WRITTEN STATEMENT OF

JOAN HUNT SMITH

Testifying before

THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

IN THE MATTER OF ARBITRATION

JUNE 9, 1988

ARBITRATION

Chicago Board Options Exchange (CBOE)

November 13 & 14, 1984

CLAIMANTS

Joan Hunt Smith, Mary-Duke Smith Trust, and George Hybert

Attorneys for Claimants:

Brace & O'Donnell
Frederick F. Brace & Patrick J. O'Donnell

DEFENDANT

Shearson/Lehman American Express

Attorneys for Defendant:

Leslie A. Klein
Theodore A. Krebsbach

Claimants' Witnesses

Joan Hunt Smith
George Hybert
Frederick J. Otto, expert
Philip Henri deRoulet, expert

Defendant's Witnesses

William Cohen, Manager	Shearson, Chicago
Anthony Festa, Compliance Officer - Options	Shearson, New York
Peter Discenza, Legal Dept. Account Analysis for Litigation	Shearson, New York

ARBITRATORS

William Lang Carroll, Arbitration Committee Chairman and Panel Chairman
Charles Cox, CBOE and Attorney
Anne Hamblin Schiave, Attorney
Sheila Reilley, Attorney
Thomas Moore, Attorney

SUMMARY

1984 CBOE Arbitration involving three separate option accounts of to the same broker; combined losses around $500,000. Defendant was Shearson/Lehman American Express. Account statements have never been independently audited.

Combined total commissions paid on these losses was $225,072. In 1982 the combined total commissions were $122,443, which accounted for over one-third of the broker's commission income for that year.

The broker was later indicted for several counts of tax fraud and sentenced to jail. Psychiatric care used as plea for leniency. Prior to arbitration he committed suicide.

Arbitration Chairman took away promised third day of arbitration as hearing began. Time allowed for presentation of three complex cases was limited to about ten hours.

Chairman allowed hearsay and uncorroborated testimony from Shearson.

Also accepted Shearson's almost completely illegible copies of customer financial statements for the three accounts. The resulting confusion was evident throughout the arbitration.

Evidence of two different financial statements for one account (one grossly inflated and backdated) surfaced at the hearing. Claimants had no knowledge of these statements as they require no signature of the customer. There was no questioning by the three experienced CBOE arbitrators as to the reason for the differences or even the existence of the second. The one inexperienced arbitrator who appeared curious seemed left confused by the illegible copies.

No financial statement for one of the claimants was produced by Shearson until later. Three financial statements for another claimant were in the arbitrators' exhibit books. However, there was no testimony about any of these.

Arbitration found No Award and denied Motion to Vacate.

After the arbitration and after enlarging all of the bad copies, claimants found the three copies for one account were all false, were all inflated and were all different. Close inspection revealed that the financial statements for all three accounts were all false and inflated. The statements were signed by the same broker and the same manager. Most statements lacked the New York Compliance Department approval initials.

One of the cases against the same broker, supplied by Shearson before the arbitration, contained only the complaint (which was similar to ours) and proof of settlement for 75% of the claim. Months after the arbitration, after finding the lady involved (who made her files available), claimants found she also had a false financial statement signed by the same broker and same manager. Shearson had removed this highly damaging evidence from the case papers given to claimants prior to arbitration.

The discovery of the series of statements made it abundantly clear that the manipulation and inflation is done for the purpose of qualifying people to trade in naked options who in fact are not qualified, and it is done without their knowledge, thus revealing even further a distinct pattern. We feel there certainly must be more.

The SEC "inquiry" farmed out all of the false financial statements to the NYSE. They used letters from the CBOE and the NYSE, along with the troubled legal record, as foundation of their report to Chairman Dingell which contained omissions, inaccuracies, misstatements, was generally incompetent, and was sympathetic to the industry, thus providing no deterrent to violations of the law which translates into encouragement.

There was testimony about churning presented by the two expert witnesses although Shearson said churning was not included in our submission agreement. Proof of unsuitability in all three cases was certainly available to the arbitrators had they chosen to study the exhibits. Shearson's apparent need to manipulate customer financial statements over and over again in an effort to qualify them for naked options surely supports the claim of unsuitability. There was no justification for the experienced arbitrators to remain mute and show no interest in the differing statements.

Could all of this have happened in a court of law?

APPENDIX OF SUPPORTING DOCUMENTS

A – Arbitration Statement of Claim and Submission Agreement

B – Arbitration Finding of No Award

C – Motion to Vacate

D – Broker Indictment and Coroner's Certificate of Suicide

E – Uniform Termination Notice

F – Joan Hunt Smith Financial Statements, Negative Consent Letters, Etc.

G – Mary Duke Smith Trust Financial Statements and Contract

H – George Hybert Financial Statement

I – Analysis of Questions & Challenging Statements of Witness by Panel

J – Philip J. Hoblin Who's Who

K – CBOE Committee Showing Association of Hoblin and William Carroll

L – Louise Schulman Case

M – Letter from Claimants' Second Attorney to Shearson's Attorney

N – Letter from Claimants' First Attorney to CBOE Arbitration Secretary

O – Letter from Chairman John D. Dingell to John S.R. Shad (SEC)

P – Letter from Patrick Healy, Chicago Crime Commission, to John Dingell

Q – SEC Report One, Letter from CBOE, JHS Response

R – SEC Report Two, Letter from NYSE, JHS Response

S – Dismissal of RICO Case for Want of Prosecution (now reinstated)

T – Manager's "Memo"

U – Special Study of Options Market to SEC, 1978

V – Risk Letter #3 with Accompanying Comfort Letter

W – Sample SEC Case Report Showing Familiarity & Understanding of
“Falsification of Customers’ Option Applications”

X – Newspaper Articles

Y – Chairman’s Statement About Arbitrators’ Deciding on Admissability of Copies

This arbitration involved the accounts of three people who suffered combined losses of around $500,000 in option trading.[1] I was one of the claimants along with my daughter's trust and a family friend. The same broker had recommended options as the proper investment instrument to facilitate our separate individual needs so the attorneys consolidated the complaints. (App. A) The total of the commissions paid by these three accounts for the years covered by the complaint was $225,072--and $122,443 of this amount was paid in 1982 alone which provided over one-third of the broker's total commission income for that year.

After the complaint was filed we waited 16 months to arbitrate. It resulted in a "NO AWARD" and also a denial of our Motion to Vacate. (App. B & C) Five months before the arbitration the broker, Herbert G. Mayer, committed suicide. Unknown to us, he had been under prolonged IRS investigation and also under psychiatric care which was used as a plea for leniency.

By way of background, one of the claimants, George Hybert, a salesman nearing retirement, had gone to college with the broker's brother. And it was George who recommended the broker to me and several of his other friends. Through the years George had done very well investing in ASA gold stock on which the broker had traded options, and the equity in his account was around $800,000 in 1980. Shearson's Chicago manager, William Cohen, several times recommended that George "diversify" into options on stocks other than gold. The broker had represented himself as an options expert who had experienced great success with his other clients. (T.207, 213, 243, 245-246) George did not follow stocks other than gold, and because he traveled one week out of every month, he agreed to diversify <u>only</u> if he would be in the same

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[1] Throughout the written testimony reference will be made to the transcript of the arbitration by "T" followed by the page number. Reference to the enclosures in the Appendix will be designated by "App." followed by a letter.

option positions as the broker, and the broker would shepherd his account--to which the broker agreed. George wanted to use the option income to increase his capital base for retirement.

George felt Mayer possessed the knowledge of the underlying stocks and the “expertise” in options. Unfortunately, as you will see, Mayer was not honorable and the stock options eventually covered 15 to 17 issues and the contracts gradually increased to between 800 and 1,000 in a given month.

I opened my account with the broker in June 1981. I was divorced, my alimony was ending, and I was not employed. I asked for help in restructuring my portfolio of high quality stocks so that I could increase my income while protecting my assets. (T.213) Options were recommended. I was told that I, too, would be put in the same positions as the broker which gave me a feeling of trust and safety. Six months later I brought over my daughter’s trust to hopefully increase her stock portfolio while protecting her assets. Options, of course, were recommended by Mayer for this purpose, and Shearson advised how to have the Trust agreement amended to provide for the use of this investment instrument. (T.124-195) Never in my limited investment experience had I ever had any dealings with options--they had never even been mentioned before I went to Shearson.

In the ensuing months the positions in both the accounts continued to grow dramatically and there were hundreds of options to monitor. Mayer’s only strategy was to <u>sell</u> options, and it was impossible to tell immediately if an option was in a profit or loss position. George and I each asked Cohen several times to include the price of the opening transaction on the weekly option report which Shearson provides only to its brokers (but which was given to us by Mayer). However, Cohen said this was too complicated for New York to do. (T.264-265)

In the spring of 1982 the market was going down but still Mayer's only strategy was to sell. (T.250) George requested help in cutting back his account and I wanted to get out of options altogether and began going down to Shearson, prompted by deep concern for the account. Mayer said it would be too expensive to buy in all of the positions at once and suggested lining them up so that all would expire in the summer. I followed his advice. George was trying to get Mayer to lighten up his account and told him he was going to have to find a better broker with professional guidance and specialists in options if something wasn't done.

