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Award

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In the Matter of the Arbitration.....

Name of Claimants

National Family Care Life Insurance Company

96-02673

Name of Respondents

Pauli & Company, Inc.

Bear Stearns Securities Corporation and

John J. "Jack" Kenny

Name of Third-Party Claimants

Pauli & Company, Inc. and

Bear Stearns Securities Corporation

Names of Third-Party Respondents

Cohig & Associates, Inc. and

Hanifen-Imhoff, Inc.

REPRESENTATION

Claimant National Family Care Life Insurance Company ("NFCL") was represented by David B. Dyer of O'Neill & Dyer of Dallas, Texas.

Respondents Pauli & Company, Inc. and Bear Stearns Securities Corporation ("Bear Stearns") were represented by L. Steven Goldblatt of Gallop, Johnson & Neuman of St. Louis, Missouri.

Respondent John J. Kenny ("Kenny") was represented by Frank Susman of Susman, Schermer, Rimmel & Shifrin of St. Louis, Missouri.

Respondents Cohig & Associates, Inc. ("Cohig") and Hanifen-Imhoff, Inc. ("Hanifen-Imhoff") were represented by Odean L. Volker of Haynes & Boone of Houston, Texas.

CASE INFORMATION

The Statement of Claim was file on June 20, 1996.

The Claimant's Submission Agreement was signed on June 21, 1996.

Respondent Kenny's Statement of Answer was filed on September 6, 1996.

Respondent Kenny's Submission Agreement was signed on September 6, 1996.

Respondents Pauli and Bear Stearns' Statement of Answer was filed on September 9, 1996.

Respondent Pauli's Submission Agreement was signed on August 13, 1996.

Respondent Bear Stearns' Submission Agreement was signed on August 13, 1996.

Claimant file a First Supplement to its Statement of Claim on July 22, 1996.

Claimant filed a Second Supplement to its Statement of Claim on September 26, 1997.

Respondent Pauli and Bear Stearns filed their Response to Claimant's Second Supplement to its Statement of Claim on October 7, 1997.

Respondents Pauli and Bear Stearns filed their Statement of Crossclaim against Cohig and Hanifen-Imhoff on September 18, 1997.

Third-party Respondents Cohig and Hanifen-Imhoff filed their Statement of Answer to the Crossclaim of Pauli and Bear Stearns on September 22, 1997.

Cohig and Hanifen-Imhoff did not execute Submission Agreements.

This case was administered under Section 10334 of the Code of Arbitration Procedure.

HEARING INFORMATION

Prehearing and Posthearing Conferences: February 27, 1997
October 24, 1997
December 11, 1997

Hearing Dates/Sessions: November 10, 11, 12, 13, 14, 1997
for two (2) sessions each day

December 1, 2, 3, 4, 5, 6, 1997
for two (2) sessions each day
and for (2) additional late sessions

January 24, 1998 for two (2) sessions

Hearing Location: Dallas, Texas

THE PARTIES

National Family Care Life Insurance Company ("National Family Care" or "NFCL", Pauli & Company, Inc. ("Pauli & Co"), Bear Stearns Securities Corporation ("Bear Stearns") and John J. "Jack" Kenny ("Kenny") were parties to litigation in the 191st State District Court of Dallas County, Cause No 95-11063-J. The District Court entered a ruling on March 12, 1996 staying the claims of NFCL against Pauli, Bear Stearns and Kenny pending arbitration.

On or about June 20, 1996, NFCL filed a Claim and Demand for Arbitration with the National Association of Security Dealers, Inc. ("NASD") against Bear Stearns, Pauli & Co (a correspondent of Bear Stearns) and Kenny (a registered representative at Pauli & Co).

During discovery, NFCL filed first and second Supplements to its claims. Bear Stearns & Pauli filed a cross action against Hanifen Imhoff, Inc. and its correspondent broker/dealer Cohig and Associates ("Hanifen/Cohig" or "Hanifen" or "Cohig" separately).

Pauli & Co. changed its name on 12/31/96 to PCIA, Inc. and transferred its assets to a successor company "Pauli Holdings L.L.C. in late 1996 and discontinued its affiliation with the NASD. The cross action was filed after Pauli & Co discontinued its affiliation with the NASD. "Pauli" or "Pauli & Co." herein is a reference to the Company named PCIA, Inc. which is no longer in business.

RELIEF REQUESTED **National Family Life Care Claims**

In its statement of claim, NFCL claims the Respondents, Kenny, Pauli and Bear Stearns received and executed trade orders from an unauthorized person (Wilson) which placed the NFCL account in highly leveraged margin positions. We understand that "admitted" assets cannot be used for margin trading by insurance companies and remain "admitted" assets without violating the Texas Insurance laws.

NFCL claims the Respondents wrongfully permitted a withdrawal of \$1,100,00.00 from the NFCL account at Pauli and failed to return this amount to Claimant.

NFCL also claims commissions, margin interest paid, and lost income from the

Respondents.

