

MEMORANDUM OF LAW

To: Client
From: Atlas Legal Research
Issue: Grounds raised in Reply to 1st Amended Statement of Claims.

Facts:

The claimants are Mr. A, Sr., Mr. A, Jr., both individually, and in his capacity as Trustee of Claimant, the A Family Irrevocable Insurance Trust and also as General Partner of Claimant, the A Family B Ltd. Partnership and A, Jr.'s wife, Claimant Mrs. A (collectively the "A's").

The A's enjoyed a long-term relationship with Mr. East Coast Broker of Investment Management Company at East Coast Office. Mr. East Coast Broker invested each account primarily in the equity securities of large companies. Each account was well diversified and did not employ options. Trading activity was minimal while Mr. East Coast Broker managed the accounts. For the account statements reviewed for the period between May 1, 1998 and November 30, 1998, a majority of the monthly statements showed no trading activity. A busy month of trading for the period reviewed showed 2-3 buys or sells. Mr. East Coast Broker retired during the summer of 2001. At that time, Mr. A, Jr., who had trading authorization for all accounts, decided to transfer the accounts from the east coast office to one of the Dallas offices of Investment Management Company.

Mr. A, Jr., had met Mr. Dallas Broker several times when visiting the local Investment Management Company's office. As Mr. Dallas Broker was the only broker with whom he was familiar, Mr. A, Jr. decided to transfer his accounts to Mr. Dallas Broker and the transfer was completed in 2001.

Mr. Dallas Broker asked the A's to sign blank option new account forms in July and December 2001, and in January, February, and March 2002. The option forms were completed by Mr. Dallas Broker who made material factual misstatements regarding the A family's investment experience, investment objectives, financial net worth, and banking reference

Following Mr. Dallas Broker's recommendation, Mr. A, Jr., began a series of covered call writes against the equities long in the various accounts. Mr. Dallas Broker's discussions of various strategies his clients employ with options piqued Mr. A Jr.'s interest. The conversation led to the discussion of "bullish put spreads" as a way to benefit from a rising market with less downside risk compared to unhedged long positions. Mr. Dallas Broker told Mr. A, Jr., that Investment Management Company "loves these put spreads" because they limit the risk of the client and the firm. Mr. A, Jr., attempted to educate himself regarding the sophisticated strategies that Mr. Dallas Broker was recommending.

At first the put spreads matured in 2003 or later. Mr. Dallas Broker then recommended that they begin to structure put spreads with maturities of 60 days, so account equity required for margin would be tied up for a shorter period of time. Mr. Dallas Broker encouraged Mr. A, Jr., to trade a minimum of 40 contracts (20 contracts per strike) per put spread so he could trade directly with Investment Management Company's option desk and receive better execution. The risks were never properly, accurately or completely explained to Mr. A, Jr., Further, those risks were not disclosed or explained at all to Mr. A, Sr.

On July 19, 2002, Mr. A, Jr., realized for the first time the amount of risk he had undertaken and the amount of stock he was about to have put to him over the options exercise weekend. Mr. A, Jr., went to Mr. Dallas Broker's office to discuss how he might meet this obligation which was over \$2.5 million. Mr. Dallas Broker suggested that Mr. A, Jr., sell the long put position of each spread and let the stock of the money option he was short be put to him over the weekend. After this meeting, Mr. A, Jr., instructed Mr. Dallas Broker to unwind his put spread positions prior to the weekend's options expiration. Mr. Dallas Broker failed to act on this execution order, although he led A, Jr. to believe that he would properly do so. Mr. Dallas Broker's unwinding of the long side of the put spread on July 19, 2002 caused the A accounts to be subject to significant margin calls.

Due to the strategies adopted, the A's lost a substantial part of their investment and filed a claim against Mr. Dallas Broker and Investment Management Company with the NASD for dispute resolution by arbitration.

Mr. Dallas Broker and Investment Management Company (collectively the "Respondents") filed a reply ("Reply") to the First Amended Statement of Claim ("Statement of Claim") in which they present their own version of facts. They also allege that the case must fail on the following legal grounds:

1. The A's understood the risks involved in the training and had provided written acknowledgment to this effect.
2. The A's decided to pursue an options trading strategy when the market was in a downtrend.
3. The A's claims are barred for failure to object.
4. The 'Second Investment' rule bars recovery.
5. The A's waived their claims by contract.
6. The A's claims on churning must be denied as.
 - a. The A's chose to pursue an investment strategy that involved buying and selling of short-term investments and therefore the high turnover rate is not indicative of trading.
 - b. The A's maintained control of their accounts.
 - c. The respondents lacked scienter.
7. The Respondents met all the duties owed to the A's.

