BEFORE THE BOARD OF ARBITRATION  
OF THE NATIONAL ASSOCIATION  
OF SECURITIES DEALERS, INC.  

IN THE MATTER OF THE §  
ARBITRATION BETWEEN §  
MELISSA A. PORTER, et al., §  
Claimants, §  
and §  
N.A.S.D. ARBITRATION NO. 02-04057 §  
MORGAN STANLEY & CO., §  
INCORPORATED and §  
MORGAN STANLEY DW, INC., §  
Respondents. §  

CLAIMANTS’ PRE-HEARING BRIEF

This is the Claimants’ pre-hearing brief. It is designed to narrow the focus of this dispute and to illustrate, in a basic way, the proof Claimants will submit to the Panel. The brief is divided into a discussion of: (1) the Claimants, (2) the Respondents and the broker involved, (3) their misrepresentations, and (4) the many NASD and SEC decisions holding that Respondents’ activities were wrong.

I. The Claimants

This section of the pre-hearing brief provides a brief listing of the Claimants and their background in securities investing before opening accounts at Morgan Stanley.
a. **Charles Black (IRA).** At the time of trading, Mr. Charles Black was 42 years of age. Mr. Black was employed as a appraiser with the Texas State Comptroller’s Office and had very little experience in securities trading. He initially invested during November 1999 through his individual retirement account and effectively closed his account at the end of March 2001 at a near-zero balance.

b. **James Lacy.** Mr. Lacy held two accounts at Morgan Stanley (the “993” and “043” accounts). Mr. Lacy was referred to Morgan Stanley by Robert Smith. At the time he invested, he was 42 years of age, had a couple of years of investment experience and a net worth of $100,000. He invested a total of $24,816 and lost half of it.

c. **Jerry and Karen Miller.** Jerry and Karen Miller were at the time of their investments with the Respondents 62 and 58 years of age. Mr. Miller was retired. As is typical of a couple of this age, Mr. and Ms. Miller had some investment experience, consisting largely of their holdings in Dell stock and other retirement-based assets. They invested a total of $1,659,332 and lost $500,425.

d. **Michael Miller.** At the time of investment, Mr. Miller was 39 years old and was employed as a real estate broker. He invested a total of $28,240 and lost $23,140, nearly four-fifths of the sum invested.

e. **Melissa Porter Hovey.** At the time of investment, Ms. Hovey was 29 years old. Her experience with investing consisted of receiving, and converting,
options in Dell stock that she received as an employee and then holding Dell stock. Ms. Hovey invested $258,064 over the course of her history and lost $166,824, or roughly two-thirds of the sum invested.

f. **Cynthia Vaughn Waidelich.** Ms. Waidelich was 29 years of age at the time of her investment experience. Like Ms. Porter, she was an employee of Dell and her investment experience consisted of receiving and converting Dell options into Dell stock and holding it. Ms. Waidelich invested $1,432,559 and lost $735,458, approximately one-half of the sum invested.

g. **Stacey Rihn Curry.** Like Ms. Waidelich and Ms. Hovey, Ms. Curry was a Dell employee who converted options into Dell stock and held it. She was 32 years of age at the time of investment. She invested cash and securities of $171,628 during August 2000 through July 2002 and lost $107,658, or roughly two-thirds of her investment.

h. **Robert and Sherry Smith.** Mr. and Ms. Smith were 38 and 41 years of age at the time of their trading with the Respondent. They invested a total of $33,966 in the accounts and lost $31,523, or about 90% of their principal, trading with Respondent.

II. The Broker and Brokerage

**Mr. Smith.** Lawrence Smith was the account executive for each of the Claimants. Mr. Smith represented to the Claimants that he was an expert in
options and a seasoned broker, having twice come out of retirement to return to the field he loved. These were lies. Mr. Smith had never been a broker and from 1992 through August 1998 was a salesman for Cowboy Pools and Spas. After joining MSDW in 1998, Mr. Smith went through the initial broker training program and was first licensed to conduct brokerage activities in Texas on January 14, 1999.

Upon information and belief, the Claimants constituted the bulk of Mr. Smith’s income-generating capacity during his initial days at MSDW.

Morgan Stanley Dean Witter (“MSDW”). Morgan Stanley Dean Witter was Mr. Smith’s employer and statutorily responsible for his supervision. It is a household name as a broker-dealer. Morgan Stanley & Co. (“MS”) is Morgan Stanley Dean Witter’s corporate parent.

