

In the Matter of the Arbitration Between

95-05923

Cowen & Company
Joseph M. Cohen
Edward I. Herbst

The Claimants were represented by: John Pritchard, Esq., Edward Flanders, Esq., and Johnita P. Due, Esq., assisted by Juan Carlos Ospina, Paralegal, Winthrop, Stimson, Putnam & Roberts, New York, New York.

The Respondents were represented by: Anthony F. Phillips, Esq., Elizabeth S. Stong, Esq., Nancy Kessler McCabe, Esq., and Terence K. McLaughlin, Esq., Willkie Farr & Gallagher, New York, New York.

The Statement of Claim was filed on December 18, 1995.
Claimants' Submission Agreement was executed on December 5, 1995.

The Joint Statement of Answer of Respondents Cowen & Co., Joseph M. Cohen, and Edward I. Herbst (collectively "Respondents") was filed on May 31, 1996.
Respondent Cowen & Co.'s Uniform Submission Agreement was executed on February 22, 1996
Respondents Cohen and Herbst did not file executed agreements to arbitrate.

HEARING INFORMATION

Pre-Hearing Conference: March 18, 1997/1 Session
November 17, 1997/1 Session

Hearing Dates/Sessions: April 24, 1997/2 Sessions
April 25, 1997/2 Sessions

April 29, 1997/2 Sessions
April 30, 1997/1 Session
May 1, 1997/2 Sessions
May 8, 1997/2 Sessions
May 9, 1997/2 Sessions
May 14, 1997/2 Sessions
May 15, 1997/2 Sessions
May 20, 1997/2 Sessions
May 22, 1997/2 Sessions
July 7, 1997/2 Sessions
July 8, 1997/2 Sessions
July 9, 1997/2 Sessions
August 11, 1997/2 Sessions
August 12, 1997/2 Sessions
August 13, 1997/2 Sessions
August 14, 1997/2 Sessions
August 15, 1997/2 Sessions
October 2, 1997/2 Sessions
October 3, 1997/2 Sessions
November 4, 1997/2 Sessions
November 5, 1997/2 Sessions
November 6, 1997/2 Sessions
November 7, 1997/1 Session
November 10, 1997/2 Sessions
November 11, 1997/2 Sessions
November 12, 1997/2 Sessions
November 13, 1997/1 Session
November 18, 1997/2 Sessions
November 19, 1997/2 Sessions
March 9, 1998/2 Sessions
March 16, 1998/2 Sessions
March 17, 1998/2 Sessions
March 23, 1998/2 Sessions
March 26, 1998/1 Session
March 31, 1998/2 Sessions

Hearing Location: NASD Regulation, Office of Dispute Resolution, New York, New York

CASE SUMMARY

In December 1995, Tecnoconsult Holdings Limited ("Tecnoconsult") and IFG Properties, N.V. ("IFG") (collectively the "Claimants") filed a Statement of Claim against Cowen & Company ("Cowen"), Edward I. Herbst ("Herbst"), Joseph M. Cohen ("Cohen"), and Supervisors 1-5 (collectively, "Respondents").

Claimants allege in their Statement of Claim that they incurred losses exceeding \$6,000,000 that resulted from unauthorized trading in derivatives. The Statement of Claim further alleges that the securities specifically identified are "Credit Suisse Bonds" and two "Inverse Floaters": 93-115SA and 93-110S. Claimants also allege that unauthorized purchases of such instruments for Claimants' accounts resulted in undisclosed commissions exceeding \$1,000,000; the Respondents concealed the unauthorized purchases, the magnitude of the commissions, and the fact that the derivatives had declined in value while held in Claimants' accounts. Claimants assert various securities and common law claims arising out of Respondents' alleged wrongdoing as follows: unauthorized trades, unsuitable purchases, churning, and misrepresentations and omissions in connection therewith, including common law fraud and breach of contract (Counts I, II and III); securities fraud (Counts IV and V); failure to supervise and comply with industry rules and standards and with other duties, including negligence (Count VI); breach of fiduciary duty (Count VII); respondeat superior (Count VIII); control person liability (Count IX); and Racketeer Influenced and Corrupt Organizations Act violations ("RICO") (Counts X and XI). Claimants seek: (i) compensatory damages in excess of \$6 million and interest thereon; (ii) punitive damages of 6,000,000, RICO treble damages exceeding \$18 million; and (iii) attorneys' and experts' fees, expenses, and other costs of arbitration.

Respondents in the Statement of Answer deny all of the allegations of wrongdoing in the statement of claim. Respondents maintain that the investments at issue were suitable for investors of Claimants' sophistication and net worth; that each investment was authorized and ratified by Francisco Gonzalez, who controlled Claimants' accounts, and/or one or more of Claimants' representatives who were responsible for monitoring the accounts; that Respondents did not trade excessively or churn Claimants' accounts or violate the securities laws in any other manner; that the investments at issue were reasonably priced at the time they were purchased as set forth in Claimants' monthly account statements; that the commissions or markups taken by Respondents were reasonable; that Respondents exercised adequate supervision and complied with applicable industry rules, standards and other duties; that Respondents did not engage in a conspiracy; and that Respondents did not owe Claimants any fiduciary duty or breach any such duty if it existed. Respondents also maintain that Claimants have failed to make out a violation on any one of their claims on which Claimants' secondary claims for control person liability or respondeat superior liability can be premised. Additionally, Respondents maintain that Claimants' RICO claims fail as a matter of both law and fact. Finally, all of Claimants' claims premised on securities fraud, including their claims for unsuitable trading, churning, unauthorized trading, securities fraud, control person liability, conspiracy, and respondent superior liability, and barred by the applicable statute of limitations.

WITNESSES

The following persons testified in person at the hearing.

Claimants' Witnesses:

Francisco Gonzalez, member of the Board of Directors and President of Tecnoconsult Holdings Limited ("Tecnoconsult"), presently an advisor to the Board of Directors and beneficial owner of IFG Properties N.V.

Lourdes Falla, Senior Relationship Manager, Chase Manhattan Bank, Tampa, Florida

Jorge Zerpa, Director of Finance, Tecnoconsult

Mauricio Iza, Executive Vice President, Grupo Foresto

Francis Xavier Maloney, Controller for the off-shore companies of Francisco Gonzalez

John F. Andrews, Accountant, partner in the accounting firm of Battaglia, Andrews and Moag, P.C.

Charlotte Kim, former employee of Cowen

Philip Schwaeber, former employee of Cowen

Roger C. Vogt, expert witness, Managing Director, CRSI

Edward I. Herbst, Respondent, Managing Director of Cowen

Andrew Carron, expert witness, National Economic Research Associates

Joseph M. Cohen, Chairman and Chief Executive Officer of Cowen

Respondents' Witnesses:

Bella Borg, expert witness, Consultant

Edward I. Herbst, Respondent, Managing Director of Cowen

RELIEF REQUESTED

Claimants requested:

1. Actual/Compensatory Damages in the amount of \$6,000,000.00.
2. Punitive/Exemplary Damages in the amount of \$6,000,000.00.
3. RICO Treble Damages in the amount of \$18,000,000.00.
4. Attorneys' and experts' fees, expenses, and other costs of arbitration.

Respondents requested:

1. That the Statement of Claim be dismissed in its entirety.

OTHER ISSUES CONSIDERED & DECIDED

Respondents Cohen and Herbst did not file with the NASD Regulation, Inc. Office of Dispute Resolution ("NASD") a properly executed submission to arbitrate. Respondents Cohen and Herbst are required to submit to arbitration pursuant to Rule 10301 of the Code and having answered the claim, appeared and testified at the hearing are bound by the determination of the arbitration panel on all issues submitted.

This dispute is eligible for disposition under Rule 10334 of the NASD Code of Arbitration Procedure (the "Code"). Pursuant to Rule 10334 an Administrative Conference was held on Thursday, November 14, 1996 and the parties agreed to the following: the controversy will be administered under Rule 10334; the parties will pay the arbitrators, in addition to the NASD honorarium, compensation of \$450.00 per day per arbitrator; the parties will also pay for any additional fees including arbitrator travel and/or accommodation expenses; and the parties requested a reasoned award.

The parties have agreed that the Award in this matter may be executed in counterpart copies or that a handwritten, signed Award may be entered. In either case, the parties have agreed to receive conformed copies of the award while the original remains on file with NASD Regulation, Inc.

FINDINGS AND CONCLUSIONS

The Parties

Claimant Tecnoconsult Holdings Limited ("Tecnoconsult") is a Bahamian corporation related to, and under common ownership with, a group of Venezuelan engineering and construction companies. Francisco Gonzalez ("Gonzalez") is the founder of Tecnoconsult.

Claimant IFG Properties, NV ("IFG") is a Netherlands Antilles corporation. IFG was founded by Francisco Gonzalez ("Gonzalez") to hold and invest his family's personal funds, and his family members were the beneficial owners of IFG.

Respondent Cowen & Company ("Cowen") is a partnership, a broker-dealer which is registered under the Securities Exchange Act of 1934 and a member of the New York Stock Exchange ("NYSE"), the National Association of Securities Dealers ("NASD"), and other exchanges.

Respondent Edward I. Herbst ("Herbst") is a Managing Director, Chief Operating Officer and the registered representative and account executive of Cowen responsible for the accounts of IFG and Tecnoconsult.

Respondent Joseph M. Cohen ("Cohen") is the Chief Executive Officer of Cowen.

The IFG Account

Gonzalez founded Tecnoconsult in 1967 and reinvested most of its earnings in the company. By 1983 IFG had approximately \$3 million of funds available for investment. Paul Pappalardo ("Pappalardo"), a mutual friend of Gonzalez and Herbst, recommended that Gonzalez consider investing through Respondents Herbst and Cowen where Pappalardo had an account. Pappalardo introduced Gonzalez to Herbst in 1984. Thereafter, Gonzalez met with Herbst at Cowen's offices in New York and told Herbst that he wanted to invest IFG's funds in fixed income securities. Herbst recommended GNMA's which he described as a "pass-through" security representing the right to receive monthly payments of principal and interest on a pool of underlying mortgages, the principal and interest of which are unconditionally guaranteed by the U.S. Government. Herbst represented that he was an experienced GNMA trader and that he could find and purchase desirable GNMA pools from selected parts of the country which were seasoned pools and thus had some degree of prepayment predictability. Gonzalez accepted this recommendation.

Prior to investing with Cowen, IFG and Tecnoconsult maintained bank and investment accounts with Chase Manhattan Bank ("Chase") in fixed-income securities.

Gonzalez opened account number 08871 at Cowen in June 1984 in the name of IFG ("IFG Account") and deposited \$1-million with instructions to invest it in GNMA's. Subsequently, IFG deposited an additional \$2-million with Cowen which was also invested in GNMA's.

Cowen's Account Executive Compliance Manual ("AE Compliance Manual") required account executives to fill out new account cards completely, including the "Investment Objectives" section of the card. This section was not completed for the IFG account.

Gonzalez signed a Cowen Customer's Agreement ("IFG Customer's Agreement") at the time of opening the IFG Account and a Trading Authorization limited to purchases and sales of

securities, options and commodities ("Trading Authorization"). Gonzalez crossed out the word "stocks" and the words "commodities and/or contracts" on the Trading Authorization. Gonzalez testified he did so because he intended the discretionary trading authority granted to be limited to "bonds," the category of securities reflected on the Trading Authorization that included GNMA's.

After the original \$3-million investment, IFG did not deposit additional funds into the IFG Account. However, Herbst had instructions, and was authorized to exercise his discretion, to reinvest the monthly principal and interest payments earned by the IFG Account on the original GNMA's in additional GNMA's on a rolling basis.

From the outset, Herbst exercised discretionary authority over the IFG Account, deciding which pools of GNMA's to buy or sell for the Account. During the eight-year period from mid-1984 until mid-1992, Herbst (with only one exception) used the principal and interest payments generated by the GNMA's exclusively to purchase additional GNMA's for the Account. Herbst primarily followed a buy and hold strategy with respect to GNMA's purchased for the Account.

Securities were purchased for Cowen's trading account, number 99-30705-2-7-00 ("Cowen Trading Account"), which then allocated the securities to customer accounts at a price including a markup. The same procedures were followed in purchasing securities for the IFG and Tecnoconsult accounts.

Cowen sent confirmations and monthly account statements with respect to purchases and sales of securities made for the IFG Account to Gonzalez's attention. In the beginning, Gonzalez reviewed the IFG monthly account statements to assure that IFG was credited with monthly principal and interest payments which were due on the GNMA's. Gonzalez developed a computer spread sheet to assist in tracking these payments. When Gonzalez found what he believed were errors, he contacted Herbst who would explain that Gonzalez was wrong or that the error would be corrected on a subsequent account statement. Later, Gonzalez, at the suggestion of Pappalardo, hired John F. Andrews ("Andrews"), an accountant, to do the verification for him. Andrews, a certified public accountant, is a partner with the accounting firm of Battaglia, Andrews and Moag, P.C. Andrews, a friend of Herbst, referred clients to each other and, during the 1992-1994 period, they had 15-20 common clients. Herbst assisted Andrews' daughter in obtaining employment at Cowen.

During the 1980s, Andrews reviewed account statements of some of Herbst's other clients, including Pappalardo, to ensure that they were receiving all of the principal and interest payments as they became due on their GNMA investments. Gonzalez hired Andrews to perform this same type of review of his IFG account statements, duplicates of which together with duplicate confirmations, were thereafter sent by Cowen directly to Andrews. Andrews tracked the principal and interest payments due on the securities purchased for the IFG Account, spoke to Herbst to resolve any errors or discrepancies, and prepared reports for Gonzalez summarizing the results of his limited review. Andrews' job was to ensure that the monthly payments Gonzalez received of principal and interest due were promptly credited. Gonzalez testified that after he retained Andrews, he reviewed primarily the summary information contained on the first page of each statement.