The basis for the claims are

COUNT I -- a) breach of contract because there was no authorization from NFCL to transfer the funds,

b) breach of trust and fiduciary duty, and

c) negligence and/or conversion of NFCL funds.

COUNT II For the period of trading activity, NFCL claims NFCL did not authorize margin trading in NFCL's account, and the margin trading was unsuitable. Damages claimed are trading losses, commissions and margin interest.

COUNT III NFCL requested attorney's fees and reimbursement of out of pocket expenses and fees.

NFCL, in a first Supplement to its Claim (filed on or about 7/25/97), alleged that Kenny acting in concert with Wilson, Boyd and others was a co-conspirator in a conspiracy to convert NFCL's assets to his own use and wrongfully converted \$1,333,000 of NFCL funds for his own use. NFCL requested money damages against Kenny and punitive damages of at least \$1,000,000.

NFCL in a Second Supplement to its Claim (filed on or about 9/29/97) alleged that Pauli & Co was negligent in its supervision of Kenny and other employees which negligence was the proximate cause of conversion, theft and loss of \$1.1 Million from NFCL's account at Pauli & Co.

NFCL alleges Bear Stearns is liable for failure to disclose to Pauli & Co that Kenny had become a correspondent broker/dealer in January 1995 while employed at Pauli & Co and for wiring funds to a firm (Hanifen/Cohig) where NFCL did not have an account and for failing to confirm the existence of an NFCL account at Hanifen/Cohig.

Claimant requests over \$4.4 Million which includes the \$1.1 Million transferred from its account as well as \$1,333,000 received by or for the benefit of Kenny from Claimant's account, \$570,344 for the unauthorized/unsuitable margin bond trading and at least \$750,000 in punitive damages (X213).

Pauli/Bear Stearns Cross Claim

Pauli & Co and Bear Stearns claim that \$1.1 Million withdrawn from the NFCL account at Pauli and Co. and moved to Hanifen/Cohig was an authorized transfer and an authorized loan to Robert Wilson by NFCL and in the alternative, if the transfer to Hanifen/Cohig was unauthorized, then they are entitled to indemnity and attorney's fees from Hanifen/Cohig.

Pauli and Bear Stearns claim

a) a breach of agreement by Hanifen/Cohig to deposit the transferred \$1.1 Million to a NFCL account, and

- b) negligent supervision in the transfer of funds into an account which did not exist. Pauli and Bear Stearns request indemnity and attorneys' fees for defense of the claim.

Attorney's Fees, Costs and Interest

All Parties requested attorney's fees costs and interest.

OTHER ISSUES CONSIDERED AND DECIDED

Exclusions

NFCL and Hanifen/Cohig have a pending litigation where NFCL directly asserts a claim against Hanifen/Cohig for the \$1.1 Million. That claim is not a matter in issue as Hanifen/Cohig declined to place that claim in issue in this arbitration. Therefor, the panel has not considered the matter of liability and damages between NFCL and Hanifen/Cohig, if any.

Jurisdiction

The Panel in a prehearing conference and at the hearing accepted and affirmed that they had and took jurisdiction over the Cross Claim between Bear Stearns and Hanifen/Cohig.

The Panel considered a motion to dismiss made by Hanifen/Cohig as to Pauli & Co because Pauli & Co. was not an NASD member at the time the Cross Claim was filed. The motion was denied. The panel finds that Pauli & Co being properly before the arbitration panel at the time an answer was filed remains properly in the arbitration until completion of the arbitration and is entitled to assert the cross claim in this arbitration.

GENERAL BACKGROUND & ISSUES

This dispute is but one of many pending litigations and arbitrations between one or more of the parties herein and with other parties. A common thread in the disputes is Robert Wilson whom all parties presently acknowledge as a con artist. Wilson conducted business under many different entities or names which he controlled. For clarity of presentation "Wilson" as used herein is substituted from time to time for a Wilson controlled entity.

In this dispute, Claimant, National Family Care Life Insurance Company (NFCL herein), a small Texas insurance company in Dallas, Texas, was solely owned by Robert Erwin ("Erwin") and Ms. Sandra Erwin. During the relevant period of time until Erwin's untimely death in May, 1995, Robert Erwin was clearly the operative party with respect to dealings and decisions made with Wilson. Another person involved in the dealings of the parties is Samuel Boyd, a Dallas attorney who was neither a party nor a witness in this hearing. The parties presented considerably conflicting evidence and testimony as to the matters in issue before this panel in which Wilson, Erwin and Boyd were deeply involved. While Wilson video deposition testimony was presented, it is difficult to accord much credibility to Wilson.

Basically, each party can find support in the evidence for different interpretations of the facts. It is not possible to reconcile all of the facts.

The Panel has reviewed all of the documentary evidence, testimony and the considerable circumstantial evidence presented in determining the controlling facts relative to the issues.

