are marked. It's not too late if you first confront this situation in the arbitration. We had one panel order the production of order tickets in other customer accounts to examine this very issue – right in the middle of the arbitration!

Lastly, we have encountered brokers who think that an adequate defense to a concentration claim is that the investor was consulted on every purchase and never complained about the concentration. We have found that defense to be ineffective. A broker has a duty to make suitable recommendations; the mere fact that the client goes along with the strategy does not somehow relieve the broker of that duty.

D. The Investor Was Concentrated Upon Arrival at the Firm – We Didn't Do It

There has been a rash of complaints by individuals who accumulated large blocks of employee stock options. If the individual worked for one the successful tech or telecom companies, it was not uncommon for such folks to have become millionaires almost overnight. Many of these employees flocked to brokerage firms for advice on not only how to handle the exercising of their employee stock options, but also for investment advice on their accumulated wealth. Many companies directed their employees to brokerage firms with which the company had a relationship, for the purposes of having the firm counsel the employee regarding the stock options.

This scenario also raises concentration issues, except that opposed to the broker having recommended the concentration; the investor has comes to the broker with the concentration in hand.

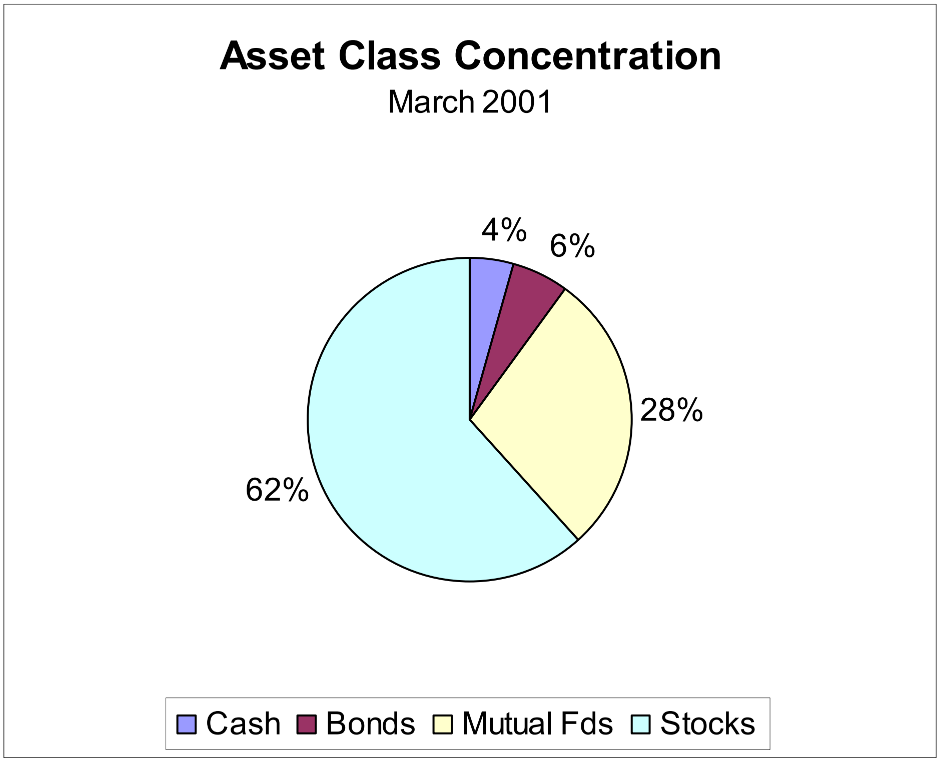
Many times, instead of recommending that the client liquidate some or all of the concentrated position or hedge it, the broker recommends that the client retain it. The broker may advise the client to use margin to pay the taxes and to pay the cost of the option stock price and, as we discussed earlier, may recommend that the client use margin to "diversify" the account. We have seen time and time again where this combination of using margin to handle the options and using margin to buy more stocks was a disaster waiting to happen.

If a broker improperly induced a client to hold a security, there is authority that such conduct is negligent. See NYSE Interpretive Memo No. 90-5 which defines "recommendation" to include a broker's influence to hold a security and NYSE Rule 405 which requires due diligence to learn essential facts of every account. If you can establish a fiduciary relationship between the client and the broker or advisor, then such relationship gives rise to a duty to speak or act. Insurance Co. of North America v. Morris, 981 S.W.2d 667, 674 (Tex. 1998). Such a failure to act gives rise to liability. See, In re Saxton, 712 N.Y.S.2d 225 (N.Y.App.Div., Aug. 10, 2000) and Matter of Estate of Janes, 659 N.Y.S.2d 165, 681 N.E.2d 332, 90 N.Y.2d 41 (N.Y. 1997)(fiduciary retained stock in inadequately diversified account while the stock lost substantial value); In re Rowe, 712 N.Y.S.2d 662 (N.Y.App.Div., Aug. 10, 2000) (a fiduciary "can be found to have been imprudent for losses resulting from negligent inattentiveness, inaction or indifference.").

