

**Vincent C. Ross Institute of Accounting Research
New York University Stern School of Business**

Ross Roundtable in Cooperation with NERA Economic Consulting

On

Getting Personal with Securities Litigation in 2014

April 7, 2014

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Professor Paul Zarowin, the Director of The Ross Institute, NYU Stern, and David Tabak of NERA welcomed the participants to the 6th annual NYU-NERA Roundtable. The NYU-NERA collaborations have always provided a treasure trove of information, multi-faceted views on legal and economic topics of current interest, followed by lively discussions. The topic of the current Roundtable, “Getting Personal with Securities Litigation in 2014, not only changed the focus from macro analyses to the micro, personal level—but in so doing—provided the participants with an insider view on a highly charged, controversial topic—“Insider Trading”. The participants found the presentations of the sometimes ludicrous, *behind the scene events* related to high-profile insider-trading disputes difficult to fathom. It is often said that “one picture is worth a thousand words”. The conference provided ample evidence that one testimony provided by NERA’s highly-qualified statisticians and economists can ultimately be worth millions of dollars.

The discussion on “personal litigation” was two-pronged: The first panel provided a brief history of customer-broker disputes, the legal remedies available, and examples of several disputes that illustrate the nature and outcomes of cases filed. Customer-broker disputes typically involve suitability claims, negligence, omission of facts, churning, and misrepresentation.¹ The second panel reviewed the legal definition of insider trading and provided an insider view on a recent, highly-publicized insider-trading case, The Mark Cuban case.

Part I: The “how to” – insider expert analyses:

Virtually all brokerage firms’ customer agreements require the arbitration of disputes in the Financial Industry Regulatory Authority [FINRA] forum, waiving their client’s right to go to court. For the past 20 years the courts have consistently upheld and enforced these agreements, eliminating the ability of most investors to file their claims in court. Although the SEC controls most aspects of the regulation of broker-dealers, state fraud laws are available as causes of action for individual investors. FINRA arbitration wins and awards have far exceeded those of the

¹ Churning is the practice of executing trades for an investment account by a broker in order to generate commissions. It is a breach of securities law in many jurisdictions, and it is generally actionable by the account holder for the return of the commissions paid, and any losses occasioned by the broker's choice of stocks

courts. “Depending on with whom you speak, arbitration is either the greatest thing since sliced bread or a proverbial *kangaroo court*.”² Historically, market declines lead to an increase in FINRA broker-customer dispute filings, whereas bull markets generally result in significant declines in FINRA filings. Although there is significant empirical evidence related to the correlation of market movements and customer- broker dispute filings, there are differing opinions as to what triggers the filings:

1. When investors lose money they blame their brokers for mismanaging their portfolios.
2. The amounts of alleged damages are significantly higher during market declines. Therefore, lawsuits become more lucrative.
3. The increase in filings is partially related to the amount of damages. The overall gains on client portfolios during market upswings obfuscate the misconduct of brokers on which the claims are based. When the tide goes out – all the debris gets exposed.
4. The change in the number of filings against brokers is a function of customer satisfaction. When their portfolios are going up—they are happy—and have no cause to question their broker’s judgment.

Suitability claims involve client claims of improper asset allocation, such as levels of concentration (i.e., lack of diversification) and use of leverage. More recently suitability cases have targeted brokers’ use of specific securities, e.g. illiquid securities, CDO’s, derivatives, and structured products. In the service of their clients, brokers must adhere to rules. “Suitability” is a function of a customer’s profile. The profile includes, but is not limited to, age, risk tolerance and financial status. Determination of suitability is complex because the benefit of hindsight will invariably become a factor in the dispute. What was knowable when the portfolio was created? What was the client’s risk tolerance at that time? The difficulty of an objective analysis of the risk profile of a client is reduced if the client has other existing accounts and trading activity.

The analysis begins with two questions: What is the liability? What are the damages? The three components of every suitability case are: liability, damages, and collectability. The question of collectability is not part of the initial analysis in suitability claims. Therefore, the analysis begins with the determination of liability and damages. In determining liability, it is important to establish the client’s role by reviewing broker-client correspondence.

Net out of pocket losses is a starting point in the calculation of damages. To assess this, the customer’s actual portfolio performance is compared to a hypothetical “but-for” performance of what is considered a well-managed portfolio. Market indices, mutual funds, or other suitable funds are used for comparability. Sensitivity analysis using the VIX³, often referred to as the “investor fear gauge”, is another useful analytical tool. Two examples of how the above tools were used by NERA, and the outcomes thereof, were presented. In both cases the brokers did not have the right to trade without the consent of the clients.