The matters in issue are as follows:

- 1) claim by NFCL against Pauli and Bear Stearns for unsuitability and for unauthorized trading of NFCL's account at Pauli;
- 2) claim by NFCL for transfer of \$1.1 Million in funds from Claimants account which is without Claimants' authorization and is brought against Pauli, Bear Stearns and Kenny;
- 3) third party cross-claim by Respondents Pauli and Bear Stearns for indemnity and contribution from Hanifen-Imhoff and Cohig if the \$1.1 Million in funds were transferred from the NFCL account without Claimants' authorization; and
- 4) claim by NFCL against Kenny for \$1.333 Million for funds received by Kenny from Wilson and from a trust account at Nations Bank in Dallas which was directed by Robert Wilson.
- 5) Punitive damages.

BACKGROUND & CASE OVERVIEW

Sophisticated cons or scams can require more than one person. Robert Wilson could not do the bond trading protocol scam on insurance companies without some help as well as the greed or gullibility of the mark. In this case, Wilson utilized the services of a brokerage firm (Pauli & Co) and a broker (Jack Kenny) to relieve the mark, (Claimant NFCL) of over \$9 Million in a short period of time. The focus of this arbitration is partially on the scam in respect to the NFCL claim for \$1.333 Million that Kenny received or benefited from Wilson and Boyd as wrongful conversion, partially on conduct or acts of the parties involved in the transfer of the \$1.1 Million out of the NFCL account at Pauli, partially as unauthorized purchases of bonds, and partially suitability of the margin trading.

Prior to NFCL's involvement with the Respondents in June 1994, the Respondents Bear Stearns, Pauli & Co and Kenny had information about and experiences with Wilson which should have fairly appraised them that Wilson was a person whose activities would suggest strongly that close monitoring was required. Kenny was an experienced bond broker, has a law degree and had done business with Wilson since 1987 while at Dean Witter. Kenny left Dean Witter in July 1992 bringing Wilson with him as a client to Pauli & Co.

Pauli & Co had notice that Kenny had left his prior employment for infraction of Dean Witter Rules regarding correspondence in respect to Letters of Credit which were sent without Branch Manager approval (X105). Thus, Pauli & Co should have had a heightened awareness to monitor correspondence of Kenny and exercise supervision of Kenny during his employment with

Pauli & Co. Pauli did neither.

Chris Pauli formed Pauli & Company, Inc which became a correspondent of Bear Stearns in 1989 (X212). The background of Chris Pauli prior to 1989 was extremely limited in respect to operation of a retail brokerage operation. Pauli & Co. was capitalized at \$250,000.

In October 1992, shortly after Kenny joined Pauli, Wilson, Kenny and Pauli entered into an agreement (X144, 145) that Wilson would acquire an interest of about 22% in Pauli & Co. for \$750,000 Cash; invest over \$10 Million in an equity loan to Pauli with Kenny being placed on the Board of Directors; there would be a bond trading program with a split of profits; and Wilson would provide Pauli & Co with a credit facility of \$40 Million. Closing was set for November 25, 1992. It never happened.

Next in November 1992, Wilson proposed with Kenny and Pauli & Co. a \$5 Million Canadian bond stripping program in connection with Bear Stearns (X141, X142). While this transaction was being considered, Pauli and Wilson worked on a deal (on November 23, 1992) for Pauli to offer \$100 Million of a Wilson Equity offering (X144). This was discussed with Bear Stearns on December 1, 1992 and outlined in a memo December 3, 1992 (X144, X146).

Wilson made another run at Pauli in December 1992 by offering to lend Pauli & Co. \$11 Million and said he would go ahead with the loan (X147, X148) but then he said he wanted return of 25,000 shares of D&K stock (worth about \$100,000) on deposit with Pauli (X148). Pauli did not return the stock and instead issued a personal promissory note payable by Chris Pauli for \$100,000 to Wilson (X55). The Wilson loan to Pauli did not occur and there wasn't any repayment of the note by Chris Pauli.

In February 1993, Kenny queried Bear Stearns if Wilson could margin 1.650 Million shares of North American Stock where 25-30% would be sold for cash distribution (X149). (North American Stock was a low priced, low quality stock.) This apparently didn't happen. Later, in March, Kenny advised Bear Stearns that Wilson had sold 150,000 shares of North American from the account (X149). In May 1993, Kenny sent Bear Stearns an example of yield curves for Canadian Bonds relative to stripping and selling coupons (X143). In October 1993, Bear Stearns notes reflect conversations and a Kenny fax dated October 5, 1993 concerns Mexican Bonds that they did not recognize. This was prior to November 1993, when Wilson had Kenny authorize a Wilson associate to bring \$600 Million worth of Mexican Bonds into the U.S. (X150). Upon return into the U.S., Bear Stearns refused to hold the bonds despite Kenny's request (X150). It was suggested that Kenny call the FBI which Kenny did and the bonds were confiscated by the FBI.

Kenny had a rubber stamp with his signature. Some of the documents in his case bear a rubber stamp signature. It can never be established for certain that such a stamped signature was with Kenny's direction or not. We understand the notarized letter of authority dated November 1, 1993 to bear a stamped signature of Kenny. (See also X41, X42, X43). We deem it a

dangerous practice for a broker to have a signature rubber stamp for use on broker stationery.