III. Respondents’ Entire Relationship Was Based upon a Series of Frauds.

A. Fraud by Smith.

MSDW’s broker Smith understood from a history in the sales industry that Claimants could take their accounts anywhere and that they would entrust their accounts to him only if they had confidence in his ability. As a result, he simply

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1 Though Claimants have requested Mr. Smith’s course materials and testing for the options programs at MS, it has refused to provide these materials, as it has any personal accounts of Mr. Smith before or during his employment with MS which might bear upon his options expertise.

2 Though Claimants have requested Mr. Smith’s financial package and debt structure data as of the date of trading, MS has refused to provide this material.

3 Claimants have requested the data necessary for them to determine what percentage of the Respondent’s agent’s business the Claimants constituted, but MSDW has refused to provide this material.
“made up” qualifications that he did not have. Collectively, he represented to the Claimants that he had years of experience as an account executive, that he was the one acknowledged expert in the field of options trading in the Austin office (referring to himself on at least one occasion and the “King of Options”), that he had twice come out of retirement in the securities field because of his great love for and success in the field and that his experience permitted him to conduct low-risk and highly profitable option trades in the form of “covered calls.”

Each of these statements was false. Smith had only recently completed his broker training with MSDW and was first licensed on January 14, 1999. Though his employment experience was varied, in the six years preceding his employment with MSDW, Smith was a salesman for Cowboy Pools and Spas, a position ill-suited to equip him with expertise in the securities field.

The result of this fraud is that the entire relationship between Claimants and MSDW is tainted. Such fraud has repeatedly been affirmed to be the basis for awards of complete rescission in the sale of securities.4

B. Morgan Stanley’s fraud by commission and omission.

1. Morgan Stanley represented that it would make independent recommendations to aid its customers.

MSDW claims that it measures its success “one investor at a time,” a phrase designed to emphasize the individualized care it promises to give to anyone allying

4 Though Claimants have requested all of Mr. Smith’s trading history to further research his activities in option trading, MSDW has refused to provide this material.
with it. MS’s code of ethics, available to investors online, requires it to “keep the best interests of the Firm’s clients paramount” and not engage in any conduct which speaks of “manipulation, abuse of privileged information, misrepresentation of facts or any other unfair dealing practice.” In his annual report to shareholders, MS CEO Phillip Purcell told his shareholders that in 1999, the firm’s “future growth depended on rededicating ourselves – and, in some cases, reorienting ourselves, to the needs and goals of our clients” and to “put their interests above our own; to measure our success by how much we help them in achieving theirs.”

Regardless of the type of accounts Claimants had with MSDW, they were entitled to believe and did believe that MSDW would offer recommendations based solely upon their best interests. Many Claimants paid up to 2.25% of their annualized return to MSDW in “Choice” accounts, and they would not have done so unless they honestly believed that the company had both the expertise and will to recommend sound investments to them.

2. Morgan Stanley concealed its conflicts of interest.

MSDW’s representations that it would give independent investment advice were false and remained so throughout the trading relationship between Claimants and MSDW. MSDW’s research, as well as the advice of its broker to buy stocks

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5 Each of the quotations contained in this opening brief are taken directly from documents contained in Claimants’ exhibits.
underwritten by MS, were both driven by economic advantages MSDW hoped to gain by selling in the “aftermarket.”


During 1999 through 2001, MS was at the top of the IPO game in connection with “tech stocks” – stocks that were supposedly the harbinger of the “new economy.” During this period, the SEC Global Settlement discloses, and MS has agreed that it cannot deny, that it made hundreds of millions of dollars from underwriting IPOs and receiving equities in connection with them. In the intense competition for new IPO business, MS told potential IPO candidates that its “retail” brokerage wing (Smith’s employer) gave it a major advantage vis-à-vis other competitors because it could effectively promote sales of their stock in the aftermarket.

These sales in the aftermarket were crucial to both management of newly public companies and to MS. To issuers’ management, many of whom could not sell their shares until a year after the IPO, maintaining the stock price of their companies was critical to the sale of their personal holdings. MS had the same incentive: it knew that it would soon be a seller of the same stocks and that to maximize its “take” from the IPO underwriting process, it would have to maintain the price of the stocks it had just launched. The SEC determined, and MS cannot
deny, that these factors inevitably influenced the research on new IPOs and the recommendations made by MS and its brokers.\footnote{MS’s fine for these activities was a record one hundred twenty-five million dollars ($125,000,000).}

The conflict of interest between MS and its customers is made clear in the case of one stock: Vignette Corporation. Vignette was an MS-underwritten IPO. During 2000, MSDW repeatedly touted the stock as a strong \textit{buy} and hundreds of shares of the stock were being accumulated in the Claimants’ accounts. Meanwhile, when it came time for MS to determine what it would do for its own account, it sold each and every one of its shares of Vignette before they could crater. Thus, while MS touted to customers that it was oriented in their favor, it was working directly against their interests – using them to prop up stock prices so they could sell it.