² Alan Foxman spent 8 years as a staff attorney with FINRA. He is currently an attorney in private practice in Boca Raton, Fla.

³ The Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

Case #1:

- The client claimed that in March 2001 he had requested a change of investment objectives from growth to capital preservation.
- In late March 2001 the value of his \$11.25 million fell to approximately \$10 million.
- The investor claimed that the broker's failure to sufficiently reduce his equity exposure resulted in a \$1.9 million loss.
- The broker counter claimed that after an upswing in the market, the investor requested reinvestment in equity.

On the assumption of liability, the estimation of damages included a calculation of out-of-pocket losses which factored in market movements during this time period. The broker provided an estimate of returns during the same period on a hypothetical capital-preservation portfolio. NERA created a "but-for" performance measure, that reduced the estimated damages by 26%. The case was settled for \$1.4 million.

Case #2:

- An investor received substantial amounts of stock-based compensation in the late 1990's.
- She retained a concentrated position and her stock holdings declined in value as the dot.com bubble burst in early 2000.
- The investor claimed that her broker should have advised her to diversify her portfolio in late 1999.
- The broker counter-claimed that he told her to diversify and she declined.

NERA'S analysis focused on three issues:

1. Sensitivity of damages to choice of index.
2. Timing of claimants "but-for" diversification.
3. Estimation of the performance of a "but-for" portfolio.

The account was opened in July, 1999. Losses could have been avoided if the shares had been sold in December, 1999. With the benefit of 20/20 hindsight, selling the stock on the day it peaked could have avoided losses of \$1.6 million. Additionally, damages were sought for the opportunity cost of losing alternative investment strategies based on the S & P index; this increased estimated damages to \$3.1 million.

In this case, disputing the issue of timing was crucial. If the claimant had wanted to diversify, arguably it should have been done when the account was opened. July, 1999 was the date used for estimating both out-of-pocket damages and damages assuming an S & P 500 index "but-for" portfolio. Albeit this was not a "suitability" case where the risk profile of the claimant is critical, examination of the investor's trading activity with another broker during the same time period hit "pay dirt". All her investment accounts were focused on technology stocks. Therefore, the NASDAQ index was more appropriate than the S & P for estimating damages on a "but-for" portfolio. The \$3.1 million claim for damages was settled for \$.7 million.

As mentioned previously, filings decline significantly when the market is going up. Filing a case for damages when the value of your portfolio is going up becomes increasingly difficult, but not impossible. Although a bull market covers up a lot of losses, bottom line, the determination of liability is based on a broker's action or inaction and not on market fluctuations. Did the broker fail to do proper diligence? Did he fail to create a suitable portfolio? This type of analysis is always relevant. If there is evidence of possible wrongdoing, the next question is: Are there damages? Some brokers do a better job than others, but historically the percentage of brokers that willfully commit fraud is small in number. The point is that it is not broker misconduct that is correlated with the market; it is the magnitude of investor losses that is highly correlated with market fluctuations.

The panel presented case examples in which damages were sought and calculated based on "net-out-of-pocket" [NOP] losses. This calculation has become widespread, and yet there is not a single state or federal statute stating NOP as an appropriate recovery. A panelist commented that "NOP is something the securities industry made up and then were extremely persuasive and successful in selling it to arbitration panels." The well-managed portfolio theory provides an objective remedy that does not rely on market conditions. There is a lot of authority in the courts for this. In the Miley versus Oppenheimer case⁴, the plaintiff recovered the commission, interest paid, and the amount of the decline in the value of her portfolio in excess of the average decline in the stock market during the time in which the broker handled her case. The use of market indices is a commonly used benchmark that is not subject to the whims of the market and reduces the problems of a hypothetical alternative investment. Even Warren Buffet has set up a trust for his wife that is structured 90% on an index.

An attorney who represents brokers said that she agreed with the statements made by counsel for investors that claims go down in bull markets. She opined that the claims go down because investors are satisfied with the returns on their investments. However, it is highly unlikely that brokers who are engaged in misconduct "check into rehab" during bull markets. What does happen in bull markets is that investors get creative in bringing claims against brokers.