In January 1994, Pauli & Co put a hold on Wilson accounts managed by Kenny because of some questionable trades (X151). Wilson wrote C.S. First Boston in January to explain the sale of restricted stock of North American Technology and to reverse a trade (X152). In February 1994, the S.E.C. requested documents in connection with trading activities of Wilson, Peter Dale (an associate of Wilson) and Vollins (referred to in Wilson's letter X152) of securities including North American Technologies (X153). Chris Pauli had Kenny execute a promissory note for return of commissions of \$16,528 for the Wilson sale of North American stock to First Boston if the trade was bad (X154).

With respect to Erwin, he was a successful businessman who had accumulated considerable wealth principally through the insurance business of NFCL and had a substantial income in seven figures. In early 1994, Wilson and Erwin had met and had discussed participation deals in proposed bond issues and acquisition of at least one insurance company (Coastal States) which would involve substantial financial returns to Erwin. We note that Erwin first invested \$750,000 with Wilson which found its way into Boyd's Trust Account on April, 1994 and was not recovered (X203, X119).

We find that this type of dealing was a motivating and principal focus of Erwin in his relationship with Wilson which continued even into 1995. Wilson, by all accounts, exuded an aura of wealth and expertise in the issuance and trading of bonds on an international scale. In our view, Erwin was an ambitious experienced risk taker but not at all knowledgeable in bond trading or bond issuances.

In March through May of 1994, apparently independent of Pauli and Kenny, Erwin's (NFCL) notes reflect numerous calculations on financial "deals" contemplated with Wilson. In one note dated 4/12 the trading profits of \$2,169,672 and interest of \$522,000 are recited which substantially correspond to numbers in the SEC 10K report of North American (X332.9, X332.20, X222). For that matter, the Erwin notes reflect numerous notations suggesting pending and proposed "deals" for 1994 and up to the untimely death of Erwin in May, 1995, none of which happened. There is scant, if any, reference in Erwin's notes to any trading activity of the bond trading protocol.

Wilson also touted Erwin to invest NFCL "admitted" assets in the bond trading protocol where the protocol, if followed and if properly collateralized, would enable trading while maintaining the character of the assets consistent with Texas insurance laws prohibiting margin trading. It would be a no-lose proposition for NFCL. According to Wilson and the expectations of Erwin, substantial profits (well over 10%) could be made and Wilson and Erwin would personally split the profits over 10% which could be a violation of the insurance code. Erwin, at a meeting at NFCL in May 1994, announced he would commit NFCL assets to the bond trading protocol of Wilson. Boyd (a lawyer for Wilson) and DeLeon (a lawyer for NFCL) were instructed to work out the details. (Previously, on April 29, 1994, Wilson gratuitously bought

the mortgage on Sam Boyd's residence (X209)). Boyd recorded the instrument on August 8, 1995. We have no difficulty in finding that Boyd at all material times acted on behalf of Wilson or for himself and was not legal counsel for NFCL. The protocol involved cashing in CD's held by NFCL and transferring the funds to a NFCL account at a bank or security firm where the protocol would be implemented.

In the initial period of initiation of the bond trading protocol for NFCL, Wilson utilized the services of Sam Boyd, the Dallas based lawyer. Boyd's function was to be the Trustee of an NFCL account at Mark Twain Bank in St. Louis, Missouri. NFCL established a NFCL account at Mark Twain Bank with \$4 Million to purchase Treasury securities. Securities were purchased for the NFCL account and NFCL was scheduled to borrow funds against Treasury securities in the NFCL account. NFCL would then loan the borrowed funds to the Boyd NFCL Trust account at the Bank. The NFCL loan to the Boyd Trust account would be pursuant to a 90 day note collateralized at 120% with Government Securities owned by Wilson. The loaned funds in the separate Boyd Trust account then would be utilized by Wilson in the profitable trading program operated by Wilson. (See X405, X128). Insurance regulatory counsel for NFCL, Hector DeLeon advised Mark Twain Bank that the bond trading protocol or program as so structured, was permitted under the Texas Insurance Code (X126).

Somehow, the above initiation was never completed at the Mark Twain Bank because the bank did not sign the Agreement which acknowledged receipt of the collateral from Wilson for the Boyd Trust account. Wilson told Erwin that the Bank's leverage on margin trading of bonds was too low and instead they would use Pauli and Bear Stearns.

Wilson then brings in Kenny and Pauli and Co. as the investment institution with Jack Kenny as the Broker. As stated above, Pauli and Company is a thinly capitalized firm and is a correspondent of Bear Stearns; and Wilson has a long standing prior relationship to Kenny. Erwin and his wife Sandra on June 7, 1994 also gave discretionary trading power in their respective personal IRA accounts which also were opened at Pauli by Kenny (X127).

Boyd also had separate Trust accounts at Pauli which Kenny had opened for him. The same Protocol was to be followed with separate Boyd Trust accounts at Pauli & Co.