8. The Respondents committed no statutory or common law fraud.
9. There is no private cause of action for violation of industry rules.
10. The claims against Investment Management Company specifically must fail as:
 - a. There can be no secondary liability for failure to supervise when there is no primary violation.
 - b. There is no liability for failure to supervise when such failure did not cause harm.

Assignment

We have been asked to review all the cases cited in the Reply and verify that they have been correctly cited. We have also been asked to find contrary or differentiating case law with specific focus on the issues of broker's duties and unsuitability. We were also asked to examine whether the fact that Mr. A, Jr., held a power of attorney for his father would impact the duty to determine suitability and whether failure to comply with the firm's own compliance manual would have any impact on the matter.

Discussion

The Respondents' argument that the A's decided to pursue the options trading strategy when the market was in a downtrend is supported by a single case that holds that any investment may turn out badly. This case is correctly cited and it is unlikely that this argument may be refutable in the law.

We will first address the argument that the A's claims are barred because they understood the risks and provided written acknowledgment to this effect. Thereafter, we shall examine whether the claims are barred for failure to object, whether a second investment bars recovery, and whether the A's waived their claims by contract.

Next we shall examine the grounds relating to churning followed by a study of the duties owed by a broker. This will be followed by an observation on the ground relating to private causes of action for violation of industry rules and the organization's compliance manual.

The last argument in the Reply that will be examined is whether the claims against Investment Management Company must fail.

We will finally discuss the viability of 'unsuitability' as a ground for recovery in this case.

Risks Understood?

The Reply correctly cites cases that hold that where the risks have been disclosed, the investor cannot claim misrepresentation. However, the trial Court in *Gochnauer*¹ found that:

Even though the Gochnauers signed an agreement stating that they understood the risks of options trading, it was incumbent upon Lester to fully explain the risks of options trading and comment on the agreement guaranteeing a 15% return on a speculative investment, a highly unusual arrangement to say the least.....

In essence, Lester induced the plaintiffs from switching their sizable investment in corporate bonds, one of the safest investments available, to option trading, one of the most speculative investments available. Lester should have known that such a switch was not one that adequately met the Gochnauers' needs of security and income from their investments. The court finds defendant Lester breached his fiduciary duty to the Gochnauers when he advised them and assisted them in hiring Kerr and in establishing the speculative option trading account. A more studied opinion of the risks of option trading in light of the Gochnauers' then-existing investment objective was owed by Lester to the Gochnauers. This he failed to do, in breach of his fiduciary duty.... But for the breach of duty, the plaintiffs would not have experienced the heavy losses of approximately \$25,000.²

This view was affirmed by the Eleventh Circuit, holding that “The judge did conclude that Lester breached his fiduciary duty as a ‘prudent broker’ in advising the Gochnauers to pursue options writing, a finding that is not clearly erroneous.”³

While this is a case from Florida, it should help to argue that even though the A’s acknowledged acceptance of risk, Mr. Dallas Broker had a duty to fully explain that this investment strategy would not meet their objectives. It must be noted that the relevant account in *Gochnauer* was also a non-discretionary account.

Failure to Object, ‘Second Investment’ & Waiver

Since these three grounds are linked, they shall be discussed together in this portion of the Memorandum.

The Reply claims that the A’s are estopped from asserting any claims against the Respondents now because they allegedly failed to object upon receiving notice of

¹ *Gochnauer v. A.G. Edwards & Sons, Inc.* 810 F.2d 1042 (C.A.11 (Fla.),1987).

² *Id.* at 1049 – 1050.

³ *Id.* at 1051.

unsuitable transactions. To this end, the Reply cites two cases, *Frota v. Prudential – Bache Secs. Inc.*⁴ and *Merrill Lynch Fehner & Smith v. Bocoock*.⁵ While both these cases discuss the proposition that failure to object bars recovery, *Bocoock* involves an extended period of 11 months during which the investor did not object. In *Frota*, the court found that there was a question of fact as to whether there was an actual failure to object as this would mean that the investor “received the trading confirmations, had the stock market experience and knowledge to comprehend those actions and then failed, within a reasonable time, to object.”⁶

Both the cases cited in the Reply stress that the reasonableness of the time taken to object is key. In the instant case, the A’s were assured by Mr. Dallas Broker that things would turn out alright and therefore did not object. Thereafter, when things did not in fact, turn out alright, the A’s filed a claim. It is, therefore, plausible that the A’s alleged delay was reasonable.