In about August 1982, the market started to climb. Mayer advised me not to buy in my calls and but rather recommended selling more in the meantime. Then one day he said, "Well, Joan, I bought in my last call today." (T.135, 136, 183)

In September 1982, George became more concerned about his account, generally and specifically, and again asked Mayer several times to call Shearson's New York options department which he finally did. Shearson's New York "options expert" would not speak to George so George asked if he could listen; the expert agreed. The only advice was simply to "bite the bullet" and "buy in at a big loss." This was just one example of our experience with Shearson's "Minds Over Money." I was present at the time and we both decided to take our accounts elsewhere. The emotional strain of the last few months had taken its toll. (T.184, 224-226)

In 1979, 217 option positions were opened for George's account. By 1982 this figure had increased dramatically to 5054 option positions in that one year. In 1981, 806 option positions were opened for my account. By 1982, 3670 option positions were opened. In 1981, 20 option positions were opened for the Trust, increasing to 861 by 1982. After Mayer executed the positions, he would very often later report, "I lowered the price just to get them off."

In 1979 Mayer had gross commissions of $218,750, and George's account generated $4,987 of that amount. In 1981, Mayer had gross commissions of $315,781 and the three accounts together generated $44,570 of this amount. In 1982, Mayer had gross commissions of $356,643, and again, these three accounts together generated $122,443 in commissions which accounted for over one-third of Mayer's total commission income (T.110, 461)

The approximate loss for George's account was $219,190; my approximate loss was $172,167; and that of the Trust was $48,445. The word "approximate" is used because these figures were extracted from Shearson's records which have never been independently audited. The losses conceivably could have been more. Shortly after opening my account with Shearson, and following Mayer's advice "to build up the account," I liquidated assets of around $119,000, and deposited that amount into the account which brought it up to around $327,000. The Trust account was worth approximately $137,000 when I took it to Shearson.

In the fall of 1982, I told my friend and neighbor, Stuart Ball, who was a senior partner of Sidley & Austin, what had been happening to us at Shearson. He advised us to sue them in the federal court, explaining the law was very clear on the fiduciary responsibility of a broker to his customer. He referred our case to a former associate of that firm whose trial ability he admired, and requested that he handle our case on a contingency basis. Sadly, two months later Mr. Ball died. It was after his death that the chosen attorney recommended arbitration over the federal court.

While we were waiting to arbitrate Mayer was indicted for three counts of income tax fraud, pled guilty to two and received a jail sentence. (App. D) Shearson had Mayer's license revoked and fired him as required by statute. On June 16, 1984, (five months before the arbitration) Mayer committed suicide. The document submitted to the New York Stock

Exchange (NYSE) by Shearson to have Mayer's license revoked misrepresented Mayer's history to the NYSE in that it supplied incorrect answers in response to questions about the broker's history. The following two questions were marked "no" when they should clearly have been marked "yes" on the "Uniform Termination Notice" (App. E):

> A. any investigation or proceeding conducted by any governmental agency or self-regulatory body which has jurisdiction over the securities, …industry?
>
> C. any major complaint or any legal proceeding by a customer of your firm?

Our case was pending and the case of Louise Schulman filed against that broker was settled in June of 1982.

Before the arbitration, we tried to obtain information about whether or not the indictment involved any of Mayer's customers or Shearson. We were assured by Shearson there was no connection although we have since heard differently. The arbitration committee prevented our obtaining any of this information and other meaningful discovery.

The CBOE Arbitration Committee had set November 13-15, 1984, for a three-day hearing. As the arbitration began, Chairman Carroll shortened the hearing to two days, thus depriving us of rebuttal time. The hearings began at approximately 4 p.m. and ended between 9 and 10 p.m., with a mandatory one-hour break for dinner. The full presentation of this complex case, which involved three separate complaints, was confined and limited to less than ten hours. We had not realized that CBOE arbitration takes place each day at the end of a full working day, so that a complaint is heard by five tired people. The chairman announced at the beginning his preference for brevity.

During the arbitration two of what were later revealed to be a series of false and inflated in-house financial statements came to light which were signed by the broker and the present

Chicago manager of Shearson, but unsigned by the customers. We were totally unaware of their existence. Shearson's financial statements do not require customer signature. Therefore, they can be manipulated easily and used as vehicles to qualify customers for types and/or degrees of option trading for which the customer is not qualified. This results in huge commissions for the brokerage house while exposing their customers to incredibly high risk of which they are unaware and probably cannot reasonably sustain.

Two false and manipulated statements were submitted for me within a ten-day period. The second was backdated to conform with the first. The first financial statement was returned to the Chicago manager by Shearson's New York Compliance Department. The statement was marked, "Wire attached"; the wire said, "Account cleared for covered calls only, please acknowledge." (T.334, 341) Apparently, within less than two weeks, a second financial statement, which almost tripled the income and more than doubled the liquid and total net worth of the first one, was presumably submitted to New York (although it bears no New York Compliance Department approval initials); this second statement apparently cleared the way for naked option trading. (T.331, 361) It is my understanding that these documents are transferred back and forth by wire.

The changes from the first in-house financial statement to the second statement were: the $30,000 income was changed to $80,000; the liquid net worth of $500,000 on the first was changed to $1,000,000 on the second; and total net worth of $750,000 on the first was changed to $1,500,000 on the second. (T.331-361, 439-444)

Other misrepresentations on both in-house financial statements were: (a) the bank was wrong; (b) my age was wrong; (c) I was not familiar with options, as it said, and I had had no experience or exposure to them whatsoever; (d) the statement said options were suitable for me and yet the New York office did not agree as they limited the first in-house financial statement to covered calls only--thus supporting my claim of unsuitability. (T.332) During the arbitration, Cohen said he never saw my first statement until the day of the arbitration as he said it had been approved by his assistant. He also said that if he had seen earlier that there were two differing statements, he probably would have done "nothing." (T.376) He did say he saw the wire from New York which said "Account approved to sell covered calls only!! Please acknowledge." (T.334 & 341) It was sent by Jim Crowley, Compliance Department. However, since the first financial statement has written on it, "Wire attached," how could he have seen the wire attached without having also seen the statement? (See App. F) Only my first statement bears Shearson's New York Compliance Office approval initials. Both statements apparently were dated 29 May 1981. I did not sign Shearson's contract until 1 June 1981.

A "negative consent" letter was mailed to me on two occasions (T.350, 351, 439-444) When I received the second negative consent letter, I noticed the $30,000 income of the first had been inflated to $80,000. I mentioned it to Mayer, he said it was a mistake and to forget it. This seemed reasonable since the other figures remained the same as on the first. (T.443) Shearson testified that the information on the negative consent letters is taken directly from the information on the financial statements. (T.444 and App. F) However, in writing the second negative consent letter, Shearson's New York Compliance Department (if indeed that is where it originated) had to have had both of my financial statements in front of them as it contained information from the first and second statements. (T.443)

There was a series of three false and inflated statements for my daughter's trust, all submitted within a five month period, all different and all signed by the same broker and manager. These statements were in the arbitrators' exhibit books but there was no testimony about them. Later, after enlarging and studying the copies, it was found that all three varied and had also been falsified.

Two of these financial statements were submitted before the signing of Shearson's contract for the Trust which, as I said before, was six months after opening my own. The first one, dated September 11, 1981, records income of $5,000 and $225,000 total net worth. A second one dated November 16, 1981, records income of $15,000 and total net worth of $250,000. The third one dated January 21, 1982, was false in the following ways: (a) she was a student at Wesleyan in Connecticut all four years (she had never been to the University of Michigan at Ann Arbor as stated by Shearson); (b) she was not yet 19 years old instead of 20; (c) her annual income had never been $15,000 (and actually was less than half that amount); (d) her total net worth was approximately $115,000 on the date of this statement, not the grossly inflated amount shown as $250,000; and, (e) she never owned a home as stated in the financial statement. (T.384) Again, there was no testimony about the Trust's three financial statements although all three appeared in the arbitrators' exhibit books. (App. G)

The following lists the sequence of events:

July 23, 1981 – Mary Duke Smith Trust formed

September 11, 1981 – Shearson's 1st statement with $5,000 income

November 16, 1981 – Shearson's 2nd statement with $15,000 income

December 9, 1981 – Shearson contract signed for Mary Duke Smith Trust by Trustee

December 21, 1981 – Amendment to Trust which was requested by Shearson in order to carry out the broker's recommendation for option trading to provide income to build her stock portfolio.

January 21, 1982 – Shearson's 3rd statement with $15,000 contained new and unauthorized option positions not even mentioned in the Trust amendment

Surely this supports the Trust's claim of unsuitability as it is clear that Shearson believed options to be unsuitable for her, and their effort to qualify the Trust is well documented. The dates of the three different statements for the Trust show that two preceded the signing of the Shearson contract and the Trust amendment. At the time of Shearson's request for the amendment, there was no hint of risk nor was there even the slightest suggestion that the Trust should not engage in option trading.

No negative consent letter was ever received for any of the three Trust financial statements. There are no New York Compliance Department approval initials on any of the three statements for the Trust.