In October 1986, Herbst suggested to Gonzalez that he purchase shares of a regional bank, NFS Financial Corporation ("NFS"). Herbst told Gonzalez that the bank was in solid financial condition and that it was a likely takeover candidate. Gonzalez agreed to purchase \$500,000 of NFS stock with Tecnoconsult funds. The expected takeover of NFS did not occur. NFS's stock price declined during the savings and loan crisis, from its purchase prices of \$14.25 in October 1986, and \$19 in December 1986 to approximately \$2 by February 1991. In order to transfer the NFS stock to Tecnoconsult which furnished the funds for the purchases, Herbst opened Cowen account number 01900 in the name of Tecnoconsult Holdings in April 1988 (the "NFS Account"). He thereafter transferred the NFS stock into that Account where it remained the Account's only asset until it was sold at a profit in January 1995. The only other non-GNMA that was purchased for the IFG Account was a principal-only CMO strip bought in 1987.

In October 1987, Herbst suggested that Gonzalez execute a Margin Agreement for the IFG Account to provide flexibility in making purchases of GNMA's for the Account. Herbst told Gonzalez that there were certain pools of GNMA's that were more desirable than others and that Herbst needed to be able to purchase these select pools for the IFG Account when they became available in the market. The only new funds that were coming into the IFG Account were the monthly principal and interest payments being received on the existing GNMA investments. These funds were not always sufficient to purchase select GNMA pools. By utilizing margin, this enabled the purchase of desirable GNMA pools when they became available by borrowing against the GNMA's in the IFG Account. The rate of interest charged by Cowen was less than the interest received on the GNMA's in the IFG Account; thus, purchasing GNMA's on margin would improve the rate of return on the Account. During the period October 1987 through mid-1992, Herbst purchased GNMA's on margin from time to time pursuant to discretion authority.

Tecnoconsult opened its first account (No. 24675) in September 1985 for the limited purpose of establishing a \$25,000 escrow for the benefit of Hospitality Valuation Services ("Hospitality"), a company located in New York which had entered into a contract with Tecnoconsult to perform a feasibility study for a resort on Bonaire in the Netherlands Antilles, the Bonaire Hotel ("Bonaire Hotel"). After Hospitality performed the contract, Cowen, as escrow agent, disbursed the \$25,000 to it and the Escrow Account remained dormant until reactivated in September 1994.

During 1988 Gonzalez sought permanent financing on behalf of Tecnoconsult for the construction of the Bonaire Hotel, which was nearing completion. Prior to obtaining permanent financing, Tecnoconsult needed an additional \$1-million in order to complete construction. Gonzalez executed a second Margin Agreement for the IFG Account dated June 1, 1988. He also executed a "Statement of Purpose of an Extension of Credit by a Customer" dated June 1, 1988, which reflected the \$1-million extension of credit for a "real estate investment," and Gonzalez signed it "for Tecnoconsult Holdings Ltd."

In 1991, Tecnoconsult entered into a joint venture with Fluor Corporation ("Fluor") pursuant to which Fluor acquired 20% of the common stock of Tecnoconsult. The stock purchase agreement between Grupo Tecno (which prior to the transaction owned all of the common stock of Tecnoconsult) and Fluor specified a base purchase price to be paid for the stock upon execution of the agreement. The agreement also contained an earnout arrangement

whereby Grupo Tecno would be entitled to additional payments if Tecnoconsult met certain earnings targets over the next five years. Tecnoconsult's earnings were predominantly in Venezuelan bolivars which, during the period 1992 through 1994, were declining. The board of directors of Tecnoconsult decided to implement a currency exchange protection program, as summarized in a letter dated August 18, 1992 from Mauricio Iza, a director of Tecnoconsult, to its shareholders, Grupo Tecno and Fluor. The letter stated that Tecnoconsult would convert the company's cash surplus in Bolivars into U.S. Dollars for investment in a GNMA portfolio at Cowen. Under the program, the company's cash needs could be met since a credit line was also available against the portfolio at a favorable rate.

By 1992, Gonzalez considered Herbst to be a trusted friend and broker and they both socialized together in New York. Gonzalez invited Herbst to the weddings of his three children which took place at the Bonaire Hotel, each of which Herbst attended. From time to time Gonzalez also sought Herbst's advice on other business matters. During this period, the value of the IFG Account had increased from IFG's initial investment of \$3-million to approximately \$5.73-million.

Tecnoconsult opened an account with Cowen in April 1992 under the name of Tecnoconsult Holdings, a company under common ownership with Tecnoconsult ("Tecno I Account"). Gonzalez and Iza instructed Herbst to invest the Account's funds in GNMA's in the same manner as the IFG Account's funds had been invested. Herbst provided Gonzalez with a Cowen brochure which described, among other things, Cowen's approach to asset management. This brochure contained the following statement:

"Our Fixed Income Approach is a conservative portfolio for those seeking maximum preservation of capital. It is based on a philosophy that "return on capital is less important than return of capital."

The evidence presented at the hearing indicated that Herbst did not check the "Investment Objectives" box on the Tecno I Account new account card. The account documentation for the Tecno I Account was incomplete; a customer's agreement was not produced; and there was an issue as to the existence of a trading authorization for this account.

Herbst invested the initial funds deposited in the Tecno I Account in GNMA's. At the end of Tecnoconsult's fiscal year, September 30, 1992, the earnings of the joint venture with Fluor had to be distributed to the partners in proportion to their respective ownership interests, i.e., 80% to Grupo Tecno and 20% to Fluor. In order to effect this distribution, Tecnoconsult opened a second account at Cowen in February 1993 through Tecnoconsult Holdings ("Tecno II Account") in which Fluor had no beneficial interest. In this regard, Gonzalez signed a Margin Agreement on March 12, 1993 and a Cowen Account Agreement on May 4, 1993. The "Investment Objectives" box was not checked on the New Account Card.

Iza's February 1, 1993 letter to Herbst requesting that Cowen open an account for Tecnoconsult states that "[w]e want to open a new investment account in the name of Tecnoconsult Holdings Ltd., which will be initially managed directly by Francisco Gonzalez until he gives you instructions otherwise." Gonzalez's instructions to Herbst were that he should

handle the Account just as he was handling the IFG Account. Iza testified that Tecnoconsult's "management" of the Account involved making deposits and withdrawals and that Cowen was handling all other management aspects of the Account.

Fluor wanted to be paid its share in U.S. Dollars, not in securities. Tecnoconsult was therefore required to distribute U.S. Dollars from the Tecno II Account to Fluor. Tecnoconsult generated the necessary cash by utilizing margin in the Tecno II Account in an amount equal to Fluor's 20% share of the joint venture's earnings. It paid Fluor with the proceeds of the margin loan, and kept the securities transferred into the Tecno II Account intact. Tecnoconsult followed the same procedure in making the fiscal year-end distributions to the two partners in 1993 and 1994.

The Tecno II Account, which was owned solely by Tecnoconsult, was initially funded with securities from the Tecno I Account. As in the case of the IFG Account (except for the NFS stock) and Tecno I Account, Herbst did not ask for Gonzalez's authorization to purchase securities for the Tecno I Account other than fixed-income securities such as GNMA's. When the Tecno II Account was opened in February 1993, 210 of the 211 investments in that account were GNMA's. The sole exception was a privately issued CMO described as "PRU-HM MTG SEC 7 1/2% B3 CMO 92-26 92507."

Andrews was retained by Gonzalez to perform the same services for the Tecno I and II Accounts that he had been performing for the IFG Account, i.e., tracking principal and interest payments. Since Tecnoconsult had a partner (Fluor) involved in the Tecno I Account, Zerpa asked Andrews to prepare a more detailed statement for the Tecno I Account. Later in 1994, Zerpa requested that Andrews prepare such statements for the Tecno II Account.

Changes in Investments in the IFG and Tecnoconsult Accounts

Eileen Corcoran ("Corcoran") had been Herbst's trader who was responsible for buying bonds, such as GNMA's, in the market for the Cowen Trading Account. During the period mid-1992 through the time of her departure until 1993, Corcoran had also been buying tranches of Collateralized Mortgage Obligations ("CMO's") known as "B Pieces." During this period, Herbst purchased some of these "B Pieces" for the IFG and Tecnoconsult Accounts.

Prior to leaving Cowen, Corcoran recommended Charlotte Kim ("Kim") as her replacement. Kim had spent three years in bond sales for institutional accounts at Kidder, Peabody & Co. ("Kidder"). Kim received no formal training at Kidder; she was self-taught in mortgage-backed derivatives. Prior to Kim's arrival, Corcoran and Herbst had little, if any, experience with complex mortgage-backed derivatives such as inverse floaters, interest only ("IOs") and inverse IOs. Herbst was interested in learning about these types of complex derivatives from Kim. Cowen provided no supervision of, and support for, Kim in the mortgage-backed derivatives area. This was confirmed by Kim when she testified she did not meet anybody at Cowen who had knowledge of these derivatives. She said that the lack of a mortgage-backed derivatives analyst made her uncomfortable because there was no one at the firm with whom to discuss her ideas.

Between September and December 1993 Herbst bought millions of dollars of mortgage-backed derivatives, the Credit Suisse derivative, and high-yield bonds for the IFG and Tecnoconsult Accounts. These purchases were made for the IFG Account entirely on margin, and, for the Tecno I and II Accounts, primarily on margin.

The changes in these Accounts from September 1993 to December 1993 (the Credit Suisse derivative was purchased in November) are shown on the following tables:

IFG Account

<u>Month/Year</u>	<u>Total Assets</u>	<u>Debit Balance</u>	<u>Net Value</u>
September, 1993	\$10,997,951	\$ 4,432,200	\$6,565,751
December, 1993	\$20,484,176	\$14,035,949	\$6,448,227

Tecno I and Tecno II Accounts

<u>Month/Year</u>	<u>Total Assets</u>	<u>Debit Balance</u>	<u>Net Value</u>
September, 1993	\$23,302,212	\$ 2,156,355	\$21,145,857
December, 1993	\$42,850,772	\$20,470,006	\$22,380,766

The Three Accounts Combined

<u>Month/year</u>	<u>Total Assets</u>	<u>Debit Balance</u>	<u>Net Value</u>
September, 1993	\$34,300,163	\$ 6,588,555	\$27,711,608
December, 1993	\$63,334,948	\$34,505,955	\$28,828,993

As the above tables illustrate, the debit balances in the IFG and Tecnoconsult Accounts combined increased by \$27.9-million, while the net values increased by \$1.1-million, with the statements showing \$2.75-million withdrawals from the Tecnoconsult Accounts.

During 1993 Cowen received commissions on the IFG and Tecnoconsult Accounts of more than \$1-million, of which Herbst's share was 45%, or about \$500,000. Of that amount, about \$375,000 was received in September through December 1993. In 1994 commissions on the IFG and Tecnoconsult Accounts were about \$950,000, of which Herbst's share was about \$430,000.

The Credit Suisse Derivative

Kim identified the Credit Suisse derivative as a potential investment for the Cowen trading account. It took her several weeks working with Credit Suisse to analyze the derivative. In November 1993, the German yield curve was inverted, that is, long-term interest rates were

lower than short-term rates. The German yield curve had been inverted for some time, and the Credit Suisse derivative was based on a prediction that the German yield curve would remain inverted until its redemption.

CS First Boston prepared a term sheet accompanied by certain analytics which it sent to prospective purchasers, including Cowen. The Credit Suisse derivative was a 13-month yield-linked note which paid interest at the rate of 7% on its principal amount. Unlike a normal note or a corporate bond, however, the note would be redeemed at maturity, December 21, 1994, according to a formula that was based on the relationship between the 3-month German LIBOR rate and the 3-year German Bond spot rates as of December 19, 1994. According to the material supplied by Credit Suisse, the Credit Suisse derivative could generate a 93.5% gain over its 13-month life; however, the term sheet made clear that an investor who purchased the derivative could lose the entire investment. The level of risk inherent in the Credit Suisse derivative was obvious from the range of outcomes Credit Suisse disclosed for the security at its maturity just 13 months from the date of purchase. At the time of purchase, Herbst considered the Credit Suisse derivative to be a very speculative and very risky investment.

The Credit Suisse term sheet fixed the trade date as November 10, 1993. The analytics supplied with the term sheet included the 3-month and 3-year spot rates (i.e., the actual interest rates pertaining on the trade date). The analytics also included forward yield curves for various German interest rates, including the 3-month and 3-year rates. According to Herbst, the forward rates are the rates in the foreign exchange market where the market was predicting that rates would be. Herbst explained that the forward rates are predictors of where future interest rates will be. According to the Credit Suisse analytics, the spot rate for the 3-month as of the trade date was 6.44%, and the spot rate for the 3-year was 5.17%. The forward yield curve supplied by Credit Suisse indicated that in 12 months, the 3-month rate would be 4.94%, and the 3-year rate would be 5.01% (i.e., the German yield curve was expected to become positively sloping).

Kim interpolated from the Credit Suisse material that the forward yield curve indicated that in 13 months the forward rate for the 3-month would be 4.85% and the forward rate for the 3-year would be 5.02%, that is, yield curve for the 3-month and 3-year rates would be even more positively sloping than in 12 months. The forward yield curve illustrated an important point which Kim wrote down in her notes in the process of analyzing the derivative, that is, the forward yield curve predicts that a negatively sloping curve will go to a positive slope.