The ‘Second Investment’ argument is in substance one of ratification. The Reply cites several cases to argue that an investor loses his right to challenge a transaction once he enters into a subsequent transaction with the same broker. However, as discussed above, ratification only occurs when the investor “had the stock market experience and knowledge to comprehend those actions and then, failed within a reasonable time, to object.”⁷

Further:

“Ratification occurs only when the customer, with full knowledge of the facts, manifests his intention to adopt the unauthorized transaction.”⁸

In the instant case, our argument is that the A’s did not have sufficient facts regarding the nature of the transactions. Therefore, they did not have full knowledge of the facts and cannot have ratified the transactions.

Lastly, the Reply argues that the A’s waived their claim to object within a ‘reasonable time’ by contract. Their contract limits the time for objecting to five days for orders and ten days for statements of account. To support this proposition, the Reply cites *Modern Settings Inc v. Prudential Bache Sec. Inc.*⁹ However, the Reply omits that

⁴ 1987 WL 4925 (S.D.N.Y.,1987).

⁵ *Merrill Lynch v. Bocoock*, 247 F.Supp. 373 (S.D.Tex.1965).

⁶ *Frota* at 4.

⁷ *Id.*

⁸ *Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng* 901 F.2d 1124 (C.A.D.C.,1990) quoting *Lewis v. Washington Metropolitan Area Transit Authority*, 463 A.2d 666, 671 (D.C.1983).

⁹ *Modern Settings Inc. v. Prudential- Bache Securities, Inc.*, 936 F.2d 640, (2d Cir.1991).

Modern Settings Inc. also stands for the proposition that where a broker makes assurances or deceptive acts, such a clause may be unenforceable.¹⁰

Since Mr. Dallas Broker made assurances to the A's, it is likely that the contractual time limit will not be enforced.

In essence, the arguments of estoppel, ratification and waiver hinge on the reasonableness of time taken to repudiate the transactions. The waiver argument depends on a contractual clause which was violated only due to the assurances of Mr. Dallas Broker. Similarly, the ratification could not be proper because the A's did not have full knowledge of the transactions and they are not estopped from raising claims because the claims have been raised within reasonable time from the occurrence of the transactions. The fact that the claims are not barred by limitation should also add weight to the argument that they have been raised within reasonable time.

Churning

The Reply correctly cites the elements necessary for churning to be 1) excessive trading in light of the customer's investment objectives, 2) broker's control over the trading account and 3) the presence of scienter. The Reply correctly argues that merely high turn over rates are insufficient to establish churning. However, it argues that the A's trading strategy required such high turn over rates. It is our argument that the strategy was unsuitable and that such high turn over rates were not warranted.

With regard to control, the Reply argues that the account was non-discretionary and the Respondents could not trade without the authorization of the A's and that, therefore, the A's retained control over their accounts. There is no argument that had the account been discretionary, the Respondents' responsibilities to the A's would have been higher. The Court in *Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,¹¹ held that:

Between the purely non-discretionary account and the purely discretionary account there is a hybrid-type account which plaintiff claims existed in this case. Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation.¹²

One of the factors used to determine this usurpation of control is the relationship between the broker and investor. In *Lieb*, the court held that:

¹⁰ *Modern Settings Inc. v. Prudential- Bache Securities, Inc.*, 936 F.2d 640, 645-46 (2d Cir.1991) cited in *Goldberg v. Kidder Peabody & Co., Inc.* 991 F.Supp. 215, 217 (S.D.N.Y.,1997).

¹¹ 461 F.Supp. 951 (D.C.Mich., 1978).

¹² *Id.* at 953.

[I]f the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence.¹³

In the instant case, Mr. Dallas Broker and Mr. A, Jr., had a long-standing personal relationship, thereby supporting a usurpation argument.

The last element of churning is scienter. The Reply cites no cases regarding lack of scienter but merely states that none exists. “Scienter in the churning context requires proof of fraudulent intent or a willful or reckless disregard for the interests of the claimants.”¹⁴

The Statement of Claim alleges willful and reckless disregard for the interests of the A’s, and it is likely that this will need further examination by a judge or jury.

Fiduciary duty owed to non-discretionary account

With regard to the duties of a broker, the Reply argues that since the account is a non-discretionary account, the broker’s duty is limited to properly executing the trade. Specifically it is argued that the broker has no duty to call upon his own professional skill and judgment as to the performance and nature of his client’s investments after the trade has been made.¹⁵

Addressing the duties of a broker with regard to a non-discretionary account, the court in *Lieb* held that:

Duties associated with a non-discretionary account include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis;¹⁶ (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests;¹⁷ (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security,¹⁸ (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the

¹³ *Id* quoting *Kravitz v. Pressman, Frohlich & Frost*, 447 F.Supp. 203 (D.Mass.1978) and *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970).