\textbf{b. Morgan Stanley infects its brokers.}

MS was not content to leave the promotion of these stocks to chance. Instead, it established an extensive, complex and (to the public) invisible system to reward brokers for selling, and causing customers to hold, equities that could generate MS profit.

MS adopted what it called the “Equity Syndicate Index” – a system designed to communicate its desires to brokers in terms they would understand. Certain stocks which MS had helped launch and in which it owned an interest were picked
to be included in the Syndicate. When this occurred, brokers’ computer monitors flashed, indicating that brokers were eligible to receive rewards from selling these stocks. But the Syndicate not only rewarded sales of the stocks, it rewarded “holds” of the stocks, regardless of whether it was in the best interests of the customers to do so. Under the Syndicate, brokers who kept their clients in these stocks for up to 100 days received additional bonus points.

These bonus points entitled brokers to allocations of new initial public offerings – the elixir of the times. IPOs during this period had first-day gains which averaged over 13.6%. Any brokerage or broker with the ability to “allocate” IPOs to its customers had the power to hand out immediate and sizeable gains.\(^7\) As a result, these IPO allocations were called “free money” by MSDW brokers. Like Pavlov’s dogs, when the bell for these stocks rang, brokers sold them aggressively and urged their clients to stay in them even as they faltered.\(^8\)

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\(^7\) These allocations were so valuable that in certain instances, MS demanded and received additional commissions for giving customers IPO allocations, a process that recently resulted in a $490,000 fine and $4,900,000 disgorgement order from the SEC.

\(^8\) Among the many documents MS has refused to produce in this case are the daily Equity Syndicate Index stock designations. What these designations would doubtless show is a virtual one-for-one correlation between stocks becoming eligible for Equity Syndicate Index credit and being sold by MSDW and Smith in droves. This is precisely why MS has pretended that the documents no longer exist.
c. Morgan Stanley concealed the entire fraud.

The key to the success of the Syndicate was customer ignorance. The summary sheet for the program distributed to brokers and branch office managers made sure of this by reciting in bold, oversized print:

FOR INTERNAL USE ONLY
NOT TO BE SHOWN OR GIVEN TO CLIENTS OR PROSPECTS

This secrecy only makes sense from the fraudulent seller’s standpoint: after all, no customer would willingly buy and hold stock knowing that her broker sold it to her not because it was good, but because it made him extra money. As the references in Section IV below illustrate, the SEC views this concealment as fraud.

d. Morgan Stanley also concealed the incentive to margin.

MSDW and Smith encouraged every single one of the Claimants to engage in margin trading, and they followed that recommendation. Margin trading is not for the faint of heart, particularly at MSDW’s prices. In a “margin” account, the customer uses her holdings as collateral to borrow money from the brokerage. The money borrowed is then invested in other stocks in the hope that gains from those securities will pay off the margin interest and make a gain.

MSDW charged 12% per annum on most sums borrowed. For a customer to just break even with her investment, therefore, she had to obtain a baseline return of 12%. In the history of the stock market, fewer than one in 15 years of trading
have produced returns in excess of 12%. As a result, margin trading is *rarely* suitable for the average investor. Only very sophisticated investors having very short-term goal orientation and very high probabilities of high rates of return are suitable for such programs. Instead, MSDW and Smith had *every single Claimant*, regardless of age, net worth, investment experience or percentage of worth, invested in margin trading. In many cases, up to 80% of the Claimants’ asset value was margined.

Again, the explanation for this tendency lies in undisclosed compensation to the broker. The MSDW compensation manual provides that brokers are awarded 15 basis points on margin debt. Thus, as the Washington State Securities Commission found in one enforcement action, MSDW established a definite incentive for its brokers to recommend the use of margin accounts, even where they were totally unsuitable.

e. Morgan Stanley’s system saddled Claimants with unsuitable investments.

Only by discovery in this case have the Claimants come to know of the very strong financial motivations that MS supplied its brokers. Now, looking at the “program” established by MSDW and Smith for Claimants, it is crystal clear that every single recommendation by MSDW and Smith was fueled by Respondents’ undisclosed self-interest. In Choice Accounts, where customers’ commissions were fixed, Smith and MSDW could not enhance commissions by simply
recommending prudent investments. The only way MSDW or Smith could enhance their “take” was to sell on margin, which induced an additional level of compensation, and to sell MSDW-underwritten IPOs to earn bonus points.

