Concentration: Too Much of a Good Thing?

by Tracy Pride Stoneman and Douglas J. Schulz

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

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

I. The Explosion in Concentration Cases

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

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

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

II. How to Plead a Concentration Case

Concentration, or overconcentration as many like to say (though we wonder if that is redundant), falls

Tracy Pride Stoneman is a long-time PIABA member, PIABA Board Member and securities lawyer who has her own firm with offices in Colorado and Texas. She can be reached at 719-783-0303 and TStone1000@aol.com. Douglas J. Schulz is a Registered Investment Advisor and NASD Certified Regulatory Compliance Professional and securities fraud expert witness. He can be reached at 719-783-3230. His website is www.securitiesexpert.com. Together they authored the book Brokerage Fraud: What Wall Street Doesn't Want You To Know, Dearborn Trade, 2002.

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

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

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

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

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

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

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

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

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

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

If the NASD and NYSE described every conceivable wrong that could be perpetrated on an investor, the respective manuals would easily expand into numerous volumes. For example, the rules do not set forth every aspect of proper

supervision, but rather require firms to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association." NASD Rule 3010.

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

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

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

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

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

October 1998

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

February 1999

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

October 2000

John Robert Van (CRD #2102824, Registered Principal, Corinth, New York) and Michael Edward Murphy (CRD #1528815, Registered Principal, Clifton Park, New York) - fined $10,000 and suspended from association with any NASD member for 15 business days...findings that they recommended unsuitable trading to public customers that resulted in excessive and inappropriate use of margin. The findings also stated that Van and Murphy recommended transactions in which the customers borrowed against existing stock positions to purchase additional shares of, among other things, "high-risk" over-the-counter stocks. The NASD found that Van and Murphy acted in disregard of their customers' interests when they disregarded the impact of use of margin and the **concentration** levels of certain securities, excessive trading, and the risks incurred in their recommendations that resulted in a total loss of approximately $211,000 and margin interest of approximately $15,300.

April 2001

William Joseph Shaughnessy (CRD #870259, Registered Representative, Tucson, Arizona) submitted an Offer of Settlement in which he was censured and fined $10,000. Without admitting or denying the allegations, Shaughnessy consented to the described sanctions and to the entry of findings that he made unsuitable recommendations for the joint securities account of public customers that

resulted in an over-**concentration** of precious metals-related investments in the account. The findings also stated that Shaughnessy completed a new account form for the customers' securities account that contained material inaccuracies. (NASD Case #C3A000036)

February 2002

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

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

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

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

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

January 1999

Securities America, Inc. (Omaha, Nebraska) submitted a Letter of Acceptance, Waiver, and Consent to the NASD pursuant to which the firm was censured and fined $10,000...The findings also stated that the firm's supervisory procedures failed to include procedures for all the types of business in which the firm engaged, failed to designate the principal responsible for the supervision of registered representatives and principals in the firm's Offices of Supervisory Jurisdiction, and failed to identify the individual responsible for the updating of the written procedures. Moreover, the procedures failed to outline the methodology for supervision of account activity, **concentration**, and use of margin in connection with accounts located in single person Offices of Supervisory Jurisdiction and branch offices.

In the Matter of PaineWebber, SEC Administrative Proceeding File No. 3-8928 (1996)("The Branch Office Manager...failed reasonably to supervise the RR's activities...by failing to take reasonable measures to investigate clear signs of **overconcentration** in accounts of the RR's customers...")

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

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

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

III. What is Concentration and How to Spot It

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

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

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

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

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

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

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

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

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

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

When do you need the money?

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

How much risk can you handle?

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

How much wiggle room do you have?

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

As the market downdraft intensified in 2001, did you:

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

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

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

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