¹⁴ *In re Thomson McKinnon Securities, Inc.* 191 B.R. 976 (Bkrcty.S.D.N.Y.,1996) quoting *Franks v. Cavanaugh*, 711 F.Supp. 1186, (S.D.N.Y.1989), *modified*, no. 88 Civ. 2121, 1989 WL 58085 (S.D.N.Y. May 24, 1989); *Moran v. Kidder Peabody & Co.*, 609 F.Supp. 661 (S.D.N.Y.1985).

¹⁵ Reply, p 23.

¹⁶ *Lieb* at 953 relying on *Cash v. Frederick and Co.*, 57 F.R.D. 71 (E.D.Wis.1972); *Hanly v. S.E.C.*, 415 F.2d 589 (2d Cir. 1969).

¹⁷ *Id.* relying on *Richardson v. Shaw*, 209 U.S. 365, 28 S.Ct. 512, 52 L.Ed. 835 (1908); *Robinson v. Merrill Lynch*, 337 F.Supp. 107 (N.D.Ala.1971), *Aff'd*, 453 F.2d 417 (5th Cir. 1972).

¹⁸ *Id* relying on *Cash v. Frederick and Co.*, 57 F.R.D. 71 (E.D.Wis.1972); *Hanly v. S.E.C.*, 415 F.2d 589 (2d Cir. 1969).

broker may have in a particular recommended security,¹⁹ (5) the duty not to misrepresent any fact material to the transaction,²⁰ and (6) the duty to transact business only after receiving prior authorization from the customer.²¹

Therefore, even with regard to a non-discretionary account, a broker has several duties. Of these, the most important to the instant case are the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis and the duty not to misrepresent any fact material to the transaction. Mr. Dallas Broker violated both these duties by, firstly, not understanding the nature of options trading himself and then by misrepresenting the fact that the stock would suit the investment strategy of the A's.

Private Cause of Action

The Reply correctly states that no private action is available for breach of industry rules. However, “violations may be considered relevant for purposes of § 10(b) unsuitability claims.”²²

Therefore, while the A's may be unable to raise a claim on the ground that an industry rule has been violated, such violation may point to the existence of other claims, namely, unsuitability.

Claims against Investment Management Company

The Reply argues that there can be no secondary liability for failure to enforce when there is no primary violation. We have argued at great length that there have been several primary violations, including but not limited to a breach of the duties of a broker. Therefore, the issue of whether there is a primary violation should at least survive a motion for summary judgment.

The next argument raised is that the failure to supervise did not result in damage. This argument does not make any positive assertions that the failure to supervise did not result in damage but instead claims that the A's will not be able to prove that the failure to supervise resulted in damage. However, it is settled that:

¹⁹ *Id.* relying on *Chasins v. Smith Barney & Co.*, 438 F.2d 1167 (2d Cir. 1971); *S.E.C. v. Capital Gains Bureau*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

²⁰ *Id.* relying on *Carras v. Burns*, 516 F.2d 251 (4th Cir.1975); *Shorrock v. Merrill Lynch, CCH Fed.Sec.L.Rep.* P 96,251 (D.Or., Nov. 18, 1977).

²¹ *Id.* relying on *Robinson v. Merrill Lynch*, 337 F.Supp. 107 (N.D.Ala.1971), *Aff'd*, 453 F.2d 417 (5th Cir. 1972).

²² *GMS Group, LLC v. Benderson* 326 F.3d 75, 82 (C.A.2 (N.Y.),2003) referring to *Brown v. E. F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir.1993).

In contrast to a pleading in federal court, a statement of claim under NASD rules need only "specify the relevant facts and the remedies sought."²³ The federal securities laws authorize the SEC to sanction broker-dealers and supervisors for "failure to supervise" personnel who engage in prohibited conduct, unless the firm and supervisors acted reasonably in discharging their duties and obligations under a system of procedures reasonably designed to prevent and detect violations.²⁴ Technically, a claim of "failure to supervise" refers to SEC enforcement practice. NASD Conduct Rule 3010(a) imposes the same duty on member 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 the NASD."²⁵

Therefore, it is sufficient that the Statement of Claim alleges that the firm failed to establish and maintain a system to supervise the activities of a broker that is in compliance with applicable laws and rules of NASD. This standard is met by the Statement of Claim.