The formula for the Credit Suisse derivative was used not only in determining the redemption price at maturity, but also to determine Cowen's purchase price for the derivative and to mark it to market from issuance to redemption. The principal redemption formula was set forth on the term sheet as follows:

100.00% plus $20.0 \times [\text{DEM LIBOR} - \text{DEM (3 YR)}]$
Plus $20.0 \times [5.02\% - \text{DEM (3 Yr)}]$ where:

DEM LIBOR = 3 month DEM LIBOR on 19 December, 1994
DEM (3 Yr) = 3 Year DEM swap rate on 19 December, 1994

In calculating the redemption price on the maturity date, the spot rates in effect on December 19, 1994 would be plugged into the formula. In setting the purchase price and in marking the derivative to market, the rates predicted for the maturity date by the forward yield curve then in effect were plugged into the same formula. This is apparent from the methodology Kim and Credit Suisse used in pricing the derivative at par on November 10, 1993, the trade date. On that date the redemption price, plugging the then spot rates into the formula, was 122. But that was not its then market value. To determine its market value, Kim plugged the forward rates for 13 months out (which she had determined by interpolation from the forward yield curve supplied by Credit Suisse) into the formula. Kim determined that if the rates predicted by the forward yield curve for the maturity date in fact occurred, an investor would get an annualized return on the Credit Suisse derivative of 3.49%. In pricing the derivative with Credit Suisse, Kim plugged the 3-month and 3-year forward rates (4.85% and 5.02% respectively) into the formula as follows:

$$\begin{aligned}\text{Principal} &= 100 + 20[\text{DEMLIB-DEM}(3\text{Yr.})] + 20[5 - \text{DEM}(3\text{Yr.})] = 100 \\ &+ 20[4.85 - 5.02] + 20[5 - 5.02] = 100 + 20[-.17] + 20[-.02] = 100 + [-.34] + [-.40] \\ &= 96.20\end{aligned}$$

The resulting principal redemption price was 96.20, representing a loss of 3.80 compared to the price of 100 at which Cowen bought the derivative from Credit Suisse. In order to calculate the total return for the instrument, Kim next determined that interest for 13 months at 7% which the purchaser would receive on the principal amount would equal 7.58%. She added 7.58% to the redemption price of 96.20 ($7.58 + 96.20 = 103.78$), obtaining a return of 3.78% on the instrument over 13 months. To complete her analysis, Kim determined that a return of 3.78% over 13 months was equal to a one year rate of return of 3.49%, which she equated to the one year U.S. Treasury bill which was then yielding 3.50%. The Credit Suisse formula was such that the derivative, when purchased at par, would yield a one year U.S. Treasury bill rate of return if the forward yield curve supplied by Credit Suisse turned out to be a precisely accurate forecast of the 3-month and 3-year spot rates at the instrument's maturity date 13 months out. If the slope of the German yield curve at the maturity of the instrument remained negative, the purchaser could make more than the 3.49% return implicit from the rates contained in forward yield curve. However, if the German yield curve went more positively sloping than the forward yield curve indicated, the purchaser stood to lose most of its investment. As Kim testified, "we took a bet that . . . the three-year forward rate on the three-year was a lot more expensive than it was actually going to be. And the same thing with FIBOR." Whether an investor was interested in purchasing the Credit Suisse derivative thus depended on where the investor believed the spot rates for the 3-month and 3-year would be on December 19, 1994, the date used in calculating the principal amount due on its maturity date, December 21, 1994. The "Realized Total Return" tables supplied by Credit Suisse with the term sheet disclosed that any combination of 3-month and 3-year interest rate movements which resulted in the negatively sloping curve turning positively sloping would result in a loss.

Herbst and Kim checked with others knowledgeable about foreign interest rates who informed them that the German yield curve would remain inverted. As Herbst testified, it is impossible to predict the direction of future interest rates. Thus, the Credit Suisse derivative was very speculative and very risky.

Prior to purchasing the Credit Suisse derivative, Credit Suisse confirmed to Kim that it was obligated to always make a reasonable bid/offer market in the bond within about two points. Herbst testified of being informed by Kim at the time that Credit Suisse would be making such a market.

Kim testified that she spent approximately 15-30 minutes explaining to Herbst the Credit Suisse derivative prior to its purchase. In the process, she reviewed with him the notes she had taken in analyzing the derivative, including the yield analysis she had done based on the forward yield curve.

Although Herbst wanted to purchase less than \$5 million of the Credit Suisse derivative because it was a new investment of a type which Cowen had never bought before, he nevertheless purchased \$5 million for the Cowen Trading Account because Credit Suisse would not sell it in smaller lots.

Of the \$5 million of the Credit Suisse derivative that Cowen purchased, Herbst allocated \$3,525,275 to the IFG and Tecnoconsult Accounts at a 1 to 1-1/2% markup over its purchase price of 100. None of the 16 other Cowen customers who received allocations of the Credit Suisse derivative purchased more than \$200,000, with most purchasing between \$25,000 and \$100,000.

The confirmations with respect to the sales of the Credit Suisse derivative to the IFG and Tecnoconsult Accounts indicate that they occurred on the following dates:

<u>Account</u>	<u>Date</u>	<u>Amount in \$</u>
IFG	no date on confirmation	\$808,000
	11/18/93	\$492,275
Tecno I	11/11/93	\$808,000
	11/18/93	\$609,000
Tecno II	11/11/93	<u>\$808,000</u>
	<u>TOTAL</u>	<u>\$3,525,275</u>

If the undated sale to IFG took place on November 11, 1993, Herbst sold each of the three Accounts \$808,000 of the derivative on the same date. However, Herbst did not sell to the IFG and Tecno I Accounts their remaining allocations of \$492,275 and \$609,000 respectively until a week later on November 18, 1993.

At the time of purchase, the Credit Suisse derivative represented about 20% of the IFG Account's net equity value and about 10% of the combined Tecnoconsult Accounts' net equity value.

The Credit Suisse derivative was not a buy and hold investment. As Kim testified, purchasers of the derivative had to actively manage this instrument and be responsive to the many factors and interest rates that might affect future German short and long-term interest rates. If these factors or rates began to move against the trade, purchasers needed to take action to avoid a loss by selling, modifying or hedging the derivative.

At the time Cowen sold the Credit Suisse derivative to IFG and Tecnoconsult, neither Herbst nor any other representative of Cowen informed Gonzalez or any other representative of IFG or Tecnoconsult of the nature or characteristics of this derivative, or of the risks, including loss of principal, which were inherent in this instrument. There was no evidence furnished that Claimants had the ability to evaluate the risk independently, or to exercise independent judgment in evaluating the risk/reward of this derivative. The panel found Gonzalez to be astute in business, but concluded that he was not a sophisticated investor with respect to derivatives. Neither of the Claimants is a financial institution nor experienced in trading derivatives. Claimants and their employees involved in these transactions did not possess significant experience and background in these complex interest rate sensitive securities. There is no evidence that Claimants and their employees received information about these kinds of derivatives before or after entering into the transactions with respondents until late 1994 when they retained Roger Vogt to analyze the Accounts. Substantially all the Claimants' investment experience was in GNMA's, with minor exceptions. Herbst exercised his discretion to allocate \$3,525,275 of the Credit Suisse derivative to the IFG and Tecnoconsult Accounts without informing Claimant or obtaining their prior approval. Nor did Cowen and/or Herbst provide IFG or Tecnoconsult with written information concerning the Credit Suisse derivative, including the Credit Suisse term sheet and analytics, until December 1994.

Cowen sent confirmations to Gonzalez for the Credit Suisse purchases in the IFG and Tecnoconsult accounts. In the "Portfolio Valuation" section of the November 1993 statements and subsequent monthly statements, the Credit Suisse position was listed under the heading "Corporate Bonds" and described as follows (for example, in the IFG statement):

<u>Quantity</u>	<u>Description</u>	<u>Market Price</u>	<u>Estimated Income</u>	<u>Annual Yield</u>
1,285,000	Credit Suisse 7% MTN DEP Notes 12 21 94	N/A	89,950.00	

Since the Credit Suisse derivative had few of the characteristics of a corporate bond, it was thus misleading to characterize it as such in the IFG and Tecnoconsult account statements. It was also misleading to represent that the derivatives had an estimated income and annual yield. In fact, the return on this derivative was more significantly dependent by movements in future German interest rates than by the 7% coupon.

The confirmations for the Credit Suisse derivative disclosed the security as follows:

CREDIT SUISSE 7%
MTN DEP NOTES 12 21 94
DATED 11/24/93 ISTCPN 06/21/94
PRIN RDM = 20 (DEM LIB-DEM 3 YR) +
20 (5.02% - DEM 3 YR) + 100%.

The description of the derivative in the "Activities in Your Account" section of the November 1993 IFG and Tecnoconsult account statements was similar to that disclosed in the confirmations, except that the portion of the description reading "ISTCPN 06/21/94" was omitted. Thereafter, the IFG and Tecnoconsult account statements disclosed only the first two lines of the security's description in the "Portfolio Valuation" section of the statements. The cryptic description was misleading in that it failed to put an investor on notice that the "7% Notes" in question were other than notes issued by Credit Suisse, a major Swiss bank. As of the beginning of November 1993 (the month when Herbst purchased \$3,525,275 worth of the Credit Suisse derivative for the IFG and Tecnoconsult Accounts) there was insufficient cash in any of the three Accounts for the purchases; the debit balances in the three accounts increased substantially in November 1993.

Within two months of purchasing the Credit Suisse derivative, Kim submitted her resignation to Cowen. At that time (January 1994) the bid and asked prices provided by CS First Boston for the derivative were 98 and 100, respectively, a two-point spread. The January 1994 IFG and Tecnoconsult monthly account statements priced the derivative at \$99.25. Kim testified that she advised Herbst to sell the Credit Suisse derivative at that time because, in her opinion, Herbst did not understand the instrument or know how to trade it. Herbst could have sold the derivative to or through CS First Boston in January 1994, but chose not to do so.

During the first three months after purchasing the Credit Suisse derivative, Cowen priced it according to formula. Kim, Ellen Marshall and/or Philip Schwaeber (Cowen employees) called CS First Boston toward month-end and obtained market prices for the derivative. As an example, in January 1994, CS First Boston gave Cowen a market price of 99.50, the price which was in fact reflected in the IFG and Tecnoconsult account statements for that month. In February 1994, the German interest rate curve started to become more positively sloping (i.e., the 3-month rate was declining and the 3-year rate was increasing). Between February 14 and February 24, 1994 the 3-month spot rate had declined from 6.04% to 6.0% and the 3-year spot rate had increased from 5.18% to 5.60%. This move in German interest rates adversely affected the value of this derivative.

Disguising Prices of Derivatives and the Withholding of Material Information

On or about February 24, 1994, in their effort to obtain month-end prices for the Credit Suisse derivative, Schwaeber and Marshall contacted CS First Boston which provided them with a price of 80.25. Marshall recorded the 80.25 price on the back-up work sheet for the February 1994 Price Change Request Form. This document was originally the back-up worksheet to the

January 1994 Price Change Request Form that Schwaeber and Marshall marked up to reflect February 1994 prices. As marked up, it formed the back-up for the February 1994 Price Change Request Form. Schwaeber testified that he informed Herbst of the decline in the price obtained from CS First Boston from 99.5 in January to 80.25 in February, and asked Herbst how he should price it in Cowen's customers' account statements. Herbst directed Schwaeber to mark the derivative down two or three points from where it had been priced in January. Herbst and Schwaeber agreed to maintain the price of the Credit Suisse derivative on the February 1994 IFG and Tecnoconsult account statements at a level substantially higher than they knew its actual market price to be. Herbst denied in his testimony that Schwaeber gave him the information concerning the decline in market value of the derivative, or that Herbst gave Schwaeber instructions to overprice it in Cowen's account statements. Based upon the testimony and documentary evidence, it is unlikely that Schwaeber and Marshall would have made the decision on their own volition to price the Credit Suisse derivative 20% higher than they were informed by CS First Boston was its true market value because neither had any responsibility for buying and/or selling the derivative or for maintaining it in the Accounts. This was Herbst's fiduciary responsibility.

Herbst had motive to misprice the Credit Suisse derivative. Herbst had not informed Gonzalez of the nature and characteristics of the Credit Suisse notes, that their value was tied to future German short and long-term interest rates which could be volatile, or that there was a significant risk of substantial loss of principal; and Credit Suisse derivative was not in accord with Claimants' investment objectives. For these reasons, and because Herbst was concerned about losing the IFG and Tecnoconsult Accounts if the losses on these Credit Suisse positions become known to Gonzalez, Herbst determined to disguise and conceal the loss of some 20% on a security Herbst had bought two months earlier.

In compliance with Herbst's directions, Schwaeber submitted a Price Change Request Form reflecting a price of 96 for the derivative for February 1994. Herbst does not deny that he authorized this price change by signing the "Authorizations" box on the February 1994 Price Change Request Form. At the time Herbst was explicitly authorized by Cowen to approve price changes for securities. In accordance with the Price Change Request Form, the Credit Suisse derivative was priced in the IFG and Tecnoconsult account statements for February 1994 at 96.

As the German interest rate curve turned positively sloping in March and April 1994, the market value of the Credit Suisse derivative continued to decline. Credit Suisse provided a month-end market price of 65.75 for the Credit Suisse derivative to Marshall on March 23, 1994. Schwaeber informed Herbst of this further decline in market value. In accordance with Herbst's prior instructions, Schwaeber marked the derivatives at 93 in the March 1994 IFG and Tecnoconsult account statements.

On or about April 21, 1994, CS First Boston sent Cowen a memorandum (the "April 21 Memorandum") containing a two-page analysis which set forth facts about the performance of the Credit Suisse derivative:

"The German curve (from 3 months to 3 years) has steepened by approximately 1.56% in the last 6 months. This combination of

falling short term rates and rising longer term rates has dealt a 'double whammy' to Deutschmark and French Franc Yield Curve Linked Notes, with many of these notes now trading in the 60-70% range."

As a result, the analysis continued, "investors will want to reassess these positions."