The “hold” periods required by MSDW for broker Smith to earn bonus points in the Syndicate required that he have a ready explanation for customers as to why they should stay in stocks that were failing month after month. To accomplish this result, Smith used covered calls. A call is the right to purchase 100 shares of stock at preset prices. If a customer sold a “call” of, say Vignette, for $50 to settle in July of 2000, she has sold the right to another to demand that she sell them Vignette at $50 per share. An “uncovered” call occurs when a customer sells a call but does not have the 100 shares of Vignette in her account to sell if the call is exercised.

In a “covered” call, however, the customer buys 100 shares of Vignette at its then-market price, say $42 per share, and sells a July call at $50. This means that if Vignette was above $50 per share at the time the call came due, it would be “called away.” If it was at $42 to $50 per share, the customer would keep her 100 shares as well as the money received for selling the call.

In either event, the customer using covered calls becomes married to the underlying stock until the call can be exercised. This required the customer to hold
the stock for between 30 and 90 days – all to the benefit of MSDW’s price support and to the broker’s point allocation.

The cookie cutter “program,” if it can be called a program at all, that MSDW and Smith devised for all of his customers was to:

1) Open the account with margin capacity and option authority;
2) Margin against existing stock (often Dell) at very high rates;
3) Use the proceeds to buy Syndicate-eligible stocks – new and speculative issues underwritten by MSDW; and
4) Write covered calls on these stocks.

This “system” was followed in every single one of the Claimants’ accounts without exception.9

The results were totally unsuitable investments for any ordinary investor and certainly for the Claimants. Their accounts were 100% invested in equities, even though six of the eight Claimants listed “capital appreciation” as their primary goal, and that designation ordinarily calls for substantial holdings of fixed-income products. None of the equities sold were what might be referred to as “blue chip” stocks, but instead were new, unproven and highly-leveraged stocks with little or no history of earnings or histories of negative earnings. But this description does not do the mismanagement of these accounts justice. The accounts were invested

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9 The “system” was probably followed in every single one of Smith and MSDW’s accounts to one degree or another, but because MSDW has refused to produce those accounts, this cannot be confirmed.
in 100% speculative, new-issue equities bought on margin and used to trade in options. Claimants will introduce expert testimony that the investments in the Claimants’ portfolios were three times more risky than a portfolio containing a mix of Standard & Poor’s 500 stocks.

The result for Claimants was disastrous: most lost 50% or better of their accounts and some lost as much as three-fourths of the assets they entrusted to MSDW. MSDW labors hard to convince the Panel, as it does in all of these cases, that these were merely “market losses” and that like other investors in the market, the Claimants simply gambled and lost. To the contrary, had MSDW simply followed the customer designations contained in the opening account statements for these clients, it would have avoided over 75% of the losses complained of here. More pointedly, even those customers such as Mike Miller who designated that they wanted speculation – translated by MSDW as 100% equity ownership – 50% of the loss could have been avoided by simply investing the customer in a balanced and diversified equities portfolio. The market did not lose 68% of its value during the timeframe of these investments – MSDW did.

IV. Undisclosed Compensation Schemes Like the Equity Syndicate Index Are Deceptive and Prohibited.

The enforcement arms of the National Association of Securities Dealers and of the Securities and Exchange Commission have condemned as fraudulent compensation systems for their brokers that favor certain securities without
disclosure of that compensation to the investing public. The Claimants believe that these authorities strongly indicate how the Panel should approach this proceeding.

A. Direct undisclosed cash payments are improper.

One of the earliest applicable enforcement actions relating to undisclosed compensation was In Re Kevin Eric Shaughnessy, Exchange Act. Rel. No. 40244, 1998 SEC Lexis 1507 (July 22, 1998). In Shaughnessy, the broker “accepted monies from a stock promoter in return for recommending the purchase of certain stocks to his customers without informing those customers or his employer brokerage firm about the payments.” In Re Kevin Eric Shaughnessy, MRC Decision, May 27, 1997, p. 1. The NASD charged that by accepting undisclosed compensation, Shaughnessy had violated Conduct Rules 2110 and 2120 of the National Association of Securities Dealers Rules of Fair Practice. Rule 2120 essentially reincorporates the anti-fraud rules of the Securities and Exchange Commission, Rule 10b-5. Id. at 10.

The Market Regulation Committee could find that Shaughnessy violated Rule 2120 only if (1) he made misrepresentations and/or omissions in connection with the purchase or sale of securities; (2) the misrepresentations and/or omissions were material; and (3) they were made with the requisite intent to deceive.