The only statement we have for George Hybert, dated 5-29-81, was inaccurate in the following ways: (a) his business address was wrong; (b) his bank was wrong; (c) his income was never $100,000; and (d) he has not owned a home since his divorce in 1977 (and this fact was known by Mayer as he had seen the two-room rental apartment George occupied at that time). Everything George owned was in the Shearson account. He never received a negative consent letter. (App. H) For some reason no statement of any kind was provided by Shearson for George until later. (T.300, 384) It is difficult to understand why his statement bears the same date as mine since he had already been a customer for many years. Leslie Klein, Shearson counsel, when asked by a panelist if George's financial statement was available, supplied an evasive answer regarding this subject. (T.300) He did the same thing in response to panelist's question about my financial statement. (T.176-178)

I must explain here that almost all of the detailed discovery and certainly our understanding of the intended purpose of these financial statements took place after the arbitration since the copies supplied to us by Shearson and allowed by the arbitrators were almost totally illegible, thus discouraging close scrutiny. (App. Y) Some feel the brokerage houses play this game with photocopies intentionally and for this specific purpose. The confusion they cause is quite obvious in the transcript; these copies would never have been allowed in a court of law. (App. F -- The documents we are submitting have been enlarged in an attempt to make them legible.) In response to our complaints about the copies, Shearson lightly commented several times that they needed a new copy machine. Can anyone seriously imagine only one copy machine at Shearson and illegible copies of that company's business being circulated throughout this giant corporation? It is ludicrous and seems quite obvious that these kinds of copies must be reserved for a specific purpose and used with a specific intent.

<u>None</u> of the three experienced arbitrators <u>asked any questions</u> of the Shearson witnesses about my two financial statements. Only one of the inexperienced arbitrators showed any interest and apparently was discouraged by the illegible copies. We did an analysis of the arbitrator verbal participation from the transcript of the arbitration. (App. I) The combined number of questions and challenging statements asked of claimants and their witnesses by the panel was <u>162</u>. The combined number of questions and challenging statements asked of the Shearson witnesses by the panel was <u>9</u>. Based on the outcome of the arbitration, this incredible imbalance would seem to reflect a certain predisposition of bias on the part of the arbitrators. (See chart on page 16.) It seemed as though the arbitrators wanted to avoid any testimony going into the record that would be detrimental to Shearson.

Carroll and Cox, as evidenced by the testimony, devoted a great deal of time to challenging and "cross-examining" one of our expert witnesses which gave the impression they were trying to negate and defuse any testimony in support of the claimants. The day after the arbitration this same expert witness received a call from Shearson's New York office. He was told he would never receive any more business from Shearson and that any of their work on which he was currently working would be taken away. Shearson also told him they would black ball him in the industry and he would never receive any more work from that source, either. This was Shearson's reaction to his truthful relating of statistics which supported the claimants. It is important that the Committee understand the "rule or ruin" mindset of the brokerage industry and its relationship to investor protection and the fairness of industry-controlled adjudication of customer claims.

After the arbitration and the discovery of all of the false in-house financial statements, but before the result of the arbitration was known, claimants filed a RICO and fraud action against Shearson and William Cohen, the Chicago manager. There was some question about the statute running for George Hybert's churning on December 1 (which was explained by counsel on the last night of the arbitration hearing) so the suit had to be filed <u>before</u> they received notice of the outcome of the arbitration. This case is pending.

When we received the "NO AWARD," we shared a feeling of shocked disbelief because this finding was contrary to the evidence, not only of churning and suitability, but had the arbitrators studied <u>all</u> of the financial statements as we did later, they would have discovered that there was a distinct pattern of mischief. Could this neglect have been intentional?

The following additional facts were also <u>never</u> divulged to us and were unknown before the arbitration. Had these facts been known, there would have been no CBOE arbitration, or any arbitration at all if we could have prevented it. Some related facts revealed during the arbitration are also listed.

1. Philip J. Hoblin, Jr., Vice President and <u>General Counsel of Shearson</u>, was a <u>former chairman of the Chicago Board Options Arbitration Committee</u>. (App. J) The high

profile and position of leadership and respect enjoyed by Hoblin in the industry, especially in the field of arbitration, is bound to have exerted some influence--conscious or unconscious--in this arbitration. The fact that this Shearson connection to the arbitration committee was withheld from the claimants certainly gives the appearance of impropriety and denied claimants any chance to withdraw from the arbitration. Knowledge of this association would have rendered it unacceptable.

Hoblin had also served on a seven-member conduct committee with William Carroll, the chairman of the arbitration panel who heard our case. (App. K) Carroll also was then serving as the CBOE Arbitration Committee Chairman.

2. Carroll owns a seat on the CBOE and has a direct interest in any bad publicity that might affect option trading and the value of his seat. He was twice vice chairman of the CBOE Arbitration Committee or a member of the committee from 1981 through 1984.

3. Chairman Carroll was in poor health (an ulcer) and announced this as the court reporter engaged by Shearson was setting up and before she began transcribing, although there is reference to this later in the transcript and the disrupting effects can be seen. Carroll said he had to eat his meals on time, quit early, and get his sleep. (T.226) His health alone rendered him inappropriate as an arbitrator and working night and day creates an undue strain for any person in this condition. Carroll told claimants more than once they would be very popular with him if they made it brief! These stated needs of the chairman due to heretofore undeclared ill health charged the air with the necessity to hurry. (T.226)

4. Chairman Carroll did not allow claimants the third day originally allotted to them. Their counsel was told emphatically by the Chairman that “no, we won’t use Friday; we’ll finish

up on Thursday evening," at the same time the ulcer was being disclosed. Counsel questioned this but Carroll's attitude and answer remained the same.

5. Before the arbitration Chairman Carroll did not provide an adequate and full list of arbitrators' backgrounds or any collateral associations which could have indicated the appearance of a conflict.

6. The fact that Carroll is a floor broker and Cox is a market maker and they <u>trade for the public</u> (which presumably includes Shearson) was not understood by claimants or described by the panelists. Cox only commented that he traded Eastman Kodak.

7. Chairman Carroll <u>interrupted</u> our counsel six times as he was trying to examine William Cohen, the only remaining co-signer of the false in-house financial statements. Carroll <u>stopped</u> counsel once saying, "I see the point of your questioning, but…" and "we know what you are getting at," and was argumentative with him. (T.359-361)

8. During the cross-examination of Cohen, claimants' attorney asked why Crowley was not present to offer corroborating testimony. Carroll immediately interrupted and stated, "How can the man answer that?" (T.338)--thus closing the door to any further discussion of what really might have occurred. Carroll's comment was purely protective of Shearson as Cohen was not only privy to but was part of Shearson's defense. Crowley was Shearson's New York compliance officer who returned my first financial statement marked "wire attached" and approved the account for covered calls only. Cohen said he told Crowley over the phone to approve my account and thus I apparently(?) was approved. Certainly Cohen knew why he had to be the only direct witness to relate this alleged "two-way" conversation.

9. In contrast to a court trial, which is a matter of public record, Chairman Carroll twice expressed a desire that everyone should join the panel in remaining silent about the

arbitration and that "the secrets stay in this room." In view of all of the false financial statements which this arbitration ignored or attempted to conceal, one can understand Carroll's concern. (T.227, 464) It is obvious that secrecy protects only the brokerage firms and further disadvantages the investor. Could it be that because what the SEC refers to as "falsification of customer option applications" seems to be quite common in the industry, our case may have threatened to unveil this despicable practice?

10. Charles Cox, industry panel member, owns a seat on the CBOE and has a direct financial interest in any bad publicity that might have an adverse effect on the way options are received by the investing public. He also controls and trades through an investment company, CBC Corporation. He was a member of the CBOE Arbitration Committee from 1981 through 1984. It appears from the transcript that Cox assumed the role of prosecuting attorney with the claimants as the defendants. Also, for example, he tried to make a collateral issue out of something of no importance as a diversionary tactic in an effort to muddy the water and detract from the contradictory financial statements.

11. Anne Hamblin Schiave, a panel member and attorney, announced at the beginning of the arbitration that she arbitrated at the CBOE and <u>did securities work</u>. (T.6) We had been told <u>only</u> that she was an attorney, and we feel that due to the nature of her work her presence tipped the scales in favor of the industry in violation of CBOE Rule 18.10 (a) (2). Had the nature of her work been supplied to us by the Secretary of the CBOE Arbitration Committee before the arbitration, as it properly should have been, and had the significance of a <u>third</u> securities-oriented arbitrator been understood, she would have been unacceptable to us as an arbitrator. In Wilco vs. Swan 201 FR 2nd 446, Circuit Judge Clark, in his dissenting opinion, stated:

> The arbitrators will act according to their business background and there will be no way--unless they volunteer foolish explanations in their decision--of checking what they do. So, what is most desirable in the ordinary arbitration becomes a clear loss of statutory right here.

12. There was no cooperation from the Secretary of the Arbitration Committee in claimants' efforts to find out the composition of CBOE panels in prior years, and the full truth from Shearson's records about the broker's other clients have never been made available to us. One has to assume, and reasonably so, that Hoblin would be better able to gain cooperation in obtaining pertinent information because of his relationship to the Committee.

13. Also placed into evidence and mentioned in the transcript of the arbitration was the case of Louise Schulman which had also been filed against Mayer. (T.380, 381 & App. L) Her complaint was very similar to our's and was pending during the time we were sustaining heavy losses; Shearson settled with Mrs. Schulman for 75% of her claim on June 18, 1982.