Herbst at first testified that while he had discussed the April 21 Memorandum with Marshall at the time he did not read it. When asked about the sentence in the letter indicating the basis on which the Notes were marked to market, Herbst testified: "I told you I didn't read this at the time." Later, in response to his own counsel's questions, Herbst testified that he had read the April 21 Memorandum, and that his decision to hold the derivative had been influenced by it. Herbst did read the April 21 Memorandum when it was received by Cowen, and he discussed its contents with Marshall and Schwaeber. The Memorandum stated:

"In evaluating the notes, investors will notice that most issues would currently redeem at about 15-20% higher than current trading levels. This "Roll-Down" is due to the fact that forward rates discount a further steeping of the curve with short rates continuing to fall as long rates continue to rise:

<u>Date</u>	<u>DEM 3 Month</u>	<u>DEM 3 Year</u>	<u>Spread</u>
Spot Rates	5.50%	5.85%	.35%
21 Sept. 94 (Fwds)	5.12	6.02	0.90
21 Dec. 94 (Fwds)	5.12	6.16	1.04

In evaluating these positions, it is crucial that investors be cognizant of these forward rates as they form the basis for the mark-to-market value of the notes."

The analysis showed that based upon spot rates, the German yield curve had already become positively sloping (the 3-month spot rate was 5.5% and the 3-year spot rate was 5.85%). Moreover, it showed that the forward rates for December 21, 1994 (the maturity date) were significantly more positively sloping than the spot rates. The April 21 Memorandum made clear that the 3-month and 3-year rates had moved against the trade. As of that date, when plugged into the formula, the forward rates for December 21, 1994 were indicating a "mark-to-market" and trading value for the derivative of 56.

The April 21 Memorandum alerted holders of the Credit Suisse derivative that "[a]s investors have evaluated these positions and designed strategies for managing their risks, three principal alternatives have emerged:" sell, hold or modify. The memorandum made clear that holding the derivative entailed a further bet against the forward yield curve:

"While historically there exists a strong positive correlation [between 3 month and 3 year German interest rates], recent months have seen this trend reversed. Current forward rates

predict that these rates will continue to move in opposite directions through year-end."

If such rates in fact continued to move in opposite directions as "predicted," the Credit Suisse derivative would decline further in value. This is precisely what happened, and the Credit Suisse derivative was redeemed on December 21, 1994 at 27.5 or half of the "mark-to-market" and trading value it had in late April 1994.

Shortly after receiving the April 21 Memorandum, Marshall spoke to an employee of CS First Boston, which offered to repurchase the derivative at 54 plus accrued interest. This was a bid at the two point spread from its mark-to-market value of 56 of which Schwaeber and Marshall informed Herbst. After reviewing and discussing the options set forth in the April 21 Memorandum, Herbst decided that it would be too expensive to hedge, and that he would rather hold on to the derivative than sell it at 54. Herbst made this decision without consulting Gonzalez or any other representative of IFG or Tecnoconsult, nor did he send a copy of the April 21 Memorandum to them. He testified his failure to contact Gonzalez about one of the largest positions in his Accounts which had performed poorly and on which CS First Boston was soliciting an important buy/sell/hold decision, by explaining that he already had authority from Gonzalez to hold the Credit Suisse derivative in the IFG and Tecnoconsult Accounts until maturity no matter what happened in the interim. Herbst's testimony is as follows: "[w]hen I purchased the security with Paco [Gonzalez], we made the decision that we were going to be a buyer and holder of it until maturity ... regardless of what happened to future German interest rates." It is improbable that Herbst would suggest or recommend, and particularly that Gonzalez would agree, that IFG and Tecnoconsult would hold on until maturity of an extremely volatile and risky security of a kind neither had seen before. On the last day of the hearing, in response to a panelist's questions, Herbst was still testifying that "[w]e knew we were locked in . . . when we purchased it." Herbst in fact reached no such understanding with Gonzalez at the time the derivative was purchased. Nor were IFG and Tecnoconsult ever "locked in" to the derivative. In fact, Herbst did exercise his discretion to hold the Credit Suisse derivative in the face of the disclosures contained in the April 21 Memorandum.

Herbst had no credible explanation why Cowen was pricing a security then bid at 54 at a price of 93 in the April 1994 statements. Herbst's rationale that the derivative "had no value until the final maturity date," which he repeated on a number of occasions, is not credible. At the end of the hearing, and in the face of the April 21 Memorandum, Herbst persisted in this testimony: Question: "Did [the Credit Suisse] formula have any relation to the market value on any given date?" Answer: "No, nothing at all." Herbst knew that CS First Boston was making a market in the derivative through April 21, 1994. Kim told him so when she resigned, and CS First Boston submitted a bid for it in April 1994, accompanied by a detailed rationale for the instrument's then market price. Because the derivative had an obtainable market value, Cowen and Herbst had a fiduciary duty to price it at that value in the IFG and Tecnoconsult account statements. Herbst deliberately chose not to do so. When asked why values were put on the monthly statements if the "security had no real market value from the date of its . . . issuance until the redemption date," Herbst testified that "we were trying to . . . show the clients, to the best of our ability the value of that investment at any given point in time." The result of Herbst's intentional misrepresentation of the value of the Credit Suisse derivative, as

calculated by the formula, was to conceal a substantial decline in its value and avoid detection by Claimants that the Credit Suisse derivative had deteriorated substantially in value.

The German yield curve continued to become more positively sloping after April 1994, and the value of the Credit Suisse derivative therefore continued to decline further. Nevertheless, Herbst and Schwaeber decided to maintain the price in the IFG and Tecnoconsult account statements alone or at most mark it down another point or two per month below where they had previously marked it. This markdown by Herbst and Schwaeber was cosmetic. The price reflected on the IFG and Tecnoconsult account statements for the derivative remained at 93 from March 1994 until July 1994 when the price was lowered one point to 92.

Herbst and Schwaeber met with three representatives of Tecnoconsult (Zerpa, Maloney and Andrews) on August 2 and 3, 1994 ("August Meeting") regarding the performance and rates of return of the two Tecnoconsult Accounts. As part of the agenda for the Meeting, Herbst and Schwaeber presented these representatives with an "Overview of Types of Investments" ("Overview") in the Accounts. The Credit Suisse derivative did not appear on the agenda which Herbst and Schwaeber used during that meeting. Andrews testified that he did not recall any conversation about Credit Suisse at the August 2nd meeting with representatives of Cowen. Andrews did recall the subject coming up during a subsequent ten-minute meeting with Zerpa and Maloney. The purpose of this brief meeting was to discuss the fact that there had been a \$1.3 million shortfall with respect to the January 1994 transfer of securities from the Tecno I Account to the Tecno II Account for purpose of making the 1993 fiscal year-end distribution to the joint venture partners. According to Andrews, the Credit Suisse Notes were discussed among himself, Zerpa and Maloney only in the context that it was one of the securities that was being transferred to make up the shortfall. One of the principal purposes of the August Meeting was for Cowen to present the Tecnoconsult representatives with rate of return calculations for the Tecnoconsult Accounts. The price for the Credit Suisse derivative which Cowen used in the rate of return calculations handed out was 92, the same price disclosed in the IFG and Tecnoconsult account statements for the month of July 1994.

By the end of August 1994, the price of the Credit Suisse derivative, based on then spot rates, was 43, and the market price based on forward rates was even lower. According to Schwaeber, he and Herbst had the following discussion:

"We determined that it now being August of 1994 and the note was maturing in December 1994, that we had four months or so to mark it down from 93 or wherever it was we had it down to what its actual redemption value was going to be, which we really didn't know for sure back then, but we knew it to be in the 40 to 50 range, or I believe[d] in August it to be the 40 to 50 range. So we set about marking it down I believe starting in August of '94 of say 10 points per month."

In the panel's judgment this evidences a deliberate plan sanctioned by Cowen to avoid full disclosure of the substantial decline in value of the derivative as reflected in the account statements.

The month-end August 1994 account statements for the IFG and Tecnoconsult Accounts reflected a price of 85 for the Credit Suisse derivative, a price which Herbst and Schwaeber had discussed and agreed upon as the first markdown. In September and October 1994, the Credit Suisse derivative was marked down another 10 points each month to 75 in September and 65 in October. In November 1994, Herbst and Schwaeber lowered the price of the derivative another 15 points to 50.

During the period August 29, 1994 through the maturity date of the Credit Suisse derivative, Marshall was under instructions from Herbst to follow closely the 3-month and 3-year German interest rates; her daily notes throughout the period contain the 3-month and 3-year spot rates. Marshall's notes for August 31, 1994, for example, reflect that the then spot rates for the 3-month and 3-year were 5% and 6.48% respectively. As noted, plugging these spot rates into the derivative's formula produced a price of 43 as of the end of August. Similarly, plugging the spot rates for the 3-month and 3-year set forth in Marshall's notes as of the end of September, October and November 1994 into the formula for the derivative, produced redemption prices of 24.88, 28.82 and 31.52 for months-ending September, October and November, respectively. Herbst and Schwaeber knew these facts when they marked the price of the Credit Suisse derivative down from 92 in the July account statements to 85 in August and to 75 in September, 65 in October and 50 in November. They picked these prices in order to manipulate the price of the derivative so that it would have a softer landing at maturity.

There was an overvaluation of approximately \$2 million in the September 1994 account statements due to a factoring mistake by Schwaeber. Herbst and Schwaeber advised Zerpa and Iza of the overvaluation at a meeting at Cowen in October 1994, but they were not told of the amount until early December 1994. Sometime in October 1994, Herbst told Gonzalez that there were errors in the valuation of some of the securities in the September 1994 account statements which would be corrected in the next statements. He also mentioned that there had been a "bad trade." Although Gonzalez did not know what Herbst meant by the term "bad trade," Gonzalez understood that another mistake had occurred which, like the valuation errors, would be corrected. Herbst did not identify the Credit Suisse "Notes" or any German interest rate-linked derivative as the security involved in the bad trade. Nor did he mention the amount of any losses. At the time Herbst mentioned to Gonzalez that there had been a bad trade, the IFG and Tecnoconsult Account statements reflected that the Accounts held the following numbers of positions: IFG-183; Tecno I-96; and Tecno II-246.

Zerpa came to Cowen's office in New York in December 1994 to oversee the year-end transfer of securities from the Tecno I Account to the Tecno II Account for purposes of the 1994 fiscal year-end profit distribution to the joint venture partners. He wanted to avoid the errors that had plagued the process in prior years. Zerpa arrived at Cowen on December 19, 1994 and met with Schwaeber and Marshall; Herbst was vacationing in Europe. As planned, the Cowen representatives reviewed with Zerpa the transfer of securities between the two Tecnoconsult Accounts. They also discussed the rate of return on the accounts. Andrews joined the meeting the next day. At that meeting, Cowen, for the first time, offered an accounting with respect to the particular securities that had been overvalued in the September 1994 account statements. During a further discussion regarding the rate of return on the Accounts, Marshall stated that, despite the bad trade, the accounts were still performing better than the seven year or 30-year

Treasuries. Zerpa wanted an explanation of what the bad trade was. Schwaeber and Marshall then explained to Zerpa the nature and characteristics of the Credit Suisse Notes and the losses that had been incurred. This was the first time that any representative of Cowen had disclosed to any representative of IFG or Tecnoconsult the nature and characteristics of the Credit Suisse Notes. During the course of the explanation, Marshall provided Zerpa with a memorandum describing the derivative, to which she attached a copy of the term sheet and some of the analytical information that Credit Suisse had provided to Cowen at the time of purchase. Schwaeber and Marshall advised Zerpa that the Credit Suisse Notes would be redeemed the next day at 27 or 28, resulting in a substantial loss for the Tecnoconsult Accounts.

Because Zerpa was told during the December meetings that Gonzalez had already been made aware of the bad trade, he obtained as much information as he could regarding the Credit Suisse notes. That night, Zerpa went back to his hotel and typed a two-page memorandum which he gave to Schwaeber and Marshall the next day. That memorandum, among other things, requested the following information: (1) a "[d]etail[ed] explanation on the Credit Swiss Notes trade, including date of purchase, when it was transfer[ed], and when it became a bad trade for the account;" and (2) "[a]ny other trade that could result in a loss at maturity."

No Cowen representative told Zerpa during the December 1994 meetings that the Tecnoconsult Accounts contained some 50 to 60 mortgage-backed derivatives, including inverse floaters, or that many of these derivatives could result in a loss at maturity.

On December 28, 1994, Zerpa wrote a memorandum to Gonzalez reporting what he had learned at the December meeting from Cowen representatives regarding the Credit Suisse derivative. Zerpa transmitted Marshall's memorandum on the subject to him. In another memorandum to Gonzalez written that same day, Zerpa reported that the Cowen representatives mentioned that this bad trade had been reported to him, but that no details or specifics on the trade were given at that time. As Zerpa also reported to Gonzalez in the memorandum, the Cowen representatives had explained to him that it became a bad trade by May of 1994, but they were unable to sell it or cut losses since there was no market to liquidate the position. The latter statement was untrue.

After receiving the Zerpa memorandum, Gonzalez called Herbst and complained for the first time about the Credit Suisse Notes. He followed up the call with a letter on December 29, 1994 in which he stated that, "as far as I am aware no one at either IFG Properties or Tecnoconsult Holdings authorized a deviation from the conservative investments you have always made for these two entities."

Herbst offered to unwind the losses sustained on the Credit Suisse derivative over the next several months. Herbst blamed the losses on Kim, and told Gonzalez that when he learned about the problem with the Credit Suisse notes he fired her. Herbst further told Gonzalez not to worry because the situation would be corrected, that he was in discussions with Credit Suisse to get the money back, and mentioned to Gonzalez " . . . maybe we have to sue these people, but we are going to get it back because definitely it was their fault."

Herbst suggested to Gonzalez in a telephone conversation after he had received the December 29 letter that he had told Gonzalez about the Credit Suisse derivative at the time of purchase and had sent a "prospectus," possibly referring to the Credit Suisse term sheet and the analytics. Gonzalez was sure Herbst had done neither, and demanded by letter dated January 4, 1995 to see any such "prospectus" and all Cowen documents and correspondence relating to the purchase of the Credit Suisse derivative. None were sent. In that same telephone conversation, Herbst again offered to repair the damage over time without putting the IFG and Tecnoconsult accounts at further risk. He told Gonzalez that he was investigating potential claims against Credit Suisse. Gonzalez concluded the letter by requesting that Cowen restore the two accounts to the position they would have benefited, had the money invested in the Credit Suisse securities been invested in GNMA's.