The Committee found that:

the omissions [to disclose compensation from the stock promoter] were material because a reasonable investor would find it material that
his or her stockbroker was receiving extra payment, from an outside stock promoter, to solicit and sell certain stock to customers. It is reasonable to infer that this fact might have altered the total mix of information for...customers, who might have believed that Shaughnessy had reasons to sell those stocks other than a belief that those investments were suitable for the particular customers.

The same is certainly true of Claimants here: they would consider “such bonuses...material information which investors should have had prior to their purchases.” *Id.*

Shaughnessy defended the fraud charge by claiming that his branch office manager told him there was “no problem” in accepting such compensation. The MRC made it clear that these defenses were ridiculous and that this issue was not a close call: “Shaughnessy’s conduct in receiving kickbacks from promoters was so clearly improper that any person who possesses a Series 7 registration should recognize it as such.” *Id.* at 12. Shaughnessy’s “everyone is doing it” defense fared no better: the Commission repeatedly held that it is ‘no defense that others in the industry may have been operating in a similarly illegal or improper manner.’ *Id.*

The panel concluded that:

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10 Such activities violate not just Rule 10b-5 of the Securities and Exchange Act, but Rule 17b of the Securities Act as well. In *In Re Ryan Mark Reynolds*, NASD National Adjudicatory Council, Complaint No. CAF990018 (June 22, 2001), the panel found that a broker’s acceptance of $200,000 in publishing costs to fund a nationwide stock advertising run constituted undisclosed compensation that violated Section 17(b) of the Securities Act of 1933. Section 17(b) provides that it is unlawful for a person to circulate any advertisement for a security without “fully disclosing the receipt...of such consideration and the amount thereof.” *Id.* at 21.
It strains credulity to suggest that a reasonable investor would not have viewed the fact that Continental paid Premier for the costs of printing and publishing the advertisements as having altered the total mix of information. Put another way, a reasonable investor…would certainly find the fact that Continental had financed such statements [material].

Id. In the words of the council, “[t]he conduct at issue here is the very conduct that Section 17(b) was intended to prohibit.” Id.

B. MSDW knew these rules, violated them and was sanctioned $75 million for doing so in the mutual funds context.

Based upon its prior pleadings and approach, MSDW will feign shock and outrage that it is even being accused of giving its brokers what amounted to kickbacks. Before embarking on this path, MSDW would do well to consider its own shameful enforcement history on the subject before the NASD.

On November 17, 2003, MSDW entered into a cease and desist and consent order with the Securities and Exchange Commission. The Commission explained its charges:

th[e] matter arises from Morgan Stanley DW’s failure to disclose adequately certain material facts to its customers in the offer and sale of mutual fund shares, thereby violating Section 17(a)(2) of the Securities Act and Rule 10b-10 under the Exchange Act. At issue in this matter are two distinct disclosure failures.

11 The investigation of this matter began in the fourth quarter of 2000, meaning that the complaints raised by the SEC about its failure to disclose extra compensation to its brokers were raised prior to the time most transactions complained of here took place. Thus, MSDW understood at the time the transactions in this case occurred that the SEC believed a system very much like the one at play here to be deceptive and fraudulent.
The order found, and MSDW cannot deny, that on January 1, 2000, it offered some 115 mutual fund families through its brokerage. Order at 6. Fourteen of these mutual fund complexes entered into agreements to pay MSDW additional consideration to promote their funds in the form of either “hard dollars” or accelerated commissions. *Id.* at 7-8. In return, just as it did with the Equity Syndicate Index in this matter, MSDW put the mutual funds on a “preferred list” that financial assistants (brokers) were to look to first when recommending funds, and offered the brokers and branch office managers accelerated compensation for selling them. *Id.* at 11, 17-18. As here, MSDW enforced the program by “lighting up” the broker’s screen to indicate that the favored mutual funds made brokers eligible for additional benefits. *Id.*

MS disclosed none of this to its customers. Instead, it relied upon the disclosures in the prospectuses and Statements of Additional Information issued by the mutual funds to the effect that those funds made certain payments and directed certain brokerages to broker-dealers who recommended them. *Id.* at 23. Just as it does here, MSDW argued that its “standard” disclosures, including the disclosures that it was an issuer or market maker in certain securities and 12b-1 disclosures, adequately advised customers that their brokers were accepting accelerated compensation (kickbacks) for selling the “preferred” funds. *Id.*

The SEC vigorously disagreed, finding that:
none of the prospectuses specifically discloses that Morgan Stanley DW receives payments from the fund complexes, that the fund complexes send portfolio brokerage commissions to Morgan Stanley DW or Morgan Stanley & Co. in exchange for enhanced sales and marketing, nor do they describe for investors the various marketing advantages provided through the programs.