Case in point:

- UPS employees had accumulated large concentrated holdings in their company's stock, with millions of dollars in leveraged positions.
- Losses were not sustained, but they claimed that the brokers' failure to diversify their portfolios provided evidence of improper risk-management strategies.
- Improper risk management included a failure to collar⁵ the position precisely three months before the market decline in 2009.
- A collar may not have been optimal, and the assumption that the employees would have done the collar is based on conjecture.

⁴ Fed. Sec. L. Rep. P 97,872, Lila A. MILEY, Plaintiff-Appellee, v. OPPENHEIMER & COMPANY, INC., No. 79-2099. United States Court of Appeals, Fifth Circuit.

⁵ A collar is an option that can be purchased to protect against declines in share price and locks in the profit. The ultimate goal of this position is that the underlying stock continues to rise until the written strike is reached.

As mentioned previously, even when the bulls are running—some brokers are in lock step. An Indian tribe accused their broker of willful misrepresentation. The tribe alleged that it sold shares below market value because the brokerage firm had omitted relevant facts. The court found intentional misrepresentation and omission of material facts. The damages awarded were estimated on what the fair market value should have been. Although the brokerage firm did not prevail, it claimed the plaintiff’s calculation was based on debatable presumptions.

It can be argued that the courts and arbitration panels are determining damages based on “precedent” rather than statute. Many securities fraud cases were resolved during a time period when churning, willful misrepresentation, and other types of fraudulent broker activity were making front-page news. Awarding damages, even when the investors did not incur losses, was viewed as a stop-gap measure against broker misconduct. In the current environment awarding damages using highly speculative, hypothetical analysis with no documentary evidence has, in the opinions of many, skewed the outcomes in favor of the investor.

The American Fund can be considered a “poster child” for the case against the 20/20 hindsight hypothetical analysis of “but-for” or “well-managed” portfolios and calculation of NOP’s. It became the most popular hypothetical investment due to the fact that it had the good fortune of avoiding a high concentration in technology stocks when the Dot.Com bubble burst in 2000. There was a case filed involving suitability and restitution settlement. The brokerage firm won in arbitration and the claimant appealed. The court issued a very detailed opinion where it stated that the well-managed- portfolio theory was too speculative and therefore unacceptable as a matter of law. Additionally, the investor should not be allowed to recover when there is a profit. Although currently the courts generally confirm decisions made by arbitration panels, they avoid issuing formal written opinions. Albeit the courts may not approve of the speculative theories, the standard for appealing arbitration awards is exceptionally high. One can perhaps infer from the court’s inaction that, in general, the costs involved in efforts to overturn arbitration awards may outweigh the benefits thereof.

The following is an example of cases that epitomize investor-friendly decisions.

- The investor purchased a variable life insurance policy on which three loans of approximately \$100K were taken out against the policy; no interest was paid for 20 years.
- Reminders were mailed annually recommending the payment of the margin interest.⁶
- The letters clearly stated that the debt on the policy may override the equity and result in the loss of the policy.
- The investor claimed she did not understand the content of the annual letters, and her broker told her “not to worry”.
- The investor also had a portfolio on which she had been receiving annual dividends.
- Net-out-of-pocket damages on this investment were calculated to be \$180K.

⁶ Net margin interest = [investment returns-interest expense]/average earning assets. A negative value of margin interest denotes that interest expense accrued on an account is greater than the amount of returns generated by the investment.

The claim was based on both the “but-for” and “well-managed” portfolio theories. However, the levels of conjecture involved, and ultimately honored, would not stand up in any court of law. The multi-level hypothesis set forth by the claimant:

- She should have been advised not to take out the loans.
- Had the loans not been taken out, an option to annuitize the income on this policy could have been exercised.
- The income could have been invested in an all bonds portfolio, thus avoiding all losses in the down market.
- The hypothetical overall damages were claimed to be \$1.5 million.
- The claimant was ultimately awarded \$750K

Not only does this case illustrate investor-biased rulings, but it is also indicative of the sweeping power awarded to arbitrators. The fact that FINRA is not required to adhere to the detailed statutes of securities regulations--and that the courts rarely overturn FINRA rulings--speaks for itself as to the amount of authority vested unto one agency. In general, brokers uphold their duty to their clients. In so doing their level of “duty” is no less than a fiduciary obligation. It is important to note that although there are very few cases that claim “intent to harm”, the economic consequences of speculation-based awards have resulted in diminished investment opportunities. The risk profile of brokers has changed; “better to err on the side of caution”.