On the subject of the potential claim against Credit Suisse, Herbst later told Gonzalez that Tecnoconsult should be the one to sue Credit Suisse and that Cowen would pay for the lawyers. However, Herbst never informed Gonzalez what the basis for a suit against Credit Suisse might be. IFG and Tecnoconsult did not seriously consider Herbst's suggestion. Herbst, however, did attempt to obtain restitution from CS First Boston. He called a senior person at CS First Boston to complain that the research on the derivative was flawed because they used forward rates and they should have used spot rates. Herbst was unable to explain in this proceeding what mistake was made. CS First Boston rejected the claim and refused to make restitution.

Herbst's testimony that he informed Gonzalez about the nature, characteristics and risks associated with the Credit Suisse derivative prior to purchasing it, and that Gonzalez authorized the purchases for the IFG and Tecnoconsult Accounts after being fully informed, is not credible or trustworthy. The cornerstone of Herbst's testimony on this subject is a 20-minute telephone call reflected on Cowen's telephone records to the Gonzalez residence in Florida. The call was placed at 3:12 p.m. on the afternoon of November 11, 1993. When Gonzalez challenged Herbst on January 4, 1995 to provide the "prospectus" he claimed he had sent regarding the derivative and all correspondence relating to the trade, Herbst could produce none. However, shortly thereafter on January 9, 1995 Herbst copied a page from Cowen's telephone records which reflected the 20-minute telephone call on November 11, 1993. The testimony indicated that Gonzalez was not at his Florida residence when the call was placed there. In fact, Gonzalez was in New York City, and had lunch that day at the Customs House restaurant in lower Manhattan. Since Gonzalez was not in Florida on November 11, Herbst's "assumption" was that "I called his home. His secretary took the call, put me on hold and transferred me to his home in New York." Herbst went on to add that "[t]here is no other explanation for a phone call to Dr. Gonzalez at his home in Miami where he did have a staff for a 20-minute phone conversation with anyone other than Dr. Gonzalez on that date." Herbst's speculation that his call to Florida was transferred to New York is belied by the fact that there is no charge for a call from the Florida number to Gonzalez's New York number during the time of the 20-minute call. Nor is there any evidence that the telephone in Gonzalez's Florida residence was capable of transferring calls. Furthermore, it is highly unlikely that Gonzalez's staff in Miami would have taken a call from Herbst in New York and then transferred the call to Gonzalez in New York, rather than simply telling Herbst that Gonzalez was in New York. Moreover, after Herbst finished the 20-minute telephone call that afternoon, he called the Florida residence again for

50 seconds at 3:58 p.m. By then, had Herbst spoken to Gonzalez, Herbst would have known he was in New York and not to call him in Florida.

Herbst testified about two very short telephone calls placed between his office at Cowen and the Gonzalez's New York apartment on November 11, 1993 between 5:02 p.m. and 5:28 p.m. The first lasted only 44 seconds and the second 6 seconds. These were obviously not the calls in which Herbst explained to Gonzalez nor obtained approval from Gonzalez to purchase the Credit Suisse notes. Further, Kim purchased the Credit Suisse derivative for the Cowen Trading Account on November 10, 1993. The Credit Suisse term sheet specified the trade date as November 10, and the trade ticket which Kim prepared is dated November 10, 1993. There is no documentary evidence that the trade took place on any day other than November 10. Herbst testified that he had gotten his customers on board before authorizing Kim to purchase the Credit Suisse derivative because Herbst was "not about to buy it unless I had customers who wanted it." It is not probable he would have obtained his largest customer's approval the day after the trade occurred.

Herbst also sold \$50,000 of the Credit Suisse derivative to a pastor for his church's account. Herbst testified that Andrews was a trustee of the church and the decision-maker with respect to that purchase of the Credit Suisse derivative for the church. Herbst also testified that prior to selling to the church, he called Andrews at the pastor's request and explained to Andrews that it was a derivative whose value was tied to German short and long-term interest rates, and its risk characteristics. Andrews testified, however, that Herbst did not tell him during that conversation that Credit Suisse was a derivative whose value was based on German short and long-term interest rates or that it was risky.

Herbst testified that on November 11, 1993 he discussed with Gonzalez the desirability of purchasing the Credit Suisse notes, which were allegedly not marginable, with cash rather than using the margin buying power in the Accounts, and that Gonzalez told him that cash would soon be coming and that he should talk to Iza about getting the cash early. Herbst's testimony is not credible. The Credit Suisse derivative was purchased on margin.

The Mortgage-Backed Derivatives

Prior to Kim's arrival at Cowen, Corcoran had occasionally been purchasing a form of CMO referred to as "B Pieces" for the Cowen Trading Account. Herbst would then purchase the derivative for the IFG and Tecnoconsult Accounts. "B Pieces" were tranches of private label, mortgage-backed pass-through securities similar to GNMA's but not U.S. Government guaranteed and, therefore, subject to the risk of default and nonpayment. When Kim arrived at Cowen, the firm began purchasing mortgage-backed derivatives such as inverse floaters, IOs and inverse IOs for the Cowen Trading Account and Herbst began purchasing them from the Trading Account for his customers' accounts.

Claimants called Roger C. Vogt ("Vogt") as their expert on the subject of the nature, characteristics and risks inherent in the mortgage-backed derivatives purchased for the IFG and Tecnoconsult Accounts. The panel found Vogt to be qualified to give expert testimony in this

proceeding.

Vogt testified concerning the creation, nature, characteristics, and risks inherent in the types of mortgage-backed derivatives which Herbst began purchasing for the IFG and Tecnoconsult Accounts in the latter half of 1993. Vogt testified that characteristics of GNMA's which make them desirable investments for individuals interested in income with safety, make them unattractive to institutional purchasers such as banks and insurance companies. This led investment bankers to carve up GNMA, FNMA, and Freddie Mac collateral into as many as 50 to 60 different tranches in a single offering for the primary purpose of creating tranches of highly predictable securities that would be attractive to institutional purchasers. Investment bankers refined the GNMA, FNMA and Freddie Mac collateral into different cash streams, or tranches, divided into senior "scheduled" tranches and "support" tranches, such as inverse floater, interest only and inverse interest only tranches which were designed to absorb the risks in the offering.

The GNMA, FNMA and Freddie Mac collateral used to create a CMO is subject to prepayment risk. Various methods evolved for measuring the speed at which particular GNMA, FNMA and Freddie Mac mortgage pools would prepay. The Public Securities Association ("PSA") developed a standard prepayment model which calibrated prepayment speeds. Movements in prevailing interest rates are a critical factor in determining prepayment speeds. As interest rates decline, prepayment speeds as measured by PSA increase, and as interest rates increase, prepayment speeds decline.

Respondents' witness, Bella Borg, whom the panel found qualified to give expert testimony in this proceeding, testified that it was critical to the profitability of the exercise of creating CMOs that in fact all or at least as many as possible of the tranches be completely sold.

NASD Notice to Brokerage Firms Selling CMOs

Risky tranches were sometimes sold to investors who did not understand them and for whom they were otherwise unsuitable. In October 1993, the NASD published a Notice to Members on the subject entitled "Members' Obligations to Customers When Selling Collateralized Mortgage Obligations" (the "CMO Notice"). The CMO Notice was published by the NASD "[i]n recognition of the potential problems and in response to an increase in complaints related to CMO sales practices and advertising in the last few years." The NASD had earlier in January, 1993 published Notice to Members 93-18 entitled "Communications with the Public About Collateralized Mortgage Obligations," which was incorporated into the NASD's Conduct Rules, IM-2210-1. The CMO Notice required Members themselves to be "conversant in all of the characteristics of CMOs to assess adequately the suitability of CMOs for their customers." It also provided that "members must ensure that their customers understand the characteristics and risks associated with CMOs." Further, the NASD required that "adequate supervisory procedures must be in place to monitor CMO activity within each Member firm." And it reminded Members of their obligations under the Fair Rules of Practice when recommending CMOs to their customers.

In July, 1992 Herbst purchased a CMO described in the "Transactions this Period" portion of the July IFG account statement as follows:

"FED NATL MTG 7 1½%RMC 92-38 D 9 25 2019
FACTOR 1.00000000MTG VAL 300000.00"

In the same statement this security is described in the "Portfolio" section as "GNMA FNAM CMO 7 1½ % [sic]."

Andrews testified he understood that these securities were "similar to a Ginnie Mae." Designations such as "RMC and "CMO," which were disclosed in the descriptions of some of the mortgage-backed derivatives in the Accounts, did not have significance to him.

In addition, the "Portfolio" section of the IFG July, 1992 account statement reflected the same kind of information for this CMO as it did for the GNMA's, including "Estimated Annual Income" and "Yield" as follows:

<u>Quantity</u>	<u>Description</u>	<u>Market Price</u>	<u>Market Value</u>	<u>Est. Income</u>	<u>Annual Yield</u>
300,000	GNMA FNAM CMO 7 1½% 92- 38D 9 25 2019	96.562	289,686	22,500	7.760

Following this initial purchase, Herbst began to purchase additional CMOs for the IFG and Tecnoconsult Accounts which, prior to Kim's arrival, were predominately "B Pieces." For example, his next CMO purchase for the IFG Account occurred in October, 1992 when he purchased a private issue CMO "B Piece" described in the IFG Account statement as:

"PRU-HM MTG 7 1½ % B3 CMO 92-27 6 25 07
FACTOR 1.00000000 MTG VAL 300000.00"

Herbst admitted that CMOs like this had risk characteristics not found in GNMA, FNMA, and Freddie Mac pass-through securities.

Beginning with the September, 1993 account statements for the IFG and Tecnoconsult Accounts, Cowen began providing substantially more summary information on the first page of the statements than had been supplied in prior formats. Among other things, Cowen began including a summary of the types of investments in the accounts. Without exception, all of the securities in the IFG and Tecnoconsult Accounts during the remaining life of Accounts were listed either under the heading "Government & Agencies" or the heading "Corporate Bonds." Listing the mortgage-backed derivatives under the heading "Government & Agencies" was misleading in that it suggested that these securities were safe, U.S. Government-guaranteed or U.S. Government agency-issued securities similar to GNMA, FNMA, and Freddie Mac mortgage pass-through securities.

In addition, the descriptions of the CMOs that appeared in the IFG and Tecnoconsult account statements did not comply with the rules of the NASD. The Conduct Rules for NASD members state that "CMOs are complex securities and require full, fair and clear disclosure in order to be understood by the investor." Therefore, in order to "prevent confusion and the possibility of misleading the reader," the NASD instructed member firms "not [to] use the proprietary names for CMOs as they do not adequately identify the product" and further prohibited its members from making "comparisons between CMOs and any other investment vehicle." The IFG and Tecnoconsult Account statements used the proprietary names for all of the CMOs which Herbst bought for them and did not adequately identify the product. This was misleading and contrary to NASD policy concerning CMOs.

Herbst testified that Gonzalez's investment strategy evolved beginning in April 1992 because premium GNMA's were becoming more difficult to find. However, as the documentary evidence showed, Herbst continued to purchase premium GNMA's throughout 1992 and 1993.

The 110S and 115SA Securities

In September, 1993, Kim was contacted by Kathleen Dalton ("Dalton") of Kidder Peabody, who was trying to sell a mortgage-backed derivative created from FNMA collateral whose proprietary name was FED NATL MTG FLT RT, RMC 93-110S 5 25 23 ("110S"). According to the prospectus dated May 25, 1993 pursuant to which this security was issued ("110S Prospectus"), 110S was an inverse floater which had been created from a support class near the bottom of the CMO's structure. Its coupon rate was highly sensitive to changes in prepayment speeds as the result of a multiplier, expressed as a percentage using the PSA standard prepayment model, and the Eleventh District Cost of Funds Index ("COFI"). At the time Kidder issued 110S in May 1993, it was priced in the prospectus to sell at 84 with a projected yield of approximately 9.5% and an average life of 16.5 years. The price was based on the then current COFI rate of 4.171% which was at a ten-year low and assumed a prepayment speed of 200% PSA. As stated in the 110S Prospectus, however, its yield could decline to 0.7% if prepayment speeds slowed to 50% and COFI went above 7% where it had been less than two years before. As prepayment speeds decreased, moreover, the average life of 110S could extend up to 28.8 years. This derivative was one of the riskiest and most volatile tranches in the 28 tranche CMO and exhibited extreme average life variability. Herbst admitted that 110S was one of the more volatile inverse floaters. As a result of its sensitivity to changes in prepayment speeds and COFI, 110S was a high-risk security whose price was extremely volatile. 110S was volatile and risky because when the prepayment speed of the underlying collateral increased, that tranche absorbed the prepayment risk in order to maintain the stability of the senior tranches in the CMO. The inverse floater is subject to loss of principal at the same time that its yield is declining because its coupon declines as interest rates rise.

Other risk characteristics of inverse floaters are that their floating rate coupons, which float inversely to their underlying indices (here COFI), are calculated by means of a formula which contains a leverage feature. Borg identified the two major risk factors inherent in inverse floaters as the underlying index (again, COFI), and the coupon leverage or multiplier.

Due to the risks inherent in 110S, the 110S Prospectus contained risk disclosures, concerning suitability and the investor's ability to bear the risk of the security. Moreover, the 110S Prospectus cautioned the reader to also read five other prospectuses to obtain complete information regarding 110S. Kim testified that no one at Cowen obtained or reviewed the 110S Prospectus prior to purchasing the derivative.