However, <u>only the complaint and proof of settlement</u> in this case were supplied to claimants before or even during the arbitration by Shearson. It was not until <u>many</u> months after the arbitration that I found the lady who was involved in this case. She instructed her attorney to open the files to us. It was then we found the same modus operandi that had been used in our cases to qualify us for naked option trading had also been used to qualify this lady for the same reason. She, too, had a financial statement which had been manipulated in order to qualify her for naked option trading. There was <u>also a non-matching negative consent letter as in my case</u>. <u>Her statement</u> (and only one was found) was <u>signed by the same broker and the same manager</u> as in our three cases. (Both of these copies were also almost illegible as were ours, and required very close inspection.) Shearson apparently had removed this highly damaging evidence from the case papers submitted before arbitration. Any similarity between the cases had been denied.

The presence of this material would have made it embarrassingly obvious to the arbitrators (and also a matter of record) that Shearson had again committed the same acts with someone other than claimants. During the arbitration Shearson's manager testified that he knew about the Schulman case, but nevertheless continued to represent Mayer to us and the public as qualified to invest our money in options, withheld this information from his customers, and allowed Mayer to continue repeating the wrong doing with claimants and other Shearson customers.

We also discovered after the arbitration that Shearson had not submitted as requested all of the complaints which had been filed against the broker. The case of George Abt was later supplied in the CBOE letter to the SEC. Mr. Abt told me the broker was trading without authorization and that he had been "disciplined."

The following chart will reveal the interest of the panel by the number of questions and challenging statements asked of each witness. It would appear that their interest leaned heavily in one direction, further indicating a predisposition of bias.

	Carroll	Cox	Schiave	Reilly	Moore	
Philip de Roulet (expert witness)	12	29	2	0	0	
Fred Otto (expert witness)	0	4	0	0	0	= 162
Joan Smith	0	22	4	3	22	
George Hybert	1	39	5	8	11	
Bill Cohen (Shearson Manager)	0	0	0	6	0	
Peter Discenza (Shearson witness)	0	3	0	0	0	= 9
Anthony Festa (Shearson witness)	0	0	0	0	0	

When our Motion to Vacate, which was before the Chicago Board Options Exchange Arbitration Committee, was denied March 25, 1985, we were advised by our attorney that the following statement from the Arbitration Committee was delivered to him by Shearson's attorney:

> The motion of claimants to vacate the award, papers in support thereof, and in opposition thereto, have been considered by the panel members. They unanimously concur in denying the motion to vacate. (March 25, 1985)

While our Motion to Vacate was before the panel, Carroll and Schiave signed affidavits prepared by Shearson's attorney to include with his brief in support of Petition for Conformation of Arbitrators Award. One could reasonably equate their attorney's effort to secure these affidavits with that of communicating with jurors during a trial; for the arbitrators to assist either side during a time a motion is before them is even more offensive and also illuminating in that it further reveals the bias.

Cox did not supply an affidavit although objection was raised to his serving as an arbitrator in Claimants' Supplemental Response. Hoblin supplied an affidavit to the court. The fact that Hoblin was a former chairman of this CBOE Arbitration Committee was somehow omitted from the brief by our second attorney. Hoblin was less than candid with the court as he also failed to mention this fact to the court in his affidavit while referring to all of his other "gratuitous efforts." (App. M)

Shearson also submitted to the confirmation court copies false and inflated in-house financial statements--one for me and one for the Trust (both inflated)--with their Supplemental Brief filed March 21, 1985, which requested that we pay Shearson's attorneys' fees. I advised the Court by letter on April 22, 1985, that the statement submitted for me was false and Shearson knew it to be false when they submitted it to the Court as I had already testified to this fact at the arbitration when the statement came to light. (T.175-180) I also told the Court that the statement for my daughter was false as well as the one for George Hybert (no statement for George was included in Shearson's supplemental brief). Not only did Shearson submit material to the court which they knew to be false without identifying it as such, but they suppressed the existence of the remainder of the series of false financial statements by not including them. My letter apparently was received by the judge after he had ruled.

One outstanding point of this case is the infidelity of the arbitrators to what they know to be the law but which they deliberately disregarded in their finding of "NO AWARD." Four out of five of the panel members are attorneys. And yet the evidence of the apparent fraud that was available, the evidence of churning as presented by expert witnesses, and the evidence of unsuitability of all of the accounts (as proven by the "necessity" to produce false statements) was simply not acted upon by the arbitrators. Shearson emerged from the arbitration proceedings unscathed and unpunished, and to this day still possesses the money it acquired through chicanery. The damage to us is far greater than just the actual losses and expenses, and would be impossible to calculate. Our health has suffered, the quality of our lives has been severely altered and the years spent in the pursuit of justice can never be replaced.

It is obvious in my case and in that of the Trust that the financial statements were falsified prior to the signing of Shearson's contracts, and had we known it, <u>certainly no contracts would have seen signed</u>. We believed Shearson to be honest and dealing in good faith at that time. In all three cases the apparent fraud <u>preceded</u> our counsel's signing of the submission agreement and was unknown to him at the time. A party may be held to arbitrate only those disputes contracted to be arbitrated.

> As a general rule, an award of arbitrators, in order to be binding, must follow the contract of submission as made by the parties. It is not for a board of arbitrators to change the terms of the submission or to determine any matter not therein contained. Their sole authority is the contract of submission. If the award is broader or narrower than the submission, <u>the whole award is void</u>. (Emphasis added.)

(327 F.2d 94; 414 U.S.C.A. 107; Flood v. Country Mut. Ins. Co. 41 IL 2d 91; 242 NE 2d 149; Buntain v. Curtis 27 IL 374; Stearns v. Cope 109 IL 340; Tucker v. Page 69 IL 179; etc.)

Surely this is not the kind of arbitration envisioned by the Securities Act. No arbitration would have been requested had all of these facts been known or revealed to us before we signed the submission agreement. Action would have been taken in the Federal Court as originally planned.

Section 2533, Rule 1823 of the CBOE Rules (also Title 9, Section 7, U.S. Code) states the arbitrators can subpoena people and records associated with member firms (such as

Shearson). The Secretary and arbitrators denied our request to make available records of the broker's personal trading as well as records of his other customers and documents that would have revealed any customer involvement with his indictment which Shearson had denied. We also requested the composition of the arbitration panels in past years. The broker's personal records were needed to support our contention that we and the broker were to be trading substantially the same option positions and/or that the broker himself had earlier experienced heavy losses which may have contributed to his dishonest efforts to earn more income (i.e., churning, false qualification of clients, etc.). These records also would have shown he was not the "qualified financial consultant" that Shearson held him out to be.

We were also advised by counsel that the CBOE would not allow Cohen's deposition to be taken. It is conceivable, had claimants been allowed discovery of this nature, they might have uncovered Shearson's and the manager's apparent deceit before the arbitration took place. Records of the broker's other customers would have supported our belief that the broker was not only unqualified to trade in options, but that his other customers also suffered losses. It is important to note here that the brokerage houses are not really concerned whether their customers make or lose money. The total commissions earned by the broker is the main consideration. After the arbitration we discovered six more customers who also lost money with Mayer during the same time frame. I forwarded these names to the SEC which proved to be a waste of time. The SEC, for whatever reason, was not interested.

The request for the composition of former CBOE arbitration panels was made after the arbitration in an effort to further investigate prior relationships of panelists (with each other, whether or not they had heard a Shearson case before, how they voted in all arbitrations, and whether any of them had served during Hoblin's chairmanship). (App. N)

Because of Mayer's serious personal problems, he was emotionally unfit to be giving financial and investment advice to Shearson's customers. We were unaware of the broker's state of mind when we sought his advice and expertise in investment matters. Shearson knew it or should have known it. Mayer had no investment plan. No matter what the market conditions were, he continually only sold options. (T.250, 426) He constantly told us we had to "put money into the account."

When Shearson's misrepresentation of our financial capabilities became obvious, assuming that the arbitrators carefully examined the evidence later, the Chairman and the arbitrators, if they had harbored any interest in a just adjudication of this matter, would have granted the motion to vacate. Instead, they chose to "cover up." Also, it is my understanding that the arbitrators never ordered a transcript of the arbitration, so one has to imagine a motion to vacate under consideration by memory alone.

These are just more facts in a series of facts that have operated so clearly in this case to protect Shearson and to limit claimants' fundamental rights and which only became apparent to us in viewing the arbitration as a whole. Since the evidence of churning was convincingly presented by our two expert witnesses, it is plausible that the arbitrators could have ignored this issue, and the evidence as well, in response to Shearson's stated position that churning was not included in our submission agreement. I can offer no excuse for the arbitrators' failure in all other areas.

When we raised the question of partiality, the confirmation court, in affirming the arbitration award, said it was relying to an extent on the affidavits supplied by the arbitrators. In Hyman v. Pottsberg's Ex'rs, C.C.A.N.Y. 1939, 101 F.2d 262, Justice Hand stated that this was error and that the arbitrators should have testified before the court. Due to attorney neglect, neither the transcript of the arbitration nor the true underlying facts of the case were ever put before the confirmation court.

Claimants' Supplemental Response Brief requested that if the Court did not determine that the facts then presently known were sufficient to deny the confirmation of the award, that the Court grant extra time in which to conduct further discovery to more fully develop the facts. We were never given this opportunity.