NFCL executed a Bear Stearns' customer agreement on June 6, 1994 and Kenny opened a margin account in the name of NFCL on June 13, 1994 for an initial deposit of \$7.8 Million Government bonds and cash (X6). The margin account was required because NFCL had to margin Treasuries in the account to get funds to loan to the Boyd Trust Account at Pauli where the loan proceeds would be collateralized.

Various documents were generated in a short period of time including NFCL Board of Director minutes on June 13, 1994 relative to fund transfers (X8), retyped Board of Director minutes on June 22, 1994, a guaranteed note from "Wilson" to NFCL dated June 14, 1994, a "Wilson" letter of credit to NFCL issued June 14, 1994, a letter of authorization proposed by

Kenny for Erwin dated June 14, 1994 authorizing Bear Stearns to transfer cash and funds from the NFCL account to the Sam Boyd Trustee account at Pauli & Co., an edited Certificate of Corporate Secretary dated June 14, 1994 authorizing trading authority in the NFCL account to Erwin, his wife Sandra, and Clyde Tullis, President of NFCL, and irrevocable Instructions dated June 15 were issued by NFCL to Sam Boyd and acknowledged by Kenny (X405).

Despite all of this documentation, it is clear that the only active NFCL account at Pauli & Co. relative to NFCL was an initial NFCL "margin" account opened by Kenny. While this account was intended to borrow funds to loan to the Boyd Trust account, it was not intended by NFCL to be a margin trading account in which bond trading would be conducted.

The protocol, as set forth in detail hereafter, was supposed to operate on a quarterly basis ending June 30, Sept. 30, Dec. 30, March 30 and so forth. At the end of each quarter, the protocol required the assets in the NFCL account to be "free and clear" for Texas insurance regulatory purposes. This required repayment of a 90 day note for the loaned funds and re-issuance of a new 90 day note.

In late June 1994, Boyd faxed Kenny a cursory summation letter from a lawyer acquaintance of Erwin broadly stating that the protocol was approved and that he could start trading on July 1. Wilson never deposited any collateral with Pauli with respect to NFCL.

In July, another series of documents were issued for the quarter ending September 30 including: a guaranteed note for the Boyd Trust account issued by "Wilson" on July 20 (X405); "Wilson" issued NFCL a letter of credit (X405); and NFCL and Boyd signed Irrevocable Instructions for the Boyd Trust Account (X405). Kenny told Erwin that Bear Stearns refused to transfer funds to a third party as requested in the Kenny drafted letter dated June 14, 1994 to Bear Stearns from NFCL (X129). Kenny told Erwin there was another way "to skin the cat" and to accomplish the transfer and that was by transfer to the Boyd Trust Account in Dallas. (Ms. Erwin testimony on 12/3/97). Thereafter, a month later, on July 22, 1994 Kenny sold substantially all of NFCL bonds in the NFCL account and NFCL began transfer of funds to Sam Boyd's Trust Account in Dallas via Town North Bank in increments through October 26, 1994. Thus, by October 26, NFCL transferred substantially all of its funds in the Pauli account to the Sam Boyd Trust Account in Dallas and the NFCL account was left with \$10,000 in cash. NFCL claims the fund transfers were directed by and at the instructions of Wilson for implementing the Bond Trading Protocol through the Boyd Trust account at Nations Bank. The respondents claim the transfers were personal loans to Wilson. It is important to note that Kenny never raised any question why the funds were not transferred back into the Sam Boyd Trust account at Pauli.

On July 28, 1994, Erwin gave Wilson an unlimited power of attorney to acquire Coastal States Life Insurance Co. (X312). As discussed above, this was an important factor to the Erwin/Wilson relationship.

From July through October 1994, active margin bond trading of over \$400 Million occurred in NFCL margin account at Pauli. This generated huge commissions of about \$260,000 for Kenny and Pauli, income to Bear Stearns and about \$218,000 of margin interest charges to NFCL. NFCL claims the margin trading was not authorized. Pauli and Kenny claim that each trade was made after discussion with Wilson and Erwin.

Of note is the matter of two bogus or fake confirmations purportedly issued by Bear Stearns for Pauli to NFCL, one dated 9/27/94 which is accompanied by a Bob Wilson FAX sheet dated 10/13/94 (X54) and one dated 9/26/94 accompanied by a Bob Wilson fax sheet dated 10/25/94. No party claims any knowledge as to the source or purpose of the confirmations. But, they occurred at the same time that Kenny opened a cash account at Pauli with the same account number as listed on the fake confirmations (X23). There was no activity in this account.

In any event, the fund transfer of NFCL to Boyd's Trust account were completed in October 1994 and NFCL wanted an exculpatory letter from Pauli on the prior margin trading in the NFCL account from July through October.

NFCL had complained to Wilson about the margin trading in the NFCL account as it occurred and Wilson had said he would take care of it each time. Tullis wrote a letter for Kenny to send to NFCL which would explain the "erroneous" margin trading in the NFCL account (X25). Kenny and/or Wilson revised the letter (X24) and by fax coordinated with Wilson (dated November 15, 1994) which differed from the Tullis letter.