In early September 1993 Kim obtained a one-page Bloomberg analysis of the derivative which had been printed out and initialized by Kidder, and described 110S on the fax as a money market alternative. Kidder's Bloomberg analysis of 110S projected an average life of 1.188 years for the security and a coupon rate of 7.285%, assuming a prepayment speed of 500 PSA on which the analysis was centered and COFI at 3.998%. Kim concluded after looking at the Bloomberg printout that 110S was a "layup" trade and recommended that Herbst purchase it.

Based on Kim's recommendation, Herbst purchased \$2 million face value of 110S, marked it up one-half a point, and then allocated the entire amount to the IFG and Tecnoconsult Accounts at a price of 101. Four months earlier when 110S was issued, it had a price of 84 and an average life of 16.5 years.

Kidder then presented Kim with 115SA, another inverse floater, this time off a scheduled class. Its coupon rate and price were again highly sensitive to changes in interest rates and prepayment speeds. 115SA was also presented as a money market alternative, focusing attention on the 1.482 year average life projected by Kidder, assuming a prepayment speed of 800 PSA. The maximum projected average life for the derivative was shown on the Bloomberg printout to be 2.332 years.

As with 110S, Kim relied on the one-page Bloomberg analysis prepared by Kidder. The prospectus for 115SA dated June 4, 1993 ("115SA Prospectus") disclosed that the average life of 115SA could extend to 26.2 years, and if COFI increased from its then ten-year low of 4.171% to 8.171% -- where it had been three years earlier -- the yield would be only 1.7%. Due to this negative convexity, the price of 115SA, which was disclosed at 93 in the 115SA Prospectus when it was issued in June, 1993, was extremely volatile. The 115SA Prospectus contained the risk disclosures similar to those found in the 110S Prospectus.

Kim recommended that Herbst purchase \$1 million face value of 115SA, which he did, and then put the entire amount into the IFG and Tecnoconsult Accounts at a price of 98 3/4.

In December 1993, Herbst purchased another \$9,275,000 (face value) of 110S for the IFG and Tecnoconsult Accounts. By the end of December 1993, 110S and 115SA made up 26% of the total account equity of the IFG and Tecnoconsult Accounts.

As of September 1993 when 110S and 115SA were purchased, U.S. interest rates, including both the 10-year U.S. Treasury bond and COFI, were at a ten-year low. COFI had declined from 4.171% to 3.881% (increasing 110S's yield), and the 10-year U.S. Treasury bond had declined from 6.15% to 5.38 (decreasing its average life). In September, 1993, Herbst expected that interest rates were going to rise from their then record low levels. Rising interest rates cause inverse floaters to decline in value because their yields decline at the same time that

their average lives extend. It was particularly risky to purchase either 110S or 115SA at a time when the relevant interest rates were at a ten-year low, and when Herbst expected interest rates to rise.

Borg testified that these 110S and 115SA COFI-based inverse floaters were less volatile than they would be had their interest rates been indexed off some of the other popular interest rates such as LIBOR. This is because, according to Borg, COFI is a lagging or sticky rate. Herbst testified that, as of the Fall of 1993, neither the IFG nor Tecnoconsult Accounts, with the exception of Credit Suisse, had a high risk profile. In fact, he testified the investment objectives of both IFG and Tecnoconsult were income with safety as they had always been.

Kim believed that 110S and 115SA were not buy and hold securities to be left in an investment account; Kim believed that a purchaser of such securities would have to watch the market very closely given the sensitivity of 110S and 115SA to rising interest rates and slowing prepayment speeds. Otherwise, she said an investor could get "hosed" if interest rates went up and the investor did not react in time.

Herbst testified he bought 110S as a short-term investment. After 110S and 115SA had extended in early May 1994, Schwaeber testified that Herbst told him that Herbst would not have bought them had he known about the extension risk.

The following description in the account statements and confirmations for 110S and 115SA did not provide adequate disclosure concerning their nature and characteristics or the risks associated with these securities, which were described as follows:

FED NATL MTG FLT RT RMC93-110S 5 25 23
FACTOR .91288180MTG VAL 684661.35;

FED NATL MTG FLT RT RMC 93-110S 5 25 23
FACTOR .99325690 MTG VAL 248314.23

Andrews testified these descriptions did not put him on notice that these securities had different risk characteristics. His understanding was that they were similar to a Ginnie Mae.

Neither Herbst nor any other representative of Cowen sought prior authorization from Gonzalez or any other representative of IFG or Tecnoconsult for purchase 110S or 115SA securities. Herbst exercised discretion in purchasing these securities. Neither Herbst nor any other representative of Cowen informed Gonzalez or any other representative of IFG or Tecnoconsult about the nature, characteristics or risks associated with inverse floaters generally or those associated with 110S or 115SA specifically.

Charlotte Kim's Concerns About the Methods Herbst Used to Price Derivatives

After being at Cowen for three months, Kim became concerned and alarmed about the prices of derivatives. She believed that the only way to price derivatives was to obtain prices from the brokerage houses from which the securities had been purchased. After obtaining prices in this manner and before she left for the evening, Kim would submit the prices with instructions to Cowen personnel that they be reflected in the firm's trading account. However, when she returned in the morning, these same securities were priced differently in Cowen's trading account at anywhere from 1/2 point to 1 1/2 points higher than the prices she had submitted the night before. When Kim confronted Herbst regarding her concerns over the pricing of the derivatives, Herbst told Kim it was none of her business. Herbst told Kim that he could price the bonds at whatever level he wanted as long as he was willing to make a market there.

In December 1993, Kim ceased buying bonds and/or derivatives for the Cowen trading account, and resigned in January, 1994. In a memorandum to Herbst dated January 28, 1994, Kim wrote "[t]his memo is to document my resistance in the involvement of all trades from trading account 99-30705-2-7-00 to clients registered with Cowen & Company since the end of November 1993." Kim documented her "resistance" to those trades because she was "pretty sure that bonds were being traded into these accounts at levels that were in my opinion not in the best interests of the clients" It was Kim's opinion that some markups were excessive. However, the panel does not accept her opinion in this regard.

When Kim resigned, she told Herbst that he should sell all of the derivatives that had been purchased because neither he nor anyone else at Cowen understood them, and they were not capable of competently trading these securities without her. Kim testified that, before she left Cowen, she was concerned about Herbst's lack of knowledge concerning derivatives; she testified:

"I spoke to every single salesperson from which I bought inverse floaters or derivatives ... and I told them to make very, very attractive markets in these bonds to buy them back because Ed Herbst needs to sell them. He cannot trade them without me. And in the event that something goes wrong without me here, that they needed to be careful, they needed to document things and needed to cover themselves in the event that Ed Herbst ran these bonds and certain accounts into the ground."

After Kim's departure from Cowen, Herbst turned over her responsibilities for purchasing mortgage-backed derivatives for Cowen's trading account for resale by Herbst into customers' accounts to Schwaeber. Schwaeber had never traded mortgage-backed derivatives and testified that he had little experience with them. Also, Schwaeber's only other experience as a trader of any sort was at Gruntal & Co. where, by his own admission, he was not very good. Beginning in March 1994, in accordance with Herbst's instructions, Schwaeber purchased a total of 25 IOs and inverse IOs for Cowen's Trading Account. Herbst then sold many of these risky mortgage-backed derivatives to the IFG and Tecnoconsult Accounts.

Mispricing of Mortgage-Backed Securities in the IFG and Tecnoconsult Accounts

One of Schwaeber's first assignments after taking over Kim's responsibilities was to price the derivative securities in Herbst's customers' accounts. Schwaeber knew that the proper way to price derivatives was to contact brokerage firms and obtain month-end prices for the securities in question. When such prices had changed from the previous month, the new prices would be reflected on a Cowen Price Change Request Form. This form would be signed by the person requesting the change, and the "Authorizations" box on the form would be signed by a managing director. The new prices set forth on the form would be disclosed in the ensuing monthly customer account statements. Kim followed this procedure in pricing derivative securities for the firm's customers' accounts while she was at Cowen. Schwaeber and Marshall followed the same procedures in December 1993 and January 1994. Herbst signed two of the three Price Change Request Forms for the month of December 1993 and the Price Change Request Form for January, 1994.

In February 1994, the Federal Reserve Bank raised interest rates by 50 basis points which significantly affected the prices of 110S and 115SA. This rise in interest rates adversely affected the market values and market prices of 110S and 115SA. Herbst and Schwaeber then adopted a course of conduct in pricing of inverse floaters similar to the one followed in pricing the Credit Suisse derivative.

Utilizing the same procedure they had used to obtain prices for the derivatives in December 1993 and January 1994 Schwaeber and Marshall listed the derivatives for which they sought month-end prices at the end of February 1994, and sent the list to the brokerage firms which had sold them the securities in question. The list sent to Kidder included 110S and 115SA. The February month-end price provided by Kidder for 110S was 81. This derivative had been disclosed on the IFG and Tecnoconsult January account statements at 99.99. The February month-end price furnished by Kidder for 115SA was 87. This security had been disclosed on the IFG and Tecnoconsult January Account statements at 105.24.

Upon learning about the declines in the prices of the inverse floaters, Schwaeber testified that he asked Herbst what he should do. Herbst instructed Schwaeber to mark 110S and 115SA down a point or two from the prior month, which is what Schwaeber did.

Schwaeber and Marshall followed the same procedure for obtaining month-end prices for customers' account statements in March 1994. Schwaeber and Marshall obtained prices from Kidder of 65 for 110S and 84.5 for 115SA, respectively.

As Schwaeber had done in February, he sought Herbst's direction as to how to deal with another substantial decrease in price for 110S and 115SA. Again, Herbst directed Schwaeber to mark the prices down another point or two from the prior month. For example, as specified in the Price Change Request Form for March 1994, the price of 110S, which had been carried in the February Account statements at 97.99, was listed in the March Account statements at 96.

Herbst told Schwaeber that if Cowen disclosed the true prices for 110S and 115SA derivatives on the IFG and Tecnoconsult Account statements in February and March 1994, the

prices of which had dropped 35% and 20%, respectively, in just two months, Cowen could lose the IFG and Tecnoconsult Accounts. At the time, these two securities made up 18% of the equity of Claimants' Accounts.

By March 1994, the prices of many of these risky mortgaged backed derivatives were plummeting. As Borg testified:

"You had the Askin liquidation at the end of March which totally collapsed the market. After Askin, you had the ripple effect, High-Yield securities, the Washington Group and several other firms, Piper Jaffray from Minneapolis. All of these firms were big derivatives players, and all of a sudden they were getting margin calls and they had to liquidate a lot of their positions. You then had Glaxo in July, . . . [and] Mitchell Hutchens, a subsidiary of PaineWebber. Right after Mitchell Hutchens, you had Kidder."

In light of the substantial declines in the market values of 110S, 115SA and the Credit Suisse derivative by March 1994, Herbst attempted to insulate himself from the potential consequences of intentional mispricing by refusing to sign any further Price Change Request Forms. In an effort to portray this decision in a favorable light, Herbst testified he ceased pricing the derivatives because he thought it might be a conflict of interest if he were both the broker and the person doing the pricing. This conflict did not concern Herbst when he signed the December 1993 and January 1994 Price Change Request Forms. Apparently no one at Cowen questioned Herbst's refusal to sign subsequent Price Change Request Forms, or inquired about his conflict of interest. Other Cowen employees with authority to sign refused to do so.

Interest rates continued to increase throughout 1994, thereby causing the values of 110S and 115SA to continue to decline further. As a result, Schwaeber stopped calling to get prices from brokers after March 1994 for the mortgage backed derivatives securities that Cowen had purchased from them. Instead, throughout the balance of 1994, Schwaeber priced 110S, 115SA, and the Credit Suisse derivative as instructed by Herbst. He priced the derivatives he had purchased for the Cowen Trading Account, which Herbst had purchased for the IFG and Tecnoconsult Accounts, using the same yield to maturity as that obtained at the time of purchase. As Schwaeber recognized at the time, since interest rates were rising throughout 1994, this pricing methodology had the effect of overpricing many of these securities in the IFG and Tecnoconsult Accounts.

Herbst was aware after March 1994 that Schwaeber had abandoned any efforts to obtain market prices for the derivatives in the IFG and Tecnoconsult Accounts from brokerage firms. Despite the fact that interest rates continued to rise throughout 1994, Herbst and Schwaeber maintained the prices of 110S and 115SA in the 90s through December 1994.

In May 1994 Schwaeber attempted to determine an approximate market price for 110S using a Bloomberg price table and plugging in index and yield assumptions which he found being used in the market for similar instruments. Based upon his analysis, which he thought reasonable at the time, Schwaeber determined that the market value of 110S was approximately

38-31/32 as of May 24, 1994. Schwaeber then informed Herbst that the prices of 110S and 115SA, were trading at approximately half of the price at which Cowen was marking them. Herbst directed him to maintain the prices of 110S and 115SA where they were disclosed in Claimants' accounts.

In December, 1994 Schwaeber testified that he called Lehman Brothers for pricing on 110S and 115SA. According to Lehman Brothers, these inverse floaters were trading as much as 50% or less than the prices disclosed for them on the IFG and Tecnoconsult account statements. Again Schwaeber informed Herbst of the prices he had learned from Lehman Brothers, and again Herbst instructed him to maintain the prices of 110S and 115SA in the 90s.

In early January, 1995, the New York Stock Exchange sought information concerning Cowen's pricing practices for mortgage-backed derivatives. Schwaeber left Cowen before month end. These two events forced Cowen, for the first time, to properly price the mortgage-backed derivatives whose values it had been inflating throughout 1994. Cowen retained outside pricing services to perform that task, including Merrill Lynch. The independent service priced 110S and 115SA at 33.47 and 29.39, respectively, which were reflected in the January 1995 IFG and Tecnoconsult Account statements. When so priced in accordance with the independent service, the net value of the IFG and Tecnoconsult Accounts, as disclosed on the Cowen account statements, declined from about \$23-million in December 1994 to about \$17-million in January 1995, a decline of some \$6-million.