A PERSONAL OVERVIEW

After the arbitration I contacted the SEC, showed them the false statements, and was told there was nothing the SEC could do--the arbitration was over. In another attempt to interest the SEC, I was told, "the broker is dead. It won't spark much interest." (Compare this reaction to the SEC's argument before the Supreme Court in Shearson v. McMahon.) If we had known the broker's death would illicite this response from the SEC, it would have been another reason not to have arbitrated. I then contacted the Justice Department. The FBI thought it was wire and mail fraud and said the assistant U.S. attorney agreed. If the Justice Department recognized this and that countless others are still at risk because of this practice, they have certainly been derelict in their duty to the public as they have not shown the slightest interest to date. The FBI finally said they had a problem because the broker was dead (totally ignoring the manager's role), but they would pass it along to the Postal Service. After several months I contacted the person at the Postal Service whose name was given to me by the FBI as having been the recipient of our case papers, and he didn't know what I was talking about. I then contacted the main postal inspector in Washington and the end result was the Postal Service decided the SEC would let them know if they found any infraction of the law which came under their jurisdiction. This also was the attitude reflected by the Justice Department.

It is noteworthy that most of the governmental agencies observed that the broker was dead and therefore showed no further interest, which seems an acute case of myopic vision. I find it extremely difficult to understand this when the evidence strongly suggests total involvement by the Chicago manager of Shearson who is alive and well. The fact that we had already been through arbitration was another handicap as people erroneously assumed that we had had our "day in court." If this were so, I would not be testifying before this committee because I feel confident we would have won in a court of law. One biased set of fact-finders caused everyone else to ignore us. To date it appears to be a condition from which one cannot recover.

I contacted Chairman John Dingell, related this story and forwarded supporting evidence. He wrote a terse letter to SEC Chairman John Shad on September 18, 1985, requesting a full inquiry. (App.O) Shad channeled the letter to the SEC Division of Market Regulation. It has been observed many times that Chairman Dingell's letter along with copies of my complaint and accompanying documentation should have properly been forwarded by Shad to the SEC Division of Enforcement.

I can truthfully say that Chairman Dingell, along with his committees, are the only ones who have cared enough to attempt to unearth this mass miscarriage of justice and recognized that there is much to be learned from this "travesty." They also seem to be the only ones who understand or care that <u>the investing public is still exposed</u> to these illegal practices. The one exception to this is Mr. Patrick Healy, Executive Director of the Chicago Crime Commission, who has been very supportive all along. (App. P)

I made repeated requests to confer with the SEC to answer any and all questions. Yet I was never contacted by them save a request for a copy of the arbitration transcript which I had previously offered. Any other information the SEC received from me I sent on my own--<u>not</u> at their request. How can a federal regulatory agency properly investigate a complaint without first interviewing the claimant to obtain all pertinent details and documentation concerning the alligation?

The attorney for the CBOE exchanged telephone calls with the SEC special counsel and wrote him a letter which contained many inaccuracies, omissions and misstatements, and presented a biased view of our case. The SEC based much of its material and opinions on this letter as well as a later one from the NYSE. The CBOE letter is even more incredible when one recalls that we had looked to their arbitration committee for a fair and unbiased hearing. The bias that existed is certainly reflected in this letter and the resulting SEC's first report to Chairman Dingell dated 28 August 1986. The SEC conducted no investigation of its own and only attempted to document the troubled legal record rather than conducting a full inquiry (as requested) or investigating any of the underlying facts of the case which surely was the intent of Chairman Dingell's directive. The SEC sent the false statements to the New York Stock Exchange (another SRO) for their review, and no determination from the NYSE had been received at the time the first SEC report was written. It appears from this report that the CBOE letter was accepted without any attempt at verification. The fact that the SEC relied on the CBOE letter as gospel along with the troubled legal record, about which I had already advised them, is so incredible and incompetent one has to wonder if it was intentional. This probably is what is referred to in Washington as a whitewash. (App. Q)

Finally, in February of 1987 a second SEC report included the findings of the NYSE, the second SRO. This was 17 months after Chairman Dingell's original request which anticipated a full report in one month. The NYSE letter was written in late December of 1986. The investigator for the NYSE had waited until he was ready to take a regular field trip to Chicago and apparently spoke to Shearson's Chicago manager who confirmed his own testimony at the arbitration. (App. R)

The Committee has been given copies of these letters and reports along with my responses. However, I will give you an example of the CBOE's bias in favor of Shearson, which is as follows:

> In late 1984, the claimants also commenced a case in federal district court, before Judge Grady, alleging the same facts as were contained in the Statement of Claim, but styling the claims as violations of RICO and state law, rather than Rule 10b-5. This case was dismissed by Judge Grady on Shearson's motion for summary judgment.

This statement by the CBOE clearly was meant to give the SEC the impression that there was no substance to our RICO case which had been filed after the arbitration but before being notified of the NO AWARD. The facts are the pattern became evident after the arbitration when the series of manipulated statements was discovered. They are the foundation of the RICO case and are not and could not be the same facts as contained in the statement of claim as they were unknown at that time. The case dismissal order clearly states "Dismissed for want of prosecution" which was due to attorney neglect. (App. S) This case was reinstated this year on a 60b motion after an evidentiary hearing.

Here is another example of CBOE bias in favor of Shearson as stated in this same letter by Frederick Krieger, Associate General Counsel for the Chicago Board Options Exchange. In his letter to the SEC he commented on our comparison of the Schulman case with our own as follows:

> We have not fully investigated the Schulman case. We understand that it does involve the same registered representative, Mr. Mayer. We understand that Shearson settled the case before arbitration was concluded. The accounts are wholly unrelated to Ms. Smith's other than involving the same registered representative.

If this is the only similarity Krieger is capable of finding, he might do well to take a refresher course in evidence.

Let me also cite one example of many inaccuracies and distortions in the NYSE report to the SEC:

> Our review revealed that Ms. Smith was apparently aware of and acceded to the options activity in her account. The branch office manager, in a memorandum dated September 28, 1981, stated that he had discussed the account with her a few days before and during that discussion she confirmed she was aware of the nature and risks of the activity in her account and approved of such activity. According to that memorandum, the customer also acknowledged she was aware of the losses in her account. In addition, the branch office manager confirmed the substance of this conversation during his testimony at the arbitration and also stated that Ms. Smith would visit the office several times a week. Furthermore, in July 1982, the customer executed a letter which specifically stated that she approved of the transactions in her account and was aware of their speculative nature.

The facts are as follows:

- The manager’s memo to which they refer is about a meeting at which he said he told me I had lost $102,000 within two of the first three months I was with Shearson. (App. T) This never happened. What I resent most and consider patently dishonest was that my denial (as well as that of George Hybert who the memo said was present at the meeting) appears in the transcript of the arbitration and was never mentioned to the SEC by the NYSE. The SEC had the transcript but also did not mention this fact to Chairman Dingell. Not only did this “meeting” never take place, but the manager never told me I had lost $102,000 or any amount for that matter. Thus, the NYSE added its own brand of bias to that of the CBOE, and the SEC, for whatever reason, became nothing more than an accomplice.
- I opened my account with Shearson in June of 1981. This memo is dated September 28, 1981. I brought my daughter’s trust to Shearson in December of 1981. Can anyone believe that any mother, having learned of a loss of this proportion, could hardly wait to share her “good fortune” with her only daughter. It is preposterous. I obviously thought the account was doing well at that time which appears to be not uncommon as the SEC

has taken note of this in <u>Fact</u>, June 1985 in its "Warning Shot" where they advise that writing uncovered options is not appropriate for everyone:

> These trading programs may provide some profits in the near-term, lulling the customers into a false confidence before a sudden turn of events produces the devastating losses.

Also, an earlier SEC report, the Report of the Special Study of the Options Market to Securities Exchange Commission, Dec. 22, 1978, printed for use of House Committee on Interstate & Foreign Commerce, (App. U) stated the following:

> Abuses, such as excessive and unauthorized trading, often go unchecked until substantial losses are sustained by the customer. The delay in detecting such problems occurs because supervisory systems are inadequate, or because the customer is so confused by his account statements--or misled by inaccurate performance reports--that he cannot determine the result of trading in his account.

- Not until the winter/spring of 1982, out of genuine concern over my recent loss of T-bills and frustration from experiencing events which I did not understand, did I begin visiting Shearson's office to see if I could learn about options and somehow obtain help to curb the terrible losses. These visits were used as a whip against us by the brokerage house as they mentioned them to suggest we knew we were losing money and therefore approved. Can you believe anything so ridiculous? When you don't know how you got into something, and you don't understand it, and there is no one qualified to teach you, you certainly don't know how to get out with minimal losses. The broker continues to control the account because you are hopelessly lost and therefore still totally reliant on the broker, like it or not.
- The letter which was mentioned, <u>dated July 9, 1982</u>, was a sanguine "comfort" letter accompanied by risk letter #3 which requires a signature. Risk letter #1 and #2 had never

been offered, nor was risk letter #4 which specifically sets forth the state of the account. Not until after George Hybert testified did I recall balking at signing this letter. (App. V)

We had been begging for help for months and this was all that was offered from the manager, and I resented it. The broker told us he would be in trouble if we didn't sign; that it was only a routine formality. I was frozen with fear over the losses, the extremes of the market and the accompanying pressures of not knowing what to do and wondering what would happen next. I was also overwhelmed by the sheer number of the option positions which changed so quickly. Again, we had no idea how to get out without exposing ourselves to greater losses than necessary. To further illustrate the strain we were under, the broker, instead of sending down to the floor small amounts of option positions to buy back at one time, would send as many as 50 or more and the floor would simply spread the distance between the bid and the ask, thus playing with us like a cat with a mouse. They knew anyone with large positions had their backs to the wall, and they took every advantage. Also the computers would fall behind and it was relatively impossible to ascertain what price you should offer in order to "buy in" a position.