Tullis wanted Kenny to state the securities were "free and clear" and had been combined in another account and that NFCL transactions were all cash transactions (X25). The signed Kenny letter sent to Tullis (pre-approved by Wilson) did not say "all cash transactions" or "free and clear" and stated the

"Euro America's (Wilson) investment adviser gave erroneous instructions to me thereby causing margining of securities that were supposed to be done in the Euro American account rather than in National Family Care's account. This problem was discovered and straightened out as of "October 31, 1994". (X27)

At the hearing, Kenny characterized the statement in the letter he signed as untrue.

Peter Dale (an Associate of Wilson) of Euro Scotia (Wilson) in a letter dated November 15, 1994 to Tullis regarding the "Euro American Insurance Company Loan" apologized for the erroneous instruction given by them (Wilson) to Pauli and Company which caused margin activity to take place in the NFCL account where it should have been in the Euro Scotia account (X28). This unrequested letter is a clear admission of Wilson directed trading of the NFCL account.

By letter dated November 30, 1994, Wilson advised Tullis that "pursuant to the terms of the secured note" Euro Scotia held specified bonds in U.S. treasuries 'free and clear' of any encumbrances for the benefit of National Family Care Life Insurance Company" and advised that they would pay off the note in full plus interest in December 1994 and the Treasuries listed in the letter would be returned to the NFCL account at Pauli (X106).

Wilson periodically received funds from the Boyd Trust account at Nations Bank in Dallas and disbursed funds therefrom for his benefit and expenses.

During the period from July 20, 1994 through January 1995, Kenny received and/or benefited from disbursement of \$1.333 Million from the Sam Boyd Trust account at Nations Bank in Dallas and from Wilson's account. Among the uses were \$913,000 to purchase the Nickolson Group for Kenny while he was a Pauli employee and \$250,000 deposit to Bear Stearns for Kenny Securities, a brokerage firm opened by Kenny while he was still a Pauli employee (X204).

For the Quarter ending December 30, 1994, Wilson executed a Note, a guarantee and a collateralized Letter of Credit for \$11.2 Million. Also, at the year end, Wilson deposited \$125,000 and \$1,000,000 in cash into the NFCL account at Pauli.

With the above funds, \$11,400,000 bonds were bought on margin in the NFCL account at Pauli on 12/30/94 (X31) and NFCL was notified by Kenny that a \$11,400,000 note (sic bonds) was in the NFCL Account 914-03841-1-7 without written reference to the margin purchase (X33). There is conflicting testimony whether NFCL authorized a margin purchase. A confirmation was mailed by Bear Stearns to NFCL.

On January 3, 1995, Bear Stearns made a maintenance margin call for \$85,000 to NFCL on the margined bonds and thereafter sold the bonds.

During the same time period, the year end of 1994 (Dec. 14), Pauli and Kenny opened a new margin account 914-03919 (on his own signature) and deposited funds of United States Insurance Employer Consumer Self Insurance Fund of Florida (X158)(USEC/FLA). Nicholson/Kenny Capital Management, Inc. entered into a discretionary trading agreement with USEC/FLA (X160). In an undated but next following account number 914-03920, Kenny opened a margin account for United States Employer Consumer Self Insurance Fund of North America (USEC/NC) with discretionary power to trade in the account (X159). In a Bear Stearns Trading Authorization for USEC/FLA and USEC/NC, Kenny answers "No" that he was not associated with any broker dealer (See X162, X163).

There was an immediate flurry of trading activity in the USEC/FLA and USEC/NC accounts which was short lived. On 12/23/94, USEC/FLA transferred most of the cash to Wilson but retained a \$7 Million bonds on margin (X164). On December 30, 1994, Kenny advised Wilson that USEC/NC account 914-03920 deposited \$1 Million and on 1/3/95, \$700,000 would be wired to Wilson (X166).

On January 3 and 4, 1995 USEC/FLA got margin call (X168). On January 6, 1995, the \$7 Million bonds in margin was cashed and the proceeds transferred from the account (X171). Then, Kenny notified USEC/FLA there was "no margin position". (X167)

On January 10, 1995, Kenny advised USEC/FLA and USEC/NC that bonds "will be transferred" into their accounts (X169). USEC/FLA advised Kenny by letter dated January 10, 1995 that purchase or sales required their prior approval (X170).

Returning to NFCL, in the period of January 18-20, frantic activity occurred between Wilson, a Wilson associate ("Baker"), Cohig and Kenny at Pauli to transfer \$1.1 Million from the NFCL account at Pauli to a Wilson Associates account at Cohig. But -- there is no documentary evidence that NFCL had a Cohig account or that NFCL ordered Kenny to transfer the funds. Basically, Kenny initially gave the account number of the Wilson associate (Baker) at Cohig and the NFCL name in the initial wire transfer. When there was no corresponding number and name at Cohig, substantial communication occurred. Through mutations in the communications, including Kenny and Cohig, the account number never changed but a name sufficiently close to the name of the account of the Wilson Associate at Cohig was arrived at where Cohig accepted the funds and the NFCL funds went to the Wilson associate account. About a week later, the Wilson associate transferred the funds by assignment at Cohig to Wilson.