Merrill Lynch also priced the IOs and inverse IOs which Schwaeber had purchased for Cowen's Trading Account, and which Herbst had, in turn, purchased for the IFG and Tecnoconsult Accounts. Schwaeber's pricing method for these mortgage-backed derivatives had the effect of inflating their values on the IFG and Tecnoconsult Account statements, because Schwaeber was not using market-based yields to do the pricing. He continued throughout 1994, in accordance with Herbst's instructions, to use for each derivative the yield to maturity for the instrument at the time of purchase. This had the effect, in a period of rising interest rates, of inflating the market prices of many of the derivatives as disclosed in Claimants' Account statements.

The prices furnished for the mortgage-backed derivatives during 1995 by the independent pricing service, as disclosed on Claimants' account statements, were substantially accurate market prices for such securities. Herbst began selling these securities during 1995 and the prices he received were very close to account statement prices. In particular, 110S and 115SA were sold in October 1995 at 58 and 75.31 respectively. Merrill Lynch's prices for these securities, as disclosed in Claimants' September 1995 account statements, were 54.91 and 73.28, respectively.

Claimants' Attempts to Obtain Accurate Information About the Value of their Accounts

In December 1993, Tecnoconsult received a report from Andrews on the Tecno I Account. The report was supposed to contain a rate of return percentage for this account supplied by Cowen to inform Tecnoconsult representatives as to how the Account was

performing. It did not. Note 4 of the Report read: "The internal rate on this account for the 3 month period ending December 31, 1993, as determined by Cowen & Company, was ____%." This blank prompted Gonzalez to request Andrews to obtain the rate of return for the Tecnoconsult Accounts from Cowen.

By March 9, 1994, having received no rate of return calculation from Cowen, Andrews wrote Herbst asking when he could expect the information. Still, no calculation was forthcoming. As a result, Gonzalez sent a letter to Herbst on June 1, 1994 in which he explained that:

"[t]here is a growing concern among the Tecnoconsult Group with the accounting of our investments with you. Somehow Jack Andrews is not providing the right answers and he claims that he is not getting the right numbers from you either -- specifically, he had been asked to report on the return on investments and somehow, he does not seem to be getting the right information from your end."

Shortly after Gonzalez sent his June 1 letter to Herbst, Zerpa was asked by Gonzalez to calculate the rate of return for the Tecnoconsult Accounts on his own. At about the same time, Gonzalez asked Maloney, an accountant who had just joined Tecnoconsult in its Florida office, to assist Zerpa in this effort. In a June 27, 1994 memorandum, Zerpa reported to Gonzalez the preliminary results of his analysis of the yield for the Tecnoconsult Accounts. Maloney's role was limited to providing Zerpa with some of the information, either from those account statements which Zerpa did not have, or from Andrews. Such information included interest earned on the accounts for each period, profit or loss reported for each period, expenses for each period, and market value for each period.

Upon completion of his rate of return analysis, Zerpa wrote to Herbst on July 19, 1994 stating that he had calculated a negative yield for the Tecnoconsult Accounts for the period April 1992 through June 1994, and attached his calculation which he had previously sent to Gonzalez in draft form. Zerpa concluded the letter by stating:

"[a]s you may see from these simple calculations, we have come up with unsettled results over the investments with Cowen. Having said this and considering the importance of discussing and clarifying this matter as soon as possible, I plan to travel to New York on the next week to meet with you. This will allow sufficient time to clear up the figures here presented and have a full and detail [sic] explanation for us."

Herbst responded by inviting Zerpa, Andrews and Maloney to New York to discuss the rate of return during the week of August 1, 1994.

In preparation for the New York meeting with the Tecnoconsult representatives, Schwaebler, at Herbst's instructions, prepared a draft agenda entitled "FOR DISCUSSION

WITH: Jorge Zerpa & Frank Maloney August 2, 1994" ("Draft Agenda"). The handwriting that appears on the Draft Agenda is Herbst's and reflects changes that Herbst told Schwaeber to make in the agenda prior to the August Meeting. After discussing with Herbst the proposed changes to the Draft Agenda, Schwaeber retyped the agenda, incorporating Herbst's changes in a Revised Agenda. The Revised Agenda was then used by Herbst and Schwaeber as their talking points for the August Meeting, but was not distributed to the Tecnoconsult representatives.

At the top of the Agenda are the words "Paco-safe," in Herbst's handwriting. According to Schwaeber, Herbst wanted to emphasize to Tecnoconsult representatives that the types of investments in the Tecnoconsult Accounts were safe GNMA-type investments. Schwaeber set forth Herbst's changes by including in the Revised Agenda the words "Paco wants safe investments" directly beneath the heading "Overview of Types of Investments." Herbst claimed that what he meant was that safe investments referred to the GNMA's, not to the overall portfolio. Herbst knew, as late as August 1994, that Gonzalez still wanted only GNMA-type investments.

The two categories of securities which Schwaeber listed for discussion on his Agenda were "GNMA" and "DERIVATIVES." Underneath the word "DERIVATIVES," "Inverse IOs" and "PAC IOs" were listed. Herbst crossed out the word "DERIVATIVES" because he did not want the word 'derivative' used at the meeting. Instead, Herbst told Schwaeber to substitute Fannie Mae and Freddie Mac. Herbst's handwritten notes next to the crossed out "DERIVATIVES" are "FNMA" and "FHLB. Mortgage-backed derivatives using "FHLB" collateral commonly appear in the IFG and Tecnoconsult Account statements as "FHLMC" or "Fed Hm Ln." Schwaeber understood that Herbst wanted him to replace the "DERIVATIVES" heading with "FNMA" and "Fed Hm Loan" and the Agenda was so amended. Herbst and Schwaeber had agreed prior to the August Meeting that they would not bring up the subject of the inverse floaters, including 110S and 115SA. At the time they knew that these volatile derivatives were trading at very depressed levels. These inverse floaters, like the Credit Suisse Notes, were taken off of the Agenda despite the fact that they represented 15% of net value of the combined \$33.5-million Tecnoconsult Accounts. In fact, these derivatives, which were among the most risky securities in the Accounts, were intentionally not discussed at the August Meeting.

Herbst and Schwaeber intentionally did not use the term "derivatives" in discussing the Tecnoconsult Accounts at the August Meeting. While they did discuss IOs, which were the only types of mortgage-backed derivatives listed on the Revised Agenda, they told the Tecnoconsult representatives that these securities were safe GNMA-type investments. In fact, all are listed under the heading "Paco wants safe investments." They did not disclose that these types of IOs were suitable only for investors with a high risk profile, nor did they disclose that many of these securities were not valued accurately on the Tecnoconsult Account statements.

Zerpa testified that he did not know what an IO was before the meeting. A principal reason for discussing the IOs was so that Herbst and Schwaeber could explain how their cash flows were to be treated in calculating the rate of return on the Accounts. Herbst and Schwaeber explained in this connection that part of the cash received on an IO had to be

allocated to principal and part to interest. No Cowen representative, including Herbst and Schwaeber, mentioned, or gave any indication at the August Meeting, that there were risks associated with IOs. Herbst simply said that IOs were similar to GNMA-type securities. Herbst also made handwritten notations on the Revised Agenda. The first notation in the upper right hand corner indicates "95% gov't guaranteed." Herbst told the Tecnoconsult representatives at the August Meeting that 95% of the securities in the account were government guaranteed. That was not a truthful statement. At that time, a large percentage of the securities in the Accounts were not GNMA nor FNMA nor Freddie Mac passthrough securities, which effectively carry a U.S. Government guarantee, but mortgage-backed derivatives, including the Credit Suisse derivative and the high-yield bonds, which do not. The NASD Conduct Rules make clear that it is misleading in most cases to describe mortgage-backed derivatives as "government guaranteed." Herbst knew that fact, or should have known it, and intentionally misled the Tecnoconsult representatives.

Herbst and Schwaeber discussed with the Tecnoconsult representatives the proper methodology for calculating the rate of return on the Tecnoconsult Accounts. In the process, they distributed their own rate of return calculations. The rate of return calculations provided by Cowen disclosed a positive 3.57% rate of return for the three-year period 1992-94. The rate of return for 1994 year-to-date was given as negative 4.20%, which compared well to the negative 4.73% year-to-date-return for the 30-year Treasury bond. These rate of return calculations substantially overstated the actual rates of return for the two Accounts because they included the Credit Suisse derivative, 110S, 115SA, and many of the IOs disclosed on the Account statements at inflated values, a fact of which Claimants were not aware.

During the portion of the Meeting devoted to the fourth subject on the Revised Agenda, "Comparison of Rates of Return," Herbst and Schwaeber returned to the main theme of the meeting, that Tecnoconsult had safe investments at Cowen. The text under the "Comparison of Rates of Return" heading states "[o]ur performance vs. 7 Year (-5.29%) and 30 Year (-12.40%) Treasury." Cowen used this information at the August Meeting to convey to the Tecnoconsult representatives that "our returns were in fact better than . . . returns on similar-type instruments in the marketplace," that is, "30-year Treasury bonds." As noted, NASD conduct rules provide that communications "should not overstate the relative safety offered by a CMO." The reason Herbst was comparing the Tecnoconsult Accounts' performance to 30-year Treasury bonds was that he had previously advised Gonzalez that the objective of the GNMA accounts that Herbst had established for him was to achieve 30-year Treasury bond returns using 7 to 10-year paper. Herbst and Schwaeber explained the disappointing rates of return on the Tecnoconsult Accounts by stating that in 1994, Tecnoconsult had invested at the height of the bond market.

On August 5, 1994, Herbst sent Zerpa a reassuring letter concerning the Tecnoconsult Accounts:

"As per our recent meeting, I would estimate our current yield on the combined Tecno portfolio over the next 4-5 years of approximately 8-10% per year."

Given the large undisclosed losses in the Tecnoconsult Accounts, this statement was incomplete, false, and misleading.

After Zerpa learned about the losses with respect to the Credit Suisse derivative, he delivered a memorandum to Cowen on December 21, 1994. In it he set forth a "GUIDELINE FOR PORTFOLIO": (a) Midterm to short term instruments fixed income. Stay within the GNMA/FNMA/CMO/IO family of instruments; (b) Low risk instruments with stable yields." Respondents attempted to characterize the direction in (a), above, as proof that Zerpa then knowingly authorized the purchase of risky CMOs and IOs. Instead, the memorandum demonstrates that as of late December 1994 Zerpa still believed, consistent with what he had been told at the August Meeting, that CMOs and IOs were "low risk instruments with stable yields," a description which he believed was applicable to the entire family of instruments, including CMOs and IOs, identified in (a). Any doubt is eliminated by Zerpa's presentation of the same "guidelines" in his December 28, 1994 memorandum to Gonzalez, which he summarized as follows: Fixed income instruments with low risk and stable yield: To stay within the family of GNMA, FNMA, CMO, or I/O.

Herbst's scheme began to unravel in late December 1994. Zerpa discovered the true nature of the Credit Suisse derivative on December 20, 1994, the day prior to maturity. In addition, Cohen fired Schwaeber on December 23, 1994 allegedly due to a loss to the firm's trading account in connection with two controversial transactions in the Tecnoconsult accounts which were subsequently cancelled.

Although fired by Cohen on December 23, 1994, Schwaeber continued for some time to work as Herbst's assistant. In late December 1994, Schwaeber obtained prices from a dealer for two mortgage-backed derivatives that he had purchased in the Spring of 1994 and learned that the bids he was getting on these securities were as much as 50 percent less than where they were priced in the account statements. Schwaeber related this information to Herbst and also told him that the inverse floaters, 115SA, and 110S probably held prices somewhere in the high 30's or low 40's which Cowen was pricing in the 90 or 92 range. Schwaeber went on to tell Herbst of his general concern about Cowen's ability to maintain a business where they were grossly mispricing securities as well as his particular situation regarding Cohen.

On December 29, 1994, Schwaeber asked Stu Alper ("Alper"), a Cowen employee, to sign the December 1994 Price Change Request Form. Alper called Schwaeber aside and said that he had checked some of the prices and he knew the prices were incorrect. Alper refused to sign the December Price Change Request Form. Schwaeber next approached Dana Lerch ("Lerch") to sign the Form, and Lerch's response was an adamant refusal.

On January 4, 1995, Bob Mann, the head of Cowen's internal audit department, sent a memorandum to Schwaeber containing twelve questions regarding CMOs and CMO pricing in connection with an examination that the NYSE was conducting at Cowen. Herbst, who received a copy of the memorandum, told Schwaeber to draft answers to the questions and then meet with him to discuss them, which he did. The handwritten notes on the document are Schwaeber's and reflect Herbst's changes to Schwaeber's draft answers, as well as answers for questions for which Schwaeber had not provided a draft answer. In particular, in response to the question

"How much of the CMO inventory is not priced by an outside source," Herbst told Schwaeber to answer, "None", which Schwaeber's handwritten notes disclose. This answer was not truthful because Schwaeber had been pricing a substantial portion of the CMO inventory internally. Such answer was false. Schwaeber told Herbst that he was not comfortable answering that question as Herbst requested. Immediately after that conversation, Schwaeber left Cowen.

After the events of late December 1994 and early January 1995 relating to Zerpa's discovery of the Credit Suisse derivative and Gonzalez's complaints to Herbst on that subject, Gonzalez began to take a hard look at the other securities in the IFG and Tecnoconsult Accounts. By letter dated January 25, 1995, Gonzalez requested that Herbst provide him with information concerning eighteen securities disclosed in the December 1994 IFG Account statement that were not GNMA's. In that same letter, Gonzalez asked Herbst whether the securities listed under the heading "Corporate Bonds" represented "the same quality as my GNMA investments." Herbst gave no response to Gonzalez's January 25 letter.

At Gonzalez's direction, Herbst began selling the non-GNMA's in the portfolio in January and February of 1995. Gonzalez's position throughout that year was that these were unauthorized purchases and that the securities were unsuitable for the IFG and Tecnoconsult Accounts because they involved undisclosed levels of risk that were much higher and were not appropriate for accounts whose investment objectives were income with safety. Accordingly, it was Gonzalez's position that Cowen should sell these securities, or take them over itself, and bear any losses sustained.