Id. at 25. Instead, the SEC found that MSDW “willfully violated: …Section 17(a)(2) of the Securities Act…; and…Rule 10b-10 under the Exchange Act by failing to disclose material information and by failing to disclose the amount and source of remuneration to be received by the broker for making sales.” MSDW has agreed not to contest or to deny this or any other finding in the cease and desist order.

MS was censured, ordered to cease and desist from further violations of Section 17(a)(2) of the Securities Act or Rule 10b-10 of the Exchange Act, and fined $75 million. 12 In addition, it was ordered to fully disclose to the public the amount and source of consideration that it received for favoring certain mutual fund complexes on its website and to take other remedial efforts. Id. at ¶ 43a-j.

The Equity Syndicate Index that MSDW employed in this case was structurally identical to its practice in the mutual funds field. The key components of each scheme were (1) compensation to the broker, influencing the broker to make decisions based upon his compensation rather than the best interests of the client; (2) which were not fully disclosed to the investing public.

12 During the MSDW investigation, Edward Jones & Co was hit with identical findings.
C. What MSDW provided to its brokers was the same as cash: *In re Monetta Financial Services* and *MSDW Letter of Acceptance*.

Instead of paying brokers commissions, as it did in its mutual fund business, the Syndicate paid them IPO allocations. The question therefore arises whether these IPO allocations were in fact benefits to the brokers. The answer to that question established by the authorities is an unequivocal “yes.” The Panel will hear direct evidence that MSDW considered IPO allocations the same as cash, occasionally even referring to them as “free money” to their brokers. In addition, a number of decisions establishing this principle have been issued involving violations by other members of the securities business and MS as well.

MS understood the value of IPO allocations and has already been fined for misusing them. In a March 2004 Letter of Acceptance, Waiver and Consent, the NASD charged that “Morgan Stanley received $4.9 million in unusually high commissions on listed agency trades from approximately 25 customers within one day of allocating shares in a ‘hot’ IPO to such customers.” Letter at 3. The NASD concluded that for MS, these IPO allocations permitted them to distribute immediate certain profit: “…customers who were successful in obtaining IPO shares from the firm stood to make significant profits by selling those shares in the aftermarket.” Letter at 4. The NASD reached the obvious conclusion that certain MSDW brokers had sought and received kickbacks from their customers in the form of commissions in exchange for allocating new IPOs to them. It concluded
that “[b]y receiving payments from certain customers without inquiry while providing the customers with allocations of hot IPOs, the firm failed to observe high standards of commercial honor and just and equitable principles of trade in violation of NASD Conduct Rule 2110.” Letter at 3. The fulcrum of the NASD complaint is a fact that MSDW knew all along: IPO allocations were money in the bank – passing them out to brokers was the same as passing out commissions or other payment.

But the SEC has also decided that the failure to disclose IPO allocations given as compensation is fraudulent. On March 27, 2000, the SEC’s enforcement efforts resulted in the decision In Re Monetta Financial Services, Inc., Administrative Proceeding 3-9546 (March 27, 2000) (hereinafter “Monetta at”).

The Administrative Law Judge (“ALJ”) issuing the decision characterized the question presented to her as:

whether the undisclosed distribution of Initial Public Offering (“IPO”) allocations by an investment adviser to certain investment company directors was illegal. Specifically: 1. Did Respondents willfully violate Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by not informing the Monetta Fund and the Monetta trust (“the Funds”), the Funds’ shareholders, and possible investors that the adviser allocated shares of hot IPOs to the personal accounts of some Funds directors and trustees?

Monetta at 1.

On appeal, the decision of the ALJ as it related to Monetta and its principal adviser was affirmed, but findings against one of the trustees was reversed. In Re Monetta Financial Services, Inc., Securities Act Release No. 8239 (June 9, 2003) (hereinafter “Monetta Appeal”).
A key evidentiary component of the decision is whether IPO allocations were of significant worth to constitute the payment of value requiring disclosure under Section 10(b) and Rule 10b-5. The ALJ agreed with the SEC’s position that they were. Relying primarily upon the testimony of Professor Kent L. Womack of the Dartmouth School of Business and Professor John Coffee, Jr. of Columbia School of Law, the ALJ concluded that “IPO allocations are highly sought after” and that:

investors who receive these first-day IPO returns through underwriters’ allocation “gifts” are substantially advantaged in any investment competition. It is important to note that investors cannot buy these returns in aftermarket trading. The immediate return is earned only by those investors who receive shares at the offering price from the underwriter. Aftermarket trading (the first opportunity for investors who are not offered shares by the underwriter) beings, on average, after the 13.5% [first-day] increase.