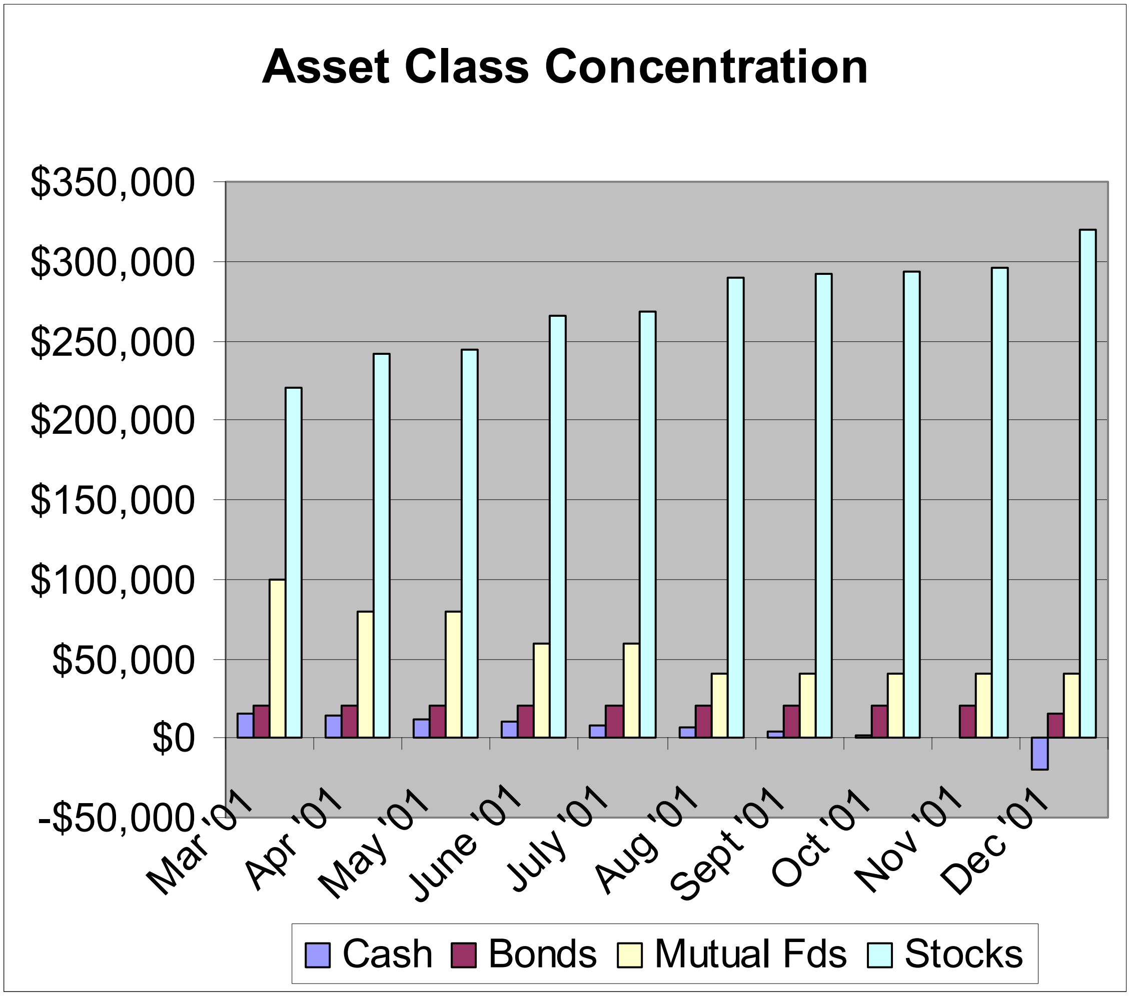
If your client arrived at the brokerage firm in a concentrated position, whether it be because of stock options or a previous negligent firm, your client may have a viable claim.