The risk letter #3 was broad brush and stated you are aware of risk, but does not state what the risk is or any of the details:

> I am and have been aware of all transactions in my account. I am and have been aware that these transactions resulted in significant commissions being paid to your firm and the Investment Executive servicing my account. In addition, all the transactions were made with my consent and with my prior full knowledge as to the nature of the speculative risks involved in these investments.

The manager at the arbitration said that the risk was infinity (T.358) (of course he never told this to us and I can't imagine that any of Shearson's other customers were/are told, either). The above letter on which they relied so heavily to defend an indefensible position was offered to us about two or three weeks after Shearson settled with Mrs. Schulman, whom you will remember also had false and manipulated statements. I feel this letter was given to us with the single intention of trying to cover Shearson. No intention or effort to help us was ever apparent. We had already been in trouble for months and our cries for help had fallen on deaf ears. They were making money and our welfare appeared to be of little concern to them.

- I am relating some of this to you so you will understand the far reaching and damaging effects of the present arbitration system. The second day of the arbitration, after we had all testified the day before, was when Shearson introduced the memo which they had never previously declared, and all the chairman had left us time to do was to deny it. It is unwise to abandon the procedures and rules of evidence required by our court system.
- I would like to share with you an example of the NYSE's protective bias in their report to the SEC.

> With respect to the <u>discrepancies</u> on Mrs. Smith's new account documents….While we have not been able to determine the reason for the discrepancies, it should be noted that under Shearson's guidelines the information on the first document would have permitted the customer to engage in the options transactions effected in her account.

First, they referred to what appears to be deliberate falsification and manipulation as "discrepancies." It is impossible to imagine they were unable to determine the reason for such "discrepancies." I have read SEC reports about this manipulation and they understand full well why it is done and have so reported.[2] For the NYSE to advise the

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[2] See accompanying SEC release #21813, March 5, 1985. (App. W)

SEC that under Shearson's guidelines I qualified under the first document is unbelievable. This statement is belied by Shearson's own actions. I was not approved under the first document for naked option trading, only for covered calls.

In the same letter the NYSE also stated:

> With respect to the alleged inaccuracies in the new account documentation for the Mary Duke Smith account for which Ms. Smith is trustee…., our review indicates they are not sufficiently material to warrant further action.

Does anyone still wonder why we are inundated with securities crimes with this kind of "cooperative coverup." It is difficult for me to image such an inane report being prepared for anyone, let alone the Chairman of the Congressional Oversight Committee.

You will find it illuminating when you read the two SEC reports to Chairman Dingell which contain letters from the CBOE and NYSE. They reveal what appears to be a certain networking between the SROs and others. They are accompanied by my responses to these reports (which must be read along with them for a full understanding) and are among the supporting documents. They will illustrate to you the flawed system which allows the SEC to:

> …refer to the relevant self-regulatory organization complaints relating to alleged securities law violations of a single registered representative where there is no indication of structural problems in the firm's compliance systems. The Division believes that this approach has permitted an efficient melding of SEC and SRO resources in addressing sales practices abuses. (SEC report to Chairman Dingell, 5 February 1985) [emphasis added]

If the case histories which I have related do not indicate "structural problems in the firm's compliance systems," I can't image what would. This fact must have been "overlooked" in the SEC's zeal to forward the series of false statements to the NYSE.

On the very next page, the SEC states as follows:

> Finally, while we agree that in light of all the circumstances of this case the inaccurate new account and options suitability documentation would not support any enforcement action, we also believe that the extent of misinformation on all three clients' forms, if found widespread at that firm or any firm, would be unacceptable. We have advised the Exchange of our views concerning this and have encouraged the NYSE to pursue this issue vigorously in its continuing sales practices review. [emphasis added]

Why is this conduct acceptable to the SEC in four cases and yet, if found widespread, it would be unacceptable? At what point would it become unacceptable? How many lives must be severely altered before the SEC will move with authority to protect the investing public? This posture is simply outrageous and cannot be allowed to continue.

The four cases referred to involved more than "securities law violations of a single registered representative." And there most certainly were "indications of structural problems in the firm's compliance systems." Also, the complete omission of any mention of manager Cohen's role in all of this is glaring. The CBOE ignored it, the NYSE ignored it, and therefore the SEC ignored it. For the SRO's to be allowed to do the so-called investigative work for the SEC, which this governmental agency then simply rubber stamps, renders the SEC impotent, and destroys the whole concept of governmental agency oversight which is protection of and for the investing public. The bitter truth is that there is really no one who is protecting the individual investor, nor is there anywhere he can turn except to Congress. And there you have it.

Furthermore, a study of SEC case reports involving "falsification of customers' option applications" reveals this is to be a time-honored, widespread, ongoing practice by the brokerage houses and the SEC has simply toyed with Chairman Dingell in their report in an effort to hoodwink the oversight committee. (App. W) Their reaction almost suggests that they never heard of this practice before. They should be held completely accountable for the continued existence of these unsigned-by-customer financial statements, as it should be obvious even to the casual observer that they should have been outlawed long ago because they aid the brokerage houses in securing illegal profits while placing the investor at high risk. The question the Congress should ask the SEC is "why has this practice been allowed to even exist, let alone to continue?" It appears the SEC is not the champion of investor rights which we have all been conditioned to believe.

The SEC broke with history and precedent by submitting an amicus curie brief on the side of the securities industry rather than the investors in the Supreme Court case Shearson vs. McMahon. The SEC advised the Supreme Court that they possessed regulatory authority over arbitration rules and procedures and that arbitration is adequate to handle fraud and RICO cases. This was a complete reversal of their position in 1975 when the SEC said arbitration could not be used to settle fraud claims. They misled the Supreme Court by advising them their regulatory authority can insure that arbitration procedures are adequate to protect statutory rights. However, in their August 1986 report to Chairman Dingell about our case, they advised him of serious limitations of their authority in the arbitration process. The Commission's Division of Market Regulation stated:

> The Commission has no authority to review a specific arbitration to assure either compliance with the procedural requirements of the Code or accurate interpretations of underlying federal securities law or other claims by the arbitrators. The Commission has no authority to overturn an arbitration award, just as it cannot do so in other private dispute resolutions, such as civil litigation.
>
> * * * * *
>
> Arbitrations have historically been considered to be private dispute resolution forums. They have not been open to the public, arbitrators generally do not provide written opinions explaining their awards and the awards are generally not known to the public unless disclosed by the parties.

Obviously the SEC deliberately misrepresented the facts to the Supreme Court and to Chairman Dingell, again attempting to hoodwink. Both postures cannot be true as they are diametrically opposed, and perhaps neither is true. The Commission's actions in this case and in Shearson v. McMahon reveals an almost perfidious aptitude for rationalizing so that its findings support the industry. Surely the SEC must experience serious loss of credibility, not only from their duplicity, but also from their complete abandonment of the individual investor in this instance. To me it is totally reprehensible, and were I in the Congress, I would not rest easy once I understood how really flawed the system is that leaves the average investor with literally no place to turn where they can receive any protection or relief from the unfair advantage which the present system has unjustly awarded the brokerage industry. Justice Blackmon saw the situation with great clarity in his Shearson v. McMahon dissenting opinion.

> Moreover, I have serious reservations about the Commission's contention that its oversight of the SROs' arbitration procedures will ensure that the process is adequate to protect an investor's rights under the Securities Act.

For those interested in acquiring a deeper understanding, I would suggest reading Justice Blackmon's entire opinion.

The Supreme Court, in this recent McMahon decision, was lulled into five-to-four complacency by the SEC. It was only after the SEC secured control of the adjudication of all securities claims (bound by mandatory contractual clauses to arbitrate) for the brokerage industry that they presented a 13-page letter of suggested changes to be implemented over the next several years in order to make arbitration more fair. This recognition of need appears to be after the fact. It would have been more responsible if these suggested improvements had been implemented, monitored and evaluated before leading the Supreme Court to believe that the arbitration system was eminently fair, protected all investor rights, and was completely under their control. It appears the great haste to secure all complaints of violations of securities law (including RICO and fraud) for industry-controlled arbitration held a greater priority for the SEC than the effort to implement fairness and protection of the investor.

It is a source of serious concern that Congress has for many years been so insensitive to an area in which there is such great opportunity for abuse of the public. In the Arbitration Act, Congress has initiated a system whereby the adjudication of the brokerage houses by <u>their</u> peers and business associates is designed to bring these abuses to swift justice. It does not work in an equitable manner, nor should it have been expected to do so--human nature being what it is. And I question whether it is wise for justice to be swift.

The arbitration process was designed to lighten the case load in the court system. <u>The laxity in enforcement of the existing laws undoubtedly contributes to the overload</u>. However, the courts make it clear they like the assistance of arbitration and are anxious to accord finality to its process. Arbitration has been assigned the same power as the court system and in some areas more--i.e., the lack of accountability of the panelists as to how they ruled and why, the weak and ambiguous rules of disclosure, the secrecy (which only serves to protect the brokerage houses), the extremely narrow area of appeal, the very loose interpretation and application of the rules of evidence, etc.