No cases have been found that show the violation of any duty/standard for failure to comply with an organization's compliance manual but cases exist for the proposition that violation of a compliance manual would enable a regulator to take action against a self regulating organization.²⁶

Unsuitability

"The elements of an unsuitability claim under Section 10(b) are that (i) the securities purchased were not suited to the buyer's needs; (ii) the defendant knew or reasonably believed the securities were not suited to the buyer's needs; (iii) the defendants recommended or purchased the unsuitable securities for the buyer anyway; (iv) with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (v) the buyer justifiably relied to its detriment on the defendant's fraudulent conduct."²⁷

²³ *Coleman & Co. Securities, Inc. v. Giaquinto Family Trust* 236, 302 F.Supp.2d 288 (S.D.N.Y.,2002) quoting NASD Code of Arbitration Procedure § 10134.

²⁴ *Id.* quoting Securities Exchange Act of 1934, §§ 15(b)(6)(A)(i), 15(b)(4)(E), 15 U.S.C. 78o(b)(6)(A)(i), 78o(b)(4)(E).

²⁵ *Id.*

²⁶ *Austin Mun. Securities, Inc. v. National Ass'n of Securities Dealers*, 757 F.2d 676, 680 (C.A.5 (Tex.),1985).

²⁷ *Pits, Ltd. v. American Express Bank Intern.* 911 F.Supp. 710, 718 (S.D.N.Y.,1996) quoting *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir.1993); *National Union Fire Ins. Co. v. Woodhead*, 917 F.2d 752, 757 (2d Cir.1990).

The scienter requirement in unsuitability cases is that the broker “believed the securities traded were unsuitable in light of the nature of the investment objectives and needs of the clients, and that defendant nevertheless traded in those securities.”²⁸

In *Rivera v. Clark Melvin Securities Corp*²⁹ the court held that scienter:

may be inferred by finding that the defendant knew or reasonably believed that the securities were unsuited to the investor's needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend or purchase the securities anyway.³⁰

In the instant case, a claim of unsuitability will lie if it can be shown that Mr. Dallas Broker knew or reasonably believed that the securities were unsuited to the A’s needs, misrepresented the unsuitability and recommended trading in them.

The research has not uncovered any cases dealing specifically with the issue of determining unsuitability independently for each client even if one client represents another on a power of attorney.

Conclusion

The Reply has properly cited various authorities but it does not conclusively defeat any of the claims made in the Statement of Claims. It is likely that the time taken by the A’s to object to the trades will be found reasonable in the light of the fact that Mr. Dallas Broker suggested waiting. Further, Mr. Dallas Broker had a duty to fully understand the implications of the stock he was suggesting before suggesting it to the A’s and clearly explain to them, the implications of dealing with that particular stock, even though the account was non-discretionary.

While there may be some doubts as to control, the fact that Mr. Dallas Broker was known to the A’s may work against him with regard to the churning claims. This principle of control also carries itself forward to the analysis of the duties owed to the holder of a non-discretionary account. If it can be shown that the broker usurped control,

²⁸ *Zaretsky v. E. F. Hutton & Co., Inc.* 509 F.Supp. 68 (S.D.N.Y., 1981) relying on *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir.1978); *Troyer v. Kargagi*, 476 F.Supp. 1142, 115 (S.D.N.Y.1979).

²⁹ 59 F.Supp.2d 280, 292 (D.Puerto Rico,1999).

³⁰ *Id.* quoting *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir.1993); *Gaudette v. Panos*, 644 F.Supp. 826 (D.Mass.1986), rev'd on other grounds, *Gaudette v. Panos*, 852 F.2d 30 (1st Cir.1988) (scienter sufficiently pled when complaint alleged that defendants made representations with recklessness, and that margin account was administered without disclosing to investors that broker knew the unsuitability of transactions and effect on interest level of margin account).

the broker has more responsibilities towards the investor. Again, the long-standing relationship may work to Mr. Dallas Broker's detriment.

With regard to the private cause of action ground, it is true that no private cause of action lies for breach of an industry rule, but this breach may be taken as evidence to prove a statutory claim. Therefore, breaches of industry rules may support the A's claim for unsuitability. It may possibly also be argued that failure to adhere to the firm's compliance manual is also a breach of industry rules and goes to prove unsuitability.

The discussion on unsuitability shows that this may be a good ground to pursue provided the requisite scienter can be proved.

We hope this helps your efforts in this case. Should you have any follow-up, please feel free to contact Kathy Atchison at 214-532-8557 or via email at kathy@atlaslegal.com. Aarathi Chellappa performed the analysis in this memo. She can be reached at aarathi@atlaslegal.com. As you know, Rocky Dhir will be out of station until Sunday May 9. We will be happy to provide any additional assistance you might need.