Monetta at 5.

But the inquiry in Monetta did not end with the single issue of whether IPO allocations such as those given to MSDW’s broker Smith for encouraging certain sales were valuable. Rather, the issue in Monetta was whether the fund director was required to disclose his favorable allocations of new IPOs to fund trustees. As the ALJ put it: “[t]he issue, however, is not simply the allocation but the failure to disclose the allocation.” Monetta and its principals argued vigorously that no rule required disclosure of the allocations of IPOs by Monetta to the trustees of its funds. Monetta at 14.
After reviewing the conduct and pertinent SEC rules, the ALJ concluded that “Mr. Bacarella violated, and he caused MFS to violate, the fiduciary duty that they owed to the Monetta Fund and the Monetta Trust by making allocations to …[the trustees] and by not disclosing those allocations to the Funds and their shareholders.” *Monetta* at 16. When pressed by the respondents, the ALJ reiterated that “there was absolutely no justification for not disclosing what was clearly a conflict of interest by the adviser, to the Funds, their investors, and potential investors.” *Id.* at 18. The Commissioners of the SEC were more direct on appeal: “MFS ignored its fiduciary duty to disclose material information to those entitled to its utmost loyalty and good faith. Bacarella acted with scienter. Bacarella made no effort to disclose these transactions to the remaining directors and trustees….” *Monetta* Appeal at 9.\(^\text{14}\)

MSDW’s decision to conceal the Equity Syndicate Index and the compensation to brokers for recommending margin is worse than the violation in *Monetta*. In *Monetta*, the failure was to disclose IPO allocations to certain trustees of the Funds that Monetta recommended to its investors – but the IPO allocations

\(^{14}\) *Monetta* strongly rebuts the MSDW argument that a mere failure to disclose this extra compensation does not constitute a fraud under the securities statutes: “MFS’s distribution of IPOs to directors/trustees of the Funds without disclosure to the other directors, trustees, or shareholders of the Funds was a conflict of interest and a breach of fiduciary duty that violated the antifraud provisions of the securities statutes. MFS and Mr. Bacarella employed a scheme to defraud in offering and selling shares of the Funds without disclosing material information in the Funds’ official filings; they obtained money by means of untrue and misleading information; and they engaged in a course of business which operated as a fraud on purchasers of the shares.” *Monetta* at 19.
in *Monetta* were not made to the *sales agents* whose receipt of them was tied to efforts to cause customers to buy and hold select stocks. Here, the IPO allocations were awarded directly to brokers as a *quid pro quo* for the recommendation of weak stocks in the IPO aftermarket. As the rulemaking history of the SEC reconfirms, this consideration directly corrupts the broker-client relationship and makes it fraudulent.

**D. SEC and NASD rulemaking efforts confirm that undisclosed additional compensation is fraudulent even when made indirectly.**

The SEC and NASD have recently altered Rules 12b-1 and 2830(k) in ways that illustrate that MSDW’s practices were fraudulent.

**1. Rule 12b-1 changes.**

Mutual funds buy and sell very high volumes of securities each year, and the fund managers must choose someone to clear the transactions. All brokerages like to have this business because it is a steady and direct flow of commission income. In 1981, the SEC passed rules allowing mutual funds to consider the sales efforts of the clearing broker as a factor when determining who may clear their transactions. Under the old rule, fund managers could reward or sanction broker-dealers for their sales efforts by granting or withholding execution orders. SEC Release IC-26591, *Prohibition on the Use of Brokerage Commissions to Finance Distribution*, October 14, 2004 at 2 (hereafter “SEC 12b Release”).

The SEC’s year-long review preceding the rule change revealed that:
directed brokerage has been assigned explicit values, recorded, and traded as part of increasingly intricate arrangements by which fund advisers barter fund brokerage for sales efforts. These arrangements are today far from the benign practice that we approved in 1981 when we allowed funds to merely consider sales in allocating brokerage.

SEC 12b Release at 2. This is precisely what occurred within MSDW internally with the Syndicate, but with IPOs rather than directed brokerage being the coinage.