In drafting the Arbitration Act, Congress failed to place the arbitrators under the same rules of conduct and disclosure as the federal judges whose place they are taking. This has opened up a whole new area of possible abuse to the average investor, and if our case is an example, it is being exploited shamefully. We were never told that Shearson’s general counsel was a former chairman of the CBOE Arbitration Committee and had served on a seven-man conduct committee with the chairman of our panel. These facts would have been more relevant to us than hearing where each panelist had gone to school, and would have rendered CBOE arbitration unacceptable had we known. The “informal” atmosphere can be a euphemism for the “good ole boy” philosophy, and this has no place in what is postured as the American judicial system. Surely this was not the intent of Congress.

One would not expect that the quality of the evidence in our case against the brokerage house would be covered up by the arbitration, thus exonerating the guilty. Nor would one expect a finding of No Award for its victims, thus perhaps effectively blocking them from other avenues of judicial relief--but it did happen. This arbitration not only denied due process and justice to the aggrieved parties, but sounds the alarm loud and clear for others seeking justice through arbitration. It also encourages brokerage house violations to continue in full measure ad infinitum. Unless the Congress acts to prevent it, this is exactly what will continue to happen regardless of any “window dressing” offered by the SEC or the SROs.

This type of arbitration can no longer be tolerated by Congress, and they should mandate that any law enforcement agency having jurisdiction should see that these practices are brought to an end. This would send a clear message that arbitration is not to be entrusted to those who dispense it with favoritism and total disregard for the laws of this land and the entitlement of its citizens. The performance of the SEC in this matter is not only inexcusable but alarming in that it also provided encouragement rather than any deterrent to violations of securities’ law, and this is not an isolated incident.

It is my hope that you will find the details of this case and the broad area of abuse it represents so reprehensible that you will initiate corrective legislation to remove the problem areas. The laxity accorded securities crimes is a national disgrace. There are too many opportunities for brokerage houses to abuse the public and sympathetic and tolerant arbitrations add to this abuse. It is an untenable situation. The whole system needs tightening and begs for reform. Changes must be implemented that will have an appreciable effect upon the prevailing injustice. The system is in desperate need of revision, not only for clarification, but so it will function fairly for all, not just for those who hold the power. The investor should be placed on equal footing with those against whom their claims are brought.

I implore you to direct your close attention to the fact that arbitration is too often inadequate, unreliable and unfair. The reputation for being grossly unfair in its return of inadequate awards makes it difficult for financially crippled investors to find attorneys to help them on a contingency basis. The route investors must follow in an effort to extricate themselves from such an arbitration is a legal and financial nightmare. It is all well and good to relieve the overworked courts, but as in this case, if fundamental fairness and justice are lost, arbitration can add to the crimes already committed. We can ill afford to lose justice and fairness in our desire to streamline and expedite these disputes. Congress would be remiss to ignore these conditions as lives of many people who depend on their elected representatives to curtail these abuses are being severely altered daily.

Further opinions regarding the advisability of arbitration were found in the “rule of thumb” set forth as a recent Chicago Bar seminar on arbitration: under $50,000--arbitrate; between $50-100,000, maybe--but think about it; over $100,000--file in the court. This was before the Shearson vs. McMahon decision.

I would like to offer to you Shearson’s own opinion regarding the fairness of arbitration as expressed in Shearson/Lehman Brothers Inc. v. Lyle Lamers in the U.S. District Court of Connecticut:

> Defendant is presumably aware that Shearson has due process and jury trial rights and is protected from highly prejudicial, vague, and factless complaints in a federal forum, but does not have the same rights in arbitration.
>
> * * * *
>
> There is no question that Shearson will suffer irreparable harm by being forced to litigate defendant's claims in arbitration. Defendant has no arbitrable claims and has waived arbitration. In spite of that, Shearson will be permanently denied the opportunity to litigate in the judicial forum guaranteed it as a matter of law, and will have to litigate in an arbitration forum that is closed to defendant as a matter of law. Its consequent loss of due process, appellate rights, jury trial rights, discovery procedures and the rules of the federal forum, as well as a real risk of collateral estoppel or inconsistent results, cannot be compensated in money damages.
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> * * * *
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> Furthermore, the "voluntary exchange of documents and information" set forth in NYSE Rule 619(b) cannot be seriously compared with the depth, breadth and frequency of <u>compulsory</u>, <u>enforceable</u> pre-trial discovery under the federal rules of procedures, of which the plaintiffs and Lamers have fully and frequently availed themselves.

This reveals Shearson to be a perfidious chameleon, for <u>they led the recent fight to secure arbitration for brokerage industry advantage</u>, and the resulting Supreme Court decision appears to leave the private investor no choice but to arbitrate; the industry understandably is delighted. The Court has removed from the investor any hope of fair adjudication of even the most serious brokerage house crimes. This is so shocking to my sense of fair play that I cannot believe a mandatory arbitration clause in a brokerage contract (that most people don't even know exists) can be constitutional, let along constitute a waiver. There is no negotiation; there appears to be no choice but to sign if you want to invest through a broker. This has placed the lives and fortunes of the investing public in the hands of an industry that has already proven itself unworthy of the trust invested by Congress in the Arbitration Act along with a governmental agency that is continually under critical fire for its performance or lack thereof. This is a far cry from the American judicial system and the rights guaranteed under the Constitution. The Congress is the only body who can see that it is changed--and it must be changed--because it is <u>the</u> right thing to do. It may be difficult to do what is right for it requires both personal and political courage, but it is possible.

IDENTIFICATION OF PROBLEM AREAS WITH SUGGESTIONS FOR IMPROVEMENT

The following comments on existing problem areas in arbitration and suggestions for improvement assume that the original conflict which has already been built into the system can be overcome. The system of incentives for compensation built on commission income exposes the investor to advice of the broker/brokerage house which is not necessarily in the best interest of the customer. In countless cases it places the broker and the investor in an adversarial position. And yet the law is very clear regarding the fiduciary responsibility of broker to customer. My true feeling is that radical surgery is required while we are only considering band-aids. However…

* * * *

1. Put an end to complacent acceptance of the quality of the Security and Exchange Commission's oversight because it malfunctions for the individual investor.

2. A more stringent oversight by the Congressional committees is needed.

3. Correct the original premise that industry-controlled arbitration is fair. It is <u>not</u> fair and cannot be under the present system.

4. No ambiguous awards. The award should not only be signed by each arbitrator, but they should also say how they voted. A written opinion should accompany every award and include findings of fact and conclusions of law. All this should be made a matter of public record.

5. Using active floor traders and market makers as arbitrators who daily do business with the brokerage houses, with the expectation that they will be able to divorce themselves from the interests of those who provide the bulk of their livelihood, is unrealistic.

When you consider that the strong possibility exists (human nature being what it is) that one has lost 40% (of a panel of five) before you even walk in the door of an arbitration, all then that is needed is one securities-minded public arbitrator or a “rookie” (who will defer to the “wisdom” and experience of the industry representatives), <u>and interest in and protection for the investor is totally lost</u>. Surely this was not the intent of the Arbitration Act.

The main interest of the Exchanges is in seeing that their member firms make money, not in recouping the customers’ losses. Let us bear that in mind when evaluating the system now in place.

6. Up-front disclosure.

a. For the public to ever have any real confidence in arbitration, Congress needs to place the arbitrators under the same rules of disclosure and conduct as the federal judges whose place they are taking.

b. It is a rule that no employee of the CBOE can be an arbitrator. Yet owners of seats on this exchange can arbitrate. They have a direct financial interest in any and all publicity that could have any adverse effect on the options industry, i.e., the volume of options traded and the monetary value of their seat. Enough scandalous notoriety has a real effect on the vested interest of seat owners. Could this not be further temptation to take advantage of the <u>barring</u> power of awards and “keep the secrets in the room.”

7. Many attorneys who are listed as public arbitrators are there to incur favor in the financial community for themselves, their clients and their corporations. It is also my

understanding that some arbitrators are there for the explicit purpose of protecting the brokerage houses. It is obvious from this "line-up" that protection for the individual investor is wanting.

What I refer to as "third-party profiteering" can be almost impossible to uncover as there are many tradeoffs and much back-scratching in this world.

Can lawyers who arbitrate with the expectation of receiving business from the brokerage houses, directly or indirectly, be totally eliminated? Certainly their bias cannot be. Can we envision regular use of public arbitrators of strong character and integrity who often side with the investor, especially in cases which involve large amounts of money or are representative of illegal practices from which the brokerage houses profit and want to hold intact? Not only would these public arbitrators never receive business or favors from the brokerage houses, they would not be asked to arbitrate very often--if at all--once their devotion to fairness and investor protection was made apparent. Remember, the industry chooses those whom they allow to arbitrate.

8. It appears to be a foregone conclusion, in light of our experience, that there is a strong tendency on the part of the industry arbitrators to protect one's fellow tradesmen. The more desperate and serious the threat, the more the industry arbitrators desire to protect and cover because they all do business with each other. It is indeed a closed and secretive "corporation."