Part II: Insider Trading--The Mark Cuban⁷ case:

Insider trading is defined as the buying or selling of a security by someone who has access to material, nonpublic information about that security. An interesting question is why is this fraudulent? Whom is the fraud being committed against? The U. S. Supreme Court has been very clear on defining insider trading as fraud that requires intent to trick someone to whom you owe a duty, for example, the issuer of the security you are trading.

Beyond the glitz and glamour of the Mark Cuban persona, and the extensive media coverage of the SEC’s allegations of insider trading, analysis of the case is both interesting and instructive. Mark made no attempt to trick anyone when he sold his shares of Mamma.com. He took advantage of his high profile to publicize not only the sale, but also his unfavorable opinion of the firm in terms of operation thereof and the individuals associated with the firm. None the less, the SEC charged him with insider trading.⁸

The basics of the case:

1. The CEO of the company called Mark to notify him of an anticipated PIPE⁹ (private investment in public equity) offer one day before the offer was going to be made.
2. Mark told him decisively that he was not interested in the offering, and that he was going to sell his shares, and then promptly sold 600,000 shares.

⁷ Securities and Exchange Commission v. Mark Cuban, Civil Action No. 08-CV-2050-D (N.D. Tex., filed November 17, 2008)

⁸ On November 17, 2008, the Commission filed a Complaint against Cuban alleging that he engaged in insider trading in securities issued by Mamma.com in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 there under.

⁹ A PIPE deal involves the selling of publicly traded securities to private investors.

3. The PIPE offer was completed after a delay of one day, and the price of the shares fell by approximately 8% the following day.
4. The SEC charged Mark with insider trading claiming he had traded on material nonpublic information

As pointed out above, an accusation of insider trading requires intent to trick someone to whom you owe a duty. The CEO was not “tricked”; he was told of the decision to sell two days in advance of the PIPE. Insofar as “duty” to the company--given the circumstances-- the argument was there was no basis for this assumption. Six years and millions of dollars of both taxpayers’ and Mark Cuban’s funds were spent on a case involving \$750,000. It was a case that clearly did not meet the definition of “insider trading”; a case that the SEC insisted on pursuing; a case that has put the questionable tactics of the SEC into the spotlight.

The case was initially dismissed by a judge in Dallas, Texas on the grounds that even if everything in the complaint was true, the facts did not meet the definition of insider trading. The case made its way through the courts on appeal and ultimately went to trial. The jury found that Mark neither had material nonpublic information nor did he have a duty to the company as he had fully disclosed his intent to trade.¹⁰

Insider analysis -- the experts:

The use of highly qualified experts can make or break a case. The allegations against Mark Cuban were based on two major issues: Was the information about the PIPE material? Was the information nonpublic? Both of these questions could be answered using econometric analyses and simple investigative procedures.

The determination of materiality was based on the statistical significance of the 8% market decline using standard econometric models. The measurement of the volatility of a firm’s share price over time determines if an 8% decline is significant, insignificant, or ordinary. Given the volatility index for this firm, the decline was ordinary and therefore not material.

Determining whether the information was nonpublic involved a standard investigation of publicly available facts. In consideration of the ease with which these facts were obtained, one can only conjecture that in their zeal to bring the case the SEC failed to perform due diligence. Standard procedure in an offering involves hiring a banker to market the transaction. In conversations with the bankers, they confirmed that there had been a wide-spread distribution of information to potential investors regarding the forthcoming PIPE. They reconfirmed this under oath on the witness stand.

What makes this case both interesting and instructive?

Information obtained from the SEC under the “Freedom of Information Act” uncovered evidence that if it were not the SEC conducting the investigation, the probability of allegations of purposeful omission of facts, misrepresentation, and lack of neutrality would be significant. Files

¹⁰ On October 16, 2013, after a three-week trial, a nine-person federal jury found Mark Cuban not liable for insider trading.

obtained from the SEC had, in addition to Form 20F,¹¹ a long letter clearly stating that the firm had obtained an investment banker for, among other things, a PIPE offering. The date of the anticipated offering was included in the letter. The day **before** the PIPE offering date written in the letter, the company's stock spiked 2,000%¹². Highly unprofessional emails making blatant reference to Mark's wealth and other innuendoes relative to his success were also obtained. In addition to providing evidence of bias—the entire case is an embarrassment to the SEC.