VI. Using Graphics to Present Your Concentration Case to the Panel

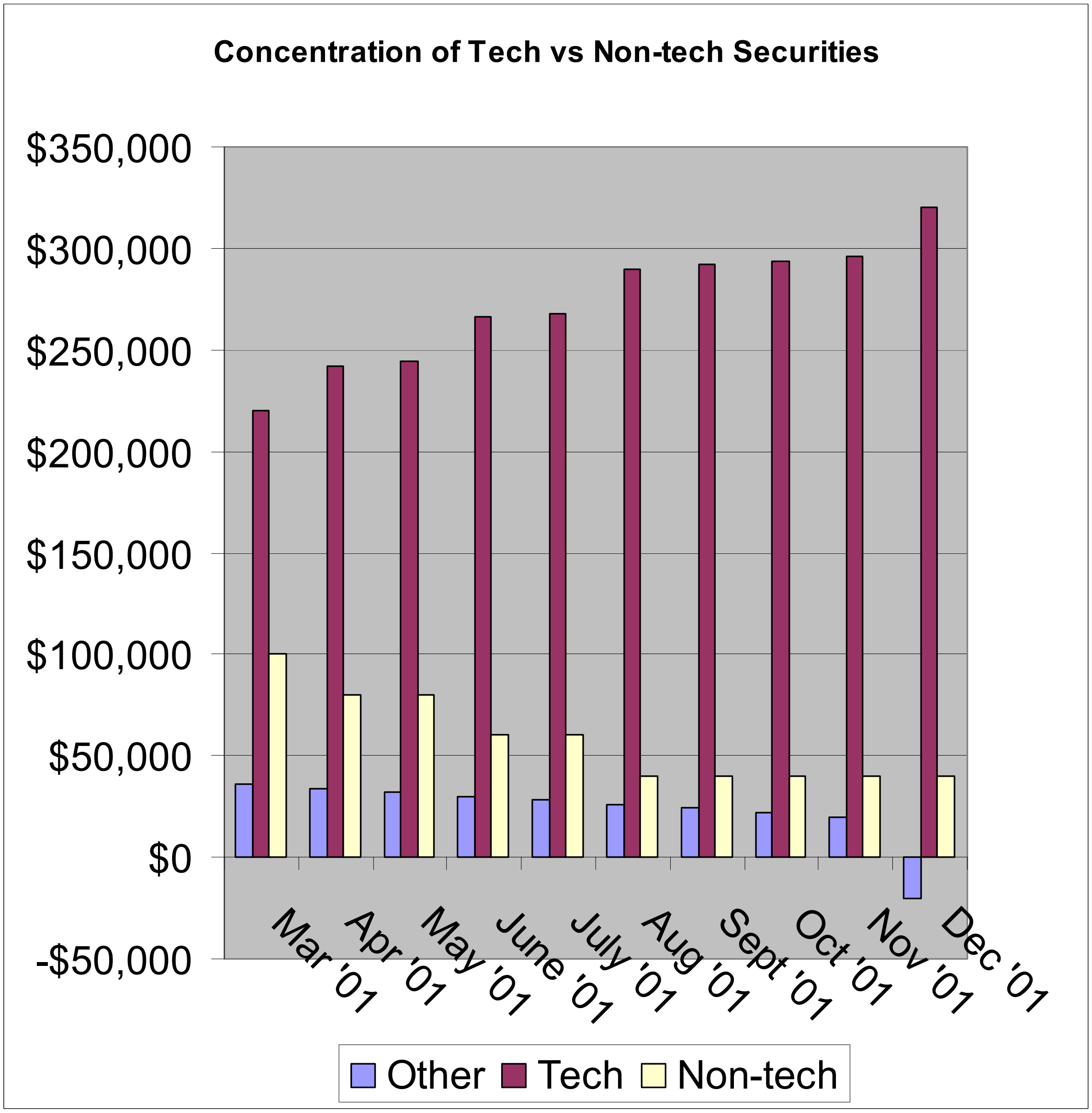
Charts and graphs are very useful tools in a concentration case. The unsuitability of concentration delivers much more of a punch when the arbitrators are staring at a color, graphic presentation. The classic illustration is the pie chart wherein the pie is investors' entire portfolio and the pieces of the pie are broken down by sector and percentages.


Asset Class Concentration
March 2001
4%
6%
28%
62%
Cash
Bonds
Mutual Fds
Stocks

Additionally, bar charts can be used to illustrate the same point.



It's also quite effective to display, for example, the percentage of technology stocks versus non-technology stocks in a bar chart.



Charts and graphs can tell your client's story in a vivid manner that will hammer home the points you need to make in a concentration case.

VII. Conclusion

NASD statistics reflect a record number of arbitrations claims being filed by investors who have sustained record losses. The brokerage industry would have the investing public and arbitrators believe that this is no fault of theirs, but rather the responsibility of the bear market. For at least the last decade, almost every brokerage firm and defense law firm has argued to arbitrators that comparing the investor's losses to the markets was improper. They claimed that "lost opportunity damages" and "market comparative analysis" was not appropriate.

How quickly they have changed their tactics. Now, these same brokerage firms and defense lawyers fill their answers and exhibits with charts showing what the investor would have lost in the market. The more aggressive defense lawyers dare to compare the client's losses to the NASDAQ, the most speculative of indices. Yet, hardly a claimant's lawyer compared client's losses to the NASDAQ when it was doubling.

But there is justice. Hopefully, you have an experienced panel that will remember the defense's dislike for market comparison damages. If not, dig out answers from some of your earlier cases. Make them an exhibit and show the panel the hypocrisy. To bolster that same point, obtain the firm's television and print ads during the time period of your client's account. The arbitration panel may find quite a contrast between what the firm was representing to the public compared to a) what it did to your client's portfolio; b) what it stated in its answer, and c) the positions it takes at the arbitration.

With Henry Blodgett and Mary Meeker pushing tech and Jack Grubman pumping telecom to their brokers and the investing public, it is not happenstance that millions of investors ended up concentrated in volatile, speculative securities. The sad reality is that millions of investors not only paid for this advice in the form of commissions and fees, but they also paid for it with their life savings.

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