NFCL claims there was a wrongful transfer of NFCL funds from the NFCL Pauli account to Cohig while Kenny, Pauli and Bear Stearns claim it was an authorized transfer and reflected a loan authorized by Erwin to Wilson. The Respondents also argue ratification by NFCL. NFCL officers testified they were surprised when they heard of the transfer and Erwin said he would handle the matter. After the fund transfer, Wilson provided NFCL with a collateralized note for \$1.1 Million. Bear Stearns further claims its transfer was an administrative clearing house function and that it followed Pauli's initial transfer instructions and was not further involved or liable for the transfer.

Bear Stearns and Pauli claim that, if the transfer was not authorized, they are entitled to indemnity from Hanifen/Imhoff and Cohig for accepting and depositing funds in a wrong account. Hanifen/Imhoff, the clearing house for Cohig, claims it received the money as a clearing house, raised the question with Cohig as to instructions for deposit and accepted the Cohig instructions to deposit into the Wilson associate account which is a clearing house function. Hanifen/Imhoff claims Cohig is responsible for the instructions, if the instructions are in error. Cohig claims the transferred funds went correctly into the account designated by Kenny and Pauli.

NFCL also seeks recovery of the \$1,333 Million disbursed to Kenny or for his benefit. Kenny's position is that the funds were loans or advances made to him by Wilson, he did not know the source of the funds and that he also was a victim of Wilson. No repayments were ever made by Kenny on the Wilson loans to Kenny. Note documents by Kenny to a Wilson entity

(which turned out to be non-existent) were executed in 1995 and back dated to 1994 (X102, X103). After the making of the "loans", Kenny testified and produced documentation to the effect that he was negotiating the loan terms with Wilson after the loans had been made.

A STATEMENT OF FACTS

In the interest of completeness, the panel hereinafter sets forth detail of additional facts in a chronological order together with additional findings of the Panel:

May 1994

On May 6, 1994, Kenny opened, on his own signature, a Bear Stearns account 914/03843-1-5 for Samuel L. Boyd P.C. U/A/D Euro American account designation "NFC" (X123). On the same date, a Revocable Trust Agreement was established by Euro American to transfer property to Boyd Trust Account #914-03843 at Bear Stearns (X124). On May 10, 1994, Boyd as Trustee of Boyd Trust (U/A/D Euro American Insurance) Acct. #914-03817 at Bear Stearns gave Robert Wilson power of Attorney over it (X2).

By letter dated May 10, 1994, Boyd transmitted an explanation of the bond trading protocol, guaranteed note, irrevocable instructions and corporate letter of credit to Hector DeLeon, insurance Counsel for NFCL (X122). The explanation advanced by Boyd was that (1)

NFCL would convert its CD's into U.S. Treasury bills, notes or bonds. This would be done by opening an account with Pauley (sic Pauli) a correspondent of Bear Stearns where the Treasury bills, notes or bonds ("bonds") would be maintained in an account owned by NFCL. (2) NFCL would borrow (margin) 80% to 85% of the face amount of the "bonds" in its NFCL account. (3) NFCL would loan the proceeds of the margin borrowing to Euro American (Wilson) and (a) Euro American would provide a 90 day note which would be fully collateralized as to the principal and interest of the "bonds" in the NFCL account by (b) a corporate letter of credit from Euro Scotia Group (Wilson) fully backed by U.S. Treasury bills, bonds or notes so that NFCL's ninety day note remains a first tier asset fully backed by U.S. Treasury bills, bonds or notes.

The documents provided to DeLeon by Boyd included the following: (1) a Guaranteed Note providing that the note would be paid from a segregated account in the name of Samuel L. Boyd Trustee; repayment would be guaranteed by a Corporate Letter of Credit by Euro Scotia fully guaranteed by U.S. Treasury Bills, notes or bonds, held in a segregated account of Samuel L. Boyd P.C. Trustee with irrevocable instructions for the guaranteed repayment; (2) Irrevocable instructions to an account Holder "Samuel L. Boyd P.C. Trustee" to (a) transfer "bonds" into a designated and segregated Brokerage Account of Samuel L. Boyd P.C. Trustee for the exclusive guarantee of Euro Scotia Letter of Credit; and (b) upon service of default notice to debit the account to meet any loan default payment. (3) A Euro Scotia Letter of Credit is extended (a) to the account of the note holder for the amount of the note upon demand if a note default notice is made on Euro American and Euro Scotia; (b) Euro Scotia will deposit "bonds" equal to the Euro

Scotia obligation in a designated and segregated account of Samuel L. Boyd P.C. Trustee at a "bank" or "securities" firm; and (c) failure to honor the Letter of Credit allows the "bank" or "securities firm" to debit the account holding the "bonds."