The SEC concluded that this undisclosed compensation to broker-dealers interfered with their independence and objectivity. In the SEC’s words:

> these practices may corrupt the relationship between broker-dealers and their customers.\(^\text{15}\) Receipt of brokerage commissions by a broker-dealer for selling fund shares creates an incentive for the broker to recommend funds that best compensate the broker rather than funds that meet the customer’s investment needs. Because of the lack of transparency of brokerage commissions and their value to a broker dealer, customers are unlikely to appreciate the extent of this conflict.

SEC 12b Release at 3. The decision also strongly rejects the type of argument that MSDW makes here – that “standard” disclosures that it is an underwriter take care of the problem, concluding that the “opaqueness” of fund transaction costs “makes it impossible for investors to control the conflict or to understand the amount of actual costs incurred for distribution of fund shares.” SEC 12b Release at 5. Just as mutual fund investors could not discern from public filings the nature and extent of consideration being paid to MSDW and other investment fund advisors,

\(^{15}\) And what example of corruption did the SEC cite in support of its rule change? Its November 17, 2003 cease and desist and consent order with Morgan Stanley Dean Witter. See SEC Release at 3, n.22.
Claimants never knew that their broker was being paid bonuses to entice them to buy and hold certain stocks.

2. Changes in NASD Rule 2830(k).

It is unlikely at this point that any additional evidence of the SEC or NASD’s condemnation of undisclosed compensation is necessary. If there were any doubt, however, it was resolved by the Securities and Exchange Commission’s approval of changes to NASD Rule 2830(k). SEC Release 34-50883 (December 20, 2004) (hereafter “Rule 2830 Release”).

Rule 2830(k) once prohibited NASD members from favoring the sale of any investment company on the basis of brokerage commissions it has received or expects to receive from any third source, including the investment company itself. NASD Rule 2830(k)(1). An exception, however, permitted an NASD member to sell the shares of or act as underwriter for an investment company where the investment company “follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions.” Rule 2830 Release at 2. The NASD and SEC agreed that the rule should be changed to prohibit NASD members from selling the shares of or acting as underwriter for any investment company even when the investment company disclosed it:

if the member knows or has reason to know that such investment company or an investment adviser or principal underwriter of the
company, has a written or oral agreement or understanding under which the company directs or is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

Id (emphasis added). In other words, even the informal and indirect kind of payment like underwriting rights or IPO allocations is invalid.

The decision was consistent with every prior ruling and enforcement action by the SEC and NASD condemning back-door consideration to brokers. In fact, the SEC recognized that extra compensation given in exchange for sales of investment company shares by the seller was no better than the cash paid the registered representative in Shaughnessy. In the Commission’s words:

[T]he proposed rule change…will strengthen NASD’s rules against quid pro quo arrangements between NASD members and investment companies whereby investment companies compensate broker-dealers for promotion of their shares with brokerage commissions (or similar transaction-related remuneration)...[because]...such practices pose significant conflicts of interest and may be harmful to fund shareholders, as well as potential purchasers of fund shares, in that they may induce broker-dealers “to recommend funds that best compensate the broker rather than funds that meet the customer’s investment needs.”

Rule 2830 Release at 4. The condemnation by the SEC of hidden compensation is old hat. What is new about the change to Rule 2830(k) is that the SEC no longer regarded disclosure of the fact that a brokerage was receiving non-monetary consideration as a “saving grace” for the kickback. Why? Because, like here, the
investor cannot “control the nature of the consideration or appreciate its significance” of the moneys being paid to induce “buy” recommendations.

Thus, whether the Panel looks to enforcement proceedings prosecutions or rulemaking processes as its guide, one basic principle will emerge: when a broker-dealer puts in place a system to influence its brokers through undisclosed compensation, they violate Rule 10b-5 and commit fraud. This is, however, precisely what MSDW did when it established the Syndicate to pay its brokers to sell and recommend that customers hold certain issues it promoted, and profited from promoting.

V. Conclusion

The Claimants’ position is simple. Would ordinary investors ever have dealt with a broker who claimed years of experience and expertise when he had none? No. Would they incur margin debt knowing that the reason it was recommended was to fatten the broker and brokerage’s pocket? No. Would ordinary investors buy stock recommended by their broker if they knew the broker recommended it to earn extra bonuses? No. Claimants were entitled to basic honesty in their dealings with MSDW but did not receive it. As a result, they received a series of identical and unsuitable investment recommendations that cost the Claimants dearly. It is for this reason that they seek compensation from the Panel.
Respectfully submitted,

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CERTIFICATE OF SERVICE

    I certify that I served a true and correct copy of the foregoing document on
    counsel of record for Morgan Stanley by facsimile on April 25, 2005.

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    Thomas M. Fulkerson