Did Mark Cuban do the right thing in spending millions to save \$750,000? Many would say “bravo”—he stood up for justice at any cost. Then there is the undeniable truth that the average individual accused unjustly does not have the resources to pursue justice, and his/her only remedy against incarceration is paying the SEC enormous fines.

Avoiding allegations of insider trading—financial institutions:

It is incumbent upon financial institutions to have programs that disclose transmission of material nonpublic information and identify the legitimacy of the communications. Policies and procedures are designed to track the source and intended recipients of both incoming and outgoing nonpublic information.

FINRA's Office of Fraud Detection and Market Intelligence perform detailed inquiries into each and every transaction. The SEC Whistle Blower Program provides incentives for employees to be on *high alert*. There is constant surveillance. Financial institutions can be subject to both civil and criminal prosecution if they fail to have programs in place that meet FINRA specifications. It is the duty of inside counsel to insure that the standards, procedures, and surveillance programs are designed to identify any connections or trades that would give rise to any suspicious communication, where the definition of “suspicious” far exceeds legal definitions of insider trading or other illegal activity. The multi-level protective barriers, i.e. programs that have been adopted to avoid transgressions, do not come without a cost. In addition to the financial costs, the constant surveillance has had a profound impact on the workplace environment and employee well being.

Regulations include but are not limited to:

- The experts that can be used for consultation.
- Detailed rules on what is considered appropriate communication with experts.
- What needs to be said before engaging in any written or oral communication with experts.
- Detailed rules for signing agreements that include specifying the scope, nature, purpose, etc. of the engagement.

There are also strict rules in place that put restrictions on conversations between public-side and private-side investor personnel. Approvals are required before starting a conversation with a client, and strict regulations severely curtail the scope of the conversation. Bankers face disciplinary action if they do not adhere to policy. The abundance of caution provides protection for bankers and clients from allegations of misconduct. A concern repeated by both panelists

¹¹ 20F is a form issued by the Securities and Exchange Commission that must be submitted by all “foreign private issuers” that have listed equity shares on exchanges in the United States. Mamma.com is a Canadian company.

¹² This provided indisputable evidence that the PIPE offering was not a secret.

and participants is that what is perceived as “SEC overreach” has resulted in the loss of business opportunity. The focus has shifted from the free flow of conversation and information needed for a business to thrive, to intensified scrutiny and documentation of any and all communication in search of “smoking guns”.

“I am exhausted just from listening” was a profound comment made by a participant. Not only would 99.9% of crossing the line on maintaining confidentiality accusations not stand up in any court of law, the economic and social welfare consequences of these onerous rules are immeasurable. The above resonates with articles we would expect to read about third-world countries—these constraints are—in no uncertain terms—Un-American. What happened to freedom of speech?

Commentary:

Mary Jo White (SEC Chairwoman) recently stated that the agency will continue its "vigorous" enforcement and keep its promise to *unleash* the SEC's "full enforcement arsenal." The term “unleash”¹³ speaks for itself as to the nature of SEC’s tactics.

Although there was extensive media coverage of the Mark Cuban case, there has been scant mention of the SEC's misconduct-- the withholding of exculpatory evidence. The SEC fought for over three years to avoid disclosure of their notes; during trial they asked the judge to exclude them from evidence. Fortunately, the judge disagreed; the evidence was introduced into trial and Mr. Cuban was cleared of all charges.

“The government's job as criminal prosecutor is not to obtain convictions, but "to do justice," ... It should be required to follow the Brady rule¹⁴ in civil trials as well. But the SEC does not ...

...An agency that has the ability to bring the full force of the federal government against a citizen in a fraud case should play by the same fair rules that have governed federal prosecutors....It should be required to turn over... evidence that could exculpate the defendant. The SEC should announce now that it will follow the mandates of the Brady rule in all pending and future cases... It is curious that the SEC has not done so.” *How the Feds Rig Their Prosecutions* (by Mark Cuban and Thomas Melsheimer, *New York Times*, April 3, 2014)

¹³ un-leash: to allow or cause (something very powerful) to happen suddenly: to remove a leash from (an animal) so that it can freely run, attack someone, etc. Merriam-Webster)

¹⁴ *Brady v. Maryland*, 373 U.S. 83 (1963) The Supreme Court held that withholding exculpatory evidence violates due process "where the evidence is material either to guilt or to punishment