9. The SEC's letter of 10 September 1987 to the SICA members states: "SICA's information pamphlets should point out clearly that investors should draw regulatory attention to their allegations when they believe that there has been fraud or that other investors may be at risk." In our case we did exactly that and were rebuffed. Even when they "investigated" in response to Chairman Dingell's request, the report was incompetent, irresponsible, inaccurate,

insufficient and was prejudicial against the investor as well as not being truly honest with Chairman Dingell. So this display of interest by the SEC, from our experience, has a nice but hollow ring.

10. Since "parties must prove their respective cases," the Arbitration Committee must allow full discovery for claimants as provided by the court system, and not tie their hands as they presently do. Discovery should be a matter of right and not an arbitrary gift from the Arbitration Committee. It goes without saying that the "books" regarding the broker, the manager or whomever claimants cite as defendants should be required to be thrown open so the Chairman and the Arbitration Committee can no longer protect the brokerage houses in this regard.

11. Pre-trial conferences and procedural hearings would be very beneficial.

12. Arbitration should follow the same rules of evidence required in the court system.

a. Allowing the "11th hour" introduction of evidence conveniently discovered by the brokerage house <u>after</u> they have heard claimants' case raises serious question as to the validity of the offering, or certainly should. (Bear in mind the arbitration chairman had taken away our promised third day.) However, in our case evidence offered under these circumstances was seized upon by the CBOE, the NYSE and rubber stamped by the SEC as sacrosanct, and <u>our denial</u> of the truthfulness of the evidence, which is recorded in the arbitration transcript, <u>was never mentioned by either SRO and was withheld from Chairman Dingell in the SEC report</u>.

b. Hearsay evidence was allowed. Tony Festa from Shearson's New York Compliance Department was allowed to testify regarding the approval of my account when Jim Crowley was the one with whom the Chicago manager said he had the conversation clearing the account.

c. Uncorroborated evidence was allowed. Jim Crowley should have been at the arbitration as he was the compliance officer to whom Cohen said he gave the instructions to clear my account for options. Prior to this, Crowley had cleared the account for covered calls only. The NYSE report as well as the SEC state that Cohen confirmed his own testimony to them. Did they truly expect him to say it was self-serving utter nonsense and untrue? Aren't we in the realm of the ridiculous?

d. Originals of evidence were not supplied; the photocopies were of a totally unacceptable nature and should not have been tolerated by the chairman. This practice should be stopped; it is unnecessary and certainly not in the interest of justice.

13. Time for presentation of claimants case is an area that needs improvement. Anyone presenting claims against brokerage houses should have all the time they require.

14. Is it feasible for arbitrators to be chosen like jurors? It may require more time, but there are some aspects that would seem to be desirable.

15. No more "two-tiered" disclosure of arbitrators' backgrounds. The entire dossier on each arbitrator in possession of the Arbitration Committee should accompany the choice of the panel which should be supplied weeks in advance of the arbitration. It should perhaps include a list of clients of the public arbitrators involved. It could also include the percentage of income, if any, of each of the industry arbitrators which is derived from the brokerage house involved in the case.

16. Complex cases involving large amounts of money belong in the court system, without exception, not in "informal" arbitration. This informality covers a multitude of sins and can no longer be acceptable. It has become arbitration's excuse for not following the laws our country made to protect its citizens.

17. An official transcript by a certified court reporter should be taken of every arbitration proceeding, and provided as "part of the service." It should not be left to chance; perhaps the brokerage house doesn't want one and the investor isn't aware of the need for one and/or can't afford the cost. Each arbitrator should receive a copy for review or reference.

18. The official transcript, the evidence presented, the award, including the arbitrator's individual vote and the reasons for that vote, and a written opinion should be a matter of public record and available for public scrutiny at all times. The devotion to secrecy now in use only further protects the brokerage house and disadvantages the investor even more.

19. Exchanges should have representatives of the Bar Association and/or some other interest outside the securities industry aid in forming questionnaires for arbitrators. These questionnaires provide the Committee with arbitrator biographies.

20. The area of appeal in the court system needs to be broadened. The present avenue of appeal is too narrow and includes areas which are almost impossible to prove. Appeal from arbitration should be no more limited than appeal from any case in the court system.

21. The inclusion of binding arbitration clauses in brokerage house contracts (which most people do not even know exist) should no longer be allowed. No negotiation has taken place, the customer has no say about the terms of the contract, and yet is held to a waiver of his right to due process guaranteed under the Constitution. Where there is no choice, there can be no waiver.

22. New legislation should return fraud and RICO claims to the court system. And any fraud discovered after submitting to arbitration must automatically result in the transfer of the case from arbitration to the court system. If, after the arbitration any fraud is discovered

which was not addressed by the arbitrators, the granting of a motion to vacate should be mandatory and the case referred to the court system.

The brokerage industry has used the SEC in an end run around the Congress to mesmerize the Supreme Court and effect the Shearson vs. McMahon decision. The Congress must restore this last vestige of any semblance of fairness to the investor.

23. Pass a law requiring each brokerage house to secure customer's signature on any and all in-house statements having anything to do with financial capabilities of customers or their investment choices and goals. This should be very easy to do and should have a significant effect on lessening the number of claims against the brokerage houses. I feel these unsigned statements are at the root core of many losses, complaints and lawsuits--more than we might imagine. Had the SEC done its job, Shearson would have been unable to engage us in the trading of naked options. This is just one of many "trap doors" left open to the brokerage industry through which they can continue to abuse the investing public without feeling the force of law due to sympathetic arbitrations and irresponsible, unresponsive SEC oversight.

24. To use lack of claimant need for an attorney as a lure to arbitrate is misleading. One definitely needs an attorney if only to establish a record for appeal. Arbitration has a long way to go before anyone could say in good conscience that one does not need an attorney. One most certainly needs an attorney to fight an unfair ruling, so it is misleading to give people the impression that they do not have to sustain this expense. To those investors already financially crippled by the actions of the brokerage house, this deceptive inducement to save on legal fees can be fatal to their success. The capacity of the brokerage houses to wage endless legal battles can be equalled by few investors, and this is a fact on which they heavily rely.

25. It is entirely misleading to advise people that arbitration is necessarily cheaper. Granted the “entrance fee” is reasonable, but given the unfairness of arbitration, this can be only the beginning of interminable legal fees and expenses.

26. It is also misleading to advise that arbitration is quicker, as if this is the goal most desired. If this is so, it can be at the expense of thoroughness and fairness to the investor. Admittedly, applying the rules of evidence used in the court system and allowing “court” quality discovery does take time. However, this “delay” would help insure a fair trial and/or at least would create a record necessary for appeal. The time alloted for the hearing is the crucial part. We waited 16 months for a hearing and were given less than ten hours to present three complex cases.

27. Arbitration should take place during a normal working day. It is not fair to claimants to expect that anyone can be at their best after a full day’s work. People do not function as well when they are tired--they make mistakes. Their attention span is not what it should be. Is this really the atmosphere we want to provide as a replacement for the courts to the individual investor seeking justice?

28. Arbitration should grant punitive damages, attorneys’ fees, and all types of relief granted by the court system. I have included two copies of our Statement of Claim. The back page of the second one had to be changed to accommodate the CBOE policy of not granting punitive damages. (App. A)

29. The Justice Department purports to place a high priority on white collar crime. The Chicago U.S. Attorney refers to them as “crimes of greed” on the local television. However, even though these four cases raise the question of fraudulent practices which expose the investing public to great risk, the Justice Department has shown no interest. Only investors with

accompanying notoriety seem to gain any access to attention. Individual investors should be given the same attention to their complaints as the brokerage houses are given when they wish to file a complaint against an employee. I believe that if enough of these white collar crimes are punished by jail sentences instead of the usual plea bargaining, there would be more caution used in the future. Only a consistently hard line approach will act as a deterrent.

30. If Congress has the resolve to grant the greatest possible assurance of fair securities arbitration to the investing public, **<u>they should remove arbitration from the control of the securities industry</u>**. What I have in mind is the possibility of creating an arbitration division (which hears nothing but arbitrations) within the federal court system. This would guarantee once and for all that those who have been through arbitration, whatever the outcome, will feel they have had their “day in court” and not remain haunted for the rest of their lives.

The consideration of this possibility will bring forth such a hue and cry from the industry, its lobbies, the SEC and all those who perceive themselves being stripped of their power that this reaction alone will illustrate to the Congress and to the public just how advantaged the securities industry is under the present system. If it does not seem acceptable to place securities arbitration within the court system, then consider requiring the arbitration committees to be directly answerable to the Congressional Oversight Committee, thereby bypassing the SEC. Congress in the past has placed too much reliance and trust in this governmental agency and it is a mistake that seems to be made over and over. It is not moral to place investors’ right to due process in the hands of the Wall Street predators while an impotent SEC is clearly sympathetic to the industry.

Another alternative for consideration would be to create a division for securities arbitration appeals <u>within the court system</u> that would operate in a low cost manner. They would do nothing but hear appeals and hopefully take a closer look as they should be less crowded than the present system. Of course, if the SEC oversight and Justice Department enforcement of securities laws does not improve, this new division of arbitration appeals would soon be overcrowded like the rest of the court system.

These problems can be solved by the Congress if it is truly committed to freeing the American investing public from the clutches of the Wall Street predators. The responsibility cannot be assigned to the SEC alone with any hope of fair and lasting solutions.