When Gonzalez could not obtain information from Herbst concerning the non-GNMA securities in the IFG and Tecnoconsult Accounts, he retained Vogt to provide him with such information. Gonzalez provided Vogt with IFG and Tecnoconsult Account statements, after which he met with Vogt for the first time on February 14, 1995. Until that meeting, Gonzalez had no understanding of the nature, characteristics, or risks associated with mortgage-backed derivatives, other than the fact that the values of many of these securities had declined dramatically in the IFG and Tecnoconsult Accounts as of January 1995. Gonzalez's lack of knowledge on the subject was apparent to Vogt at this first meeting with him.

As part of his analysis of the mortgage-backed derivatives in the Accounts, Vogt prepared a sensitivity analysis in June 1995 to show how the value of the mortgage-backed derivatives in the Accounts would change in response to changes in prevailing interest rates. Vogt included the mortgage-backed securities then disclosed in the Accounts and determined, using Bloomberg pricing tables, how their prices or values would change if interest rates rose or fell from their then levels by 100, 200, and 300 basis points. This analysis demonstrated the extreme volatility and risky nature of the mortgage-backed derivatives portfolio.

Claimants' Damages

Claimants are entitled to damages as a result of Respondents' wrongful and reckless conduct relating to the derivatives, Credit Suisse Notes, RMC 93-115SA and REMIC 93-110S.

Claimants' witness on damages, Dr. Andrew Carron, a Senior Consultant at National Economic Research Associates ("Dr. Carron"), testified to assess the damages that Claimants had sustained in the non-GNMA portion of their portfolios with Cowen. Dr. Carron first analyzed each non-GNMA security purchased for the IFG and Tecnoconsult Accounts and their performance over the entire period. Based upon this analysis, Dr. Carron prepared two compilations with respect to these securities. The first includes only those non-GNMA securities on which Claimants sustained a loss as set forth below. The second includes all non-GNMA securities that were in the Accounts, including those on which the Claimants realized a gain.

For each security in each such compilation, Dr. Carron set forth (1) the purchase price, (2) the total interest received on the security as credited to the Accounts from time to time, (3) the total principal received as credited to the Accounts from time to time and (4) the price received upon sale of the security. By adding the total interest received, the total principal received and the sales price, and subtracting that sum from the security's purchase price, Dr. Carron computed a capital profit or loss for each security. Dr. Carron also determined the cost of carrying the security in Claimants' Accounts by computing the portion of the margin interest charged by Cowen, as disclosed on Claimants' Account statements, which was associated with each security. This, as discussed below, enabled Dr. Carron to compute an investment profit or loss for each security in Claimants' Accounts.

Dr. Carron also aggregated each of the categories described above for each of the three Accounts in order to calculate total "capital" and "investment" losses sustained on the non-GNMA securities in each of the Accounts. Dr. Carron's computations, both on a security-by-security and on an aggregate basis, form the raw material for Claimants' damages presentation as set forth below.

The Credit Suisse Derivative

Claimants sustained actual out-of-pocket losses on the Credit Suisse derivative which was purchased in November 1993 at an aggregate purchase price of \$3,525,275, and at maturity, 13 months later, was redeemed at an aggregate of \$961,860. While the derivative was in their Accounts, Claimants received an aggregate of \$262,246 in interest. Accordingly, they incurred an actual out-of-pocket loss on the amount they invested in the derivative (giving Respondents credit for interest received) of \$2,301,169 (\$3,525,275 - \$961,860 - \$262,246 = \$2,301,169). The details of the losses in the IFG and Tecnoconsult Accounts are as follows:

	<u>Purchase Price</u>	<u>Total Interest Received</u>	<u>Sale Price</u>	<u>Net Loss</u>
IFG	\$1,300,275	\$ 96,696	\$354,660	\$ 848,919
Tecnoconsult	\$2,225,000	\$165,550	\$607,200	\$1,452,250
<u>Totals:</u>	<u>\$3,525,275</u>	<u>\$262,246</u>	<u>\$961,860</u>	<u>\$2,301,169</u>

Associated margin interest in both accounts totals \$179,866 which amount, when added to the \$2,301,169 net loss, totals \$2,481,035.

110S and 115SA

Claimants sustained actual out-of-pocket capital losses on 110S and 115SA (giving Respondents credit for interest and principal payments received) of \$1,319,953 (\$430,458 for IFG + \$889,495 for Tecnoconsult = \$1,319,953). The actual net loss sustained by IFG is as follows:

	<u>Purchase Price</u>	<u>Interest Received</u>	<u>Principal Received</u>	<u>Sale Price</u>	<u>Net Loss</u>
110S	\$2,429,603	\$213,350	\$937,654	\$ 871,691	\$406,908
115SA	<u>\$ 245,210</u>	<u>\$ 28,111</u>	<u>\$ 32,343</u>	<u>\$ 161,206</u>	<u>\$ 23,550</u>
<u>Totals:</u>	<u>\$2,674,813</u>	<u>\$241,461</u>	<u>\$969,997</u>	<u>\$1,032,897</u>	<u>\$430,458</u>

The actual net loss sustained by Tecnoconsult is as follows:

	<u>Purchase Price</u>	<u>Interest Received</u>	<u>Principal Received</u>	<u>Sale Price</u>	<u>Net Loss</u>
110S	\$4,788,028	\$423,919	\$1,796,072	\$1,749,194	\$818,843
115SA	<u>\$ 735,631</u>	<u>\$ 84,334</u>	<u>\$ 97,028</u>	<u>\$ 483,617</u>	<u>\$ 70,652</u>
<u>Totals:</u>	<u>\$5,523,659</u>	<u>\$508,253</u>	<u>\$1,893,100</u>	<u>\$2,232,811</u>	<u>\$889,495</u>

Associated margin interest in both accounts totals \$625,913 which amount, when added to the \$1,319,953 net loss (\$430,458 + \$889,495), totals \$1,945,866.

However, Claimants are not entitled to an award for the full amount of the losses sustained in 110S and 115SA. The non-GNMA investments began in January, 1993. Over the course of the next two years, some 60 non-GNMA investments, including 110S and 115SA, were purchased in the Accounts. The descriptions of these securities differed from the description of the GNMA investments and should have alerted those persons reviewing the monthly statements to inquire about these investments. Also, there was serious concern on Claimants' part about the rate of return on the Accounts prior to the August Meeting. In August 1994, Claimants and Respondents calculated differing rates of return on the Accounts, which should have led to an in-depth inquiry. They were not galvanized into action until December 1994 and they became more focused on the non-GNMA area of the portfolio only in January 1995. Claimants should have taken prompt action to inquire further about the positions in 110S and 115SA after the August Meeting. In view of Claimants' affirmative obligation to timely object and their duty to mitigate damages, the award of damages with respect to 110S and 115SA is reduced to \$1,362,106 from \$1,945,866.

Accordingly, Claimants are awarded damages for losses on the Credit Suisse derivative in the sum of \$2,481,035, and for losses on 110S and 115SA in the sum of \$1,362,106, for a

total award of \$3,843,141, jointly and severally against Respondents Cowen & Company and Edward I. Herbst.

The claims against Respondent Joseph M. Cohen and Supervisors 1-5 and all other claims are dismissed in their entirety.

This award determines all motions reserved for decision at the hearing.

Pre-Award Interest

Claimants are entitled to award interest on the damages awarded at the rate of 6% per annum from October 1, 1995 to the date of payment of the award.

Attorneys' Fees, Costs and Expenses

Claimants are entitled to recover the attorneys' fees, costs and expenses, excluding forum fees and arbitrators' compensation, which they incurred in prosecuting this proceeding. See, *PaineWebber Inc. v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996). The panel awards a total of \$850,000, without interest, to Claimants as and for attorneys' fees, costs and expenses.

Punitive Damages

This is an appropriate case for punitive damages. See, *Mastrobuono v. Shearson Lehman Hutton Inc.*, 514 U.S. 52 (1995). The panel awards punitive damages in the sum of \$200,000 against Respondent Edward I. Herbst, individually, payable to the Claimants, for the unauthorized purchase of the Credit Suisse derivative; for failing to disclose to the Claimants that the derivatives were volatile and risky instruments; for withholding from Claimants material and relevant information concerning the April 21st Memorandum thereby depriving Claimants of the opportunity to make an informed decision whether to mitigate Claimants' losses; and for intentionally mispricing and not marking this derivative and the other derivatives to market which resulted in the overstatement of the value of Claimants' Accounts.

AWARD

After considering the pleadings, the testimony and the evidence presented at the hearing and post hearing submissions, the undersigned arbitrators have decided in full and final resolution of the issues submitted for determination as follows:

1. That Respondents Cowen & Company and Edward I. Herbst are liable jointly and severally and shall pay to Claimants the sum of \$2,481,035, plus simple interest at the rate of 6% per annum, from October 1, 1995 to the date of payment of the award, for the losses on the Credit Suisse derivative;
2. That Respondents Cowen & Company and Edward I. Herbst are liable jointly and severally and shall pay to the Claimants the sum of \$1,362,106, plus simple interest at the rate of 6% per annum, from October 1, 1995 to the date of payment of the award, for the losses on the 110S and 115SA derivatives;
3. That Respondents Cowen & Company and Edward I. Herbst are liable jointly and severally and shall pay to Claimants the sum of \$850,000, without interest, for attorney fees, costs and expenses;
4. That Respondent Edward I. Herbst is liable individually and shall pay to the Claimants the sum of \$200,000 without interest, as and for punitive damages;
5. That the claims against Respondent Joseph M. Cohen and Supervisors 1-5 are dismissed in their entirety;
6. That Respondents Cowen & Company and Edward I. Herbst are liable jointly and severally to and shall reimburse directly to Claimants interim deposits in the amount of \$14,709.02; and
7. That any and all other requests for relief not specifically identified are dismissed in their entirety.

OTHER COSTS

Pursuant to Rule 10334(a)(4), the parties agreed during the Administrative Conference, that the arbitrators were to receive, in addition to the NASD honorarium, additional compensation in the amount of \$450.00 per day per arbitrator for hearing and deliberation days. In addition, the arbitrators received compensation for travel and/or accommodations expenses, and these costs will be shared jointly by the Claimants and Respondents collectively.

Additional Arbitrator Compensation:

Arbitrator Expenses	\$16,256.95
Deliberation and Award Preparation	\$ 5,400.00
37 Hearing Days (3 arbitrators @ \$450/arb.) x 1,350.00	\$49,950.00
Total Direct Costs	<u>\$71,606.95</u>
Direct Costs /2	\$35,803.48

Claimants

Interim Deposits	\$50,512.50
Share of Direct Costs	<u>\$35,803.48</u>
Balance [to be reimbursed by Respondents]	\$14,709.02

Respondents

Interim Deposits	\$49,012.50
Share of Direct Costs	<u>\$35,803.48</u>
Balance	\$13,209.02

Pursuant to Rule 10333 of the Code, Cowen & Co. was assessed a member surcharge in the amount of \$500.00, which has been paid.

FORUM FEES

Pursuant to Rule 10332(c) and 10334 of the Code, the following Forum Fees are assessed:

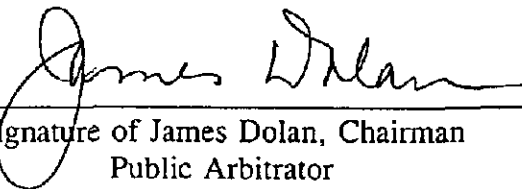
2 Pre-Hearing Conferences	x	\$ 300.00	= \$ 600.00
70 Hearing Sessions	x	\$1500.00	= <u>\$105,000.00</u>
Total Forum Fees			= <u>\$105,600.00</u>

Forum Fees are assessed to Respondents Cowan and Herbst, joint and several. Respondents Cowan and Herbst shall receive credit for their interim deposit balance of \$13,209.02; as well as Claimants' interim deposit balance of \$14,709.02, which Respondents Cowan and Herbst were ordered to reimburse to Claimants. Therefore, Respondents Cowen and Herbst have a net Forum Fee balance of \$77,681.96.

Fees are payable to the NASD Regulation, Inc. Office of Dispute Resolution.

AFFIRMATION AND CONCURRING ARBITRATOR'S SIGNATURE

I, JAMES DOLAN, ESQ., do hereby affirm, pursuant to Article 7507 of the Civil Procedure Law and Rules, that I am the individual described herein and who executed this instrument, which is my award.

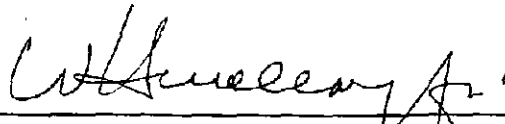


Signature of James Dolan, Chairman
Public Arbitrator

Date Decision Served by NASD Regulation: February 9, 1999

AFFIRMATION AND CONCURRING ARBITRATOR'S SIGNATURE

I, **WILLIAM H. MALLOY, JR., ESQ.**, do hereby affirm, pursuant to Article 7507 of the Civil Procedure Law and Rules, that I am the individual described herein and who executed this instrument, which is my award.

A handwritten signature in cursive script, appearing to read "William H. Malloy, Jr.", written over a horizontal line.

Signature of William H. Malloy, Jr.
Public Arbitrator

Date Decision Served by NASD Regulation: February 9, 1999

AFFIRMATION AND CONCURRING ARBITRATOR'S SIGNATURE

I, RICHARD S. PESKIN, ESQ., do hereby affirm, pursuant to Article 7507 of the Civil Procedure Law and Rules, that I am the individual described herein and who executed this instrument, which is my award.

A handwritten signature in cursive script, appearing to read "Richard S. Peskin", written over a horizontal line.

Signature of Richard S. Peskin
Industry Arbitrator

Date Decision Served by NASD Regulation: February 9, 1999