The 90 day note would be due at the end of each calendar quarter and repaid so that NFCL would have free and clear assets in its account for reporting purposes. The process is repeated for each quarter.

Kenny, at Wilson's request, writes a letter dated May 18 to Sam Boyd to the effect that Kenny had known Wilson since 1987, that Wilson was a valued client of Pauli, that Wilson during 1993 traded approximately 250 Million in U.S. Treasury bonds (X3). There was no Pauli approval for this letter transmittal. Exactly why this letter was sent to Boyd is not clear since Kenny previously had opened a Boyd account and knew of the Wilson Power of Attorney in the Boyd account. The letter could serve to enhance Wilson's credentials to a third party. Kenny, at Wilson's request, in a letter to Wilson stated that Pauli was a correspondent of a primary dealer in U.S. Government obligations, that during 1993, "your various accounts" had transactions in U.S. Government bonds in excess of \$250 Million and that Pauli could offer \$100 Million in U.S. Government obligations (X4). Obviously, this letter from Pauli creates a mantle of respectability for Wilson. Pauli with a \$250,000 Capitalization was making a large representation. This Kenny letter was not approved by Pauli.

It was through the efforts of Boyd and Wilson, that NFCL first committed funds to the Mark Twain Bank in Saint Louis, Missouri. Whether this bank location, proximate to Pauli & Co. was a factor in the scam is not apparent but use of the bank would lend respectability to the scam. We are told that Mark Twain Bank was not used because the leverage offered there was "too low" at 5 to 1 and Wilson said 10 to 1 was preferable. Of some importance was the requirement of collateralized U.S. Treasury notes or bonds for the account which would receive the NFCL loans. There was no credible evidence that Wilson, in fact, owned any U.S. Treasury bonds free and clear for collateral purposes. In fact, the Wilson balance sheet reflected "trade credits" of several million dollars which turned out to be characterized as "third tier credits" which had no value as collateral. The trade credits were "purchased" by Wilson in Europe and the CPA furnishing the Wilson report notified Bear Stearns and Pauli & Co. of the failure of the trade credits in June 1994. Thus, Bear Stearns, Pauli & Co. and Kenny, in the course of business, should have been fairly appraised that Wilson had a questionable balance sheet.

On or about May 26, 1994, Wilson, Boyd and NFCL executed documentation (Guaranteed Note, Letter of Credit, Irrevocable Instructions) (X405, X128) to initiate the bond trading protocol with \$4 Million at the Mark Twain Bank in St. Louis, Missouri. NFCL deposited funds into an account in their name, and DeLeon (counsel for NFCL) advised Mark Twain that the protocol, if followed, would be proper under Texas Insurance laws (X126).

DeLeon's letter does not follow the Boyd outline of May 10 in that DeLeon would have the "bonds" deposited in the Mark Twain Bank as an NFCL account and would borrow 80% of

the value of the assets from Pauley (sic "Pauli"). It would appear more consistent to have the borrowing at Mark Twain Bank. In any event, the loan proceeds are loaned to Euro American through a guaranteed note and the issuance of an irrevocable letter of credit both secured through a trust account at Mark Twain Bank in the name of Samuel L. Boyd P.C.. The Samuel L. Boyd Trust account has U.S. Treasury bills, notes and bonds. The irrevocable instructions will be issued to the bank and the bank will abide by the instructions. DeLeon stresses the bank's willingness to acknowledge and honor the irrevocable instructions² are "critical" to the proper management of the NFCL account.

The Guaranteed Note of 5/26/94 (due 29 June 1994) (X128) differs slightly from the original note (X122). The Letter of Credit dated May 27, 1994 (X128) differ slightly from the original Letter of Credit (X122). Similarly, the irrevocable instructions dated May 26, 1994 (X128) differ slightly from the original instructions (X122). These differences are consistent with the testimony that DeLeon and Boyd were instructed by Erwin to work out any differences necessary to make the "deal" happen.

As noted heretofore, this scenario failed, because Wilson elected not to deposit "free & clear" collateral in the bank. The document (X128) for the deposit of collateral is signed by Erwin and Boyd but not Mark Twain Bank.

For some unexplained purpose, "Wilson" executed a Revocable Trust Agreement dated May 6, 1994 to transfer property to "Samuel L. Boyd P.C. Trustee" in a trust account (X124). The document has a handwritten designation "914-03843" (See also X129). As stated above, the new account form for 914-03843 was opened by the sole signature of Kenny (X123).

June 1994

In June 1994, Pauli & Co. as the correspondent broker of Bear Stearns opens an NFCL margin account (#924-03841-1-7) with a typed date of June 6, 1994, with a deposit of \$7.8 Million Government bonds and cash on June 6, 1994 (Arb X5, X303.13, X303.14, X6, X7). A Bear Stearns report of opening the new account 914-03841 is handwritten as 6/13/94).

NFCL executes Board of Director minutes dated June 13, 1994 (X8). The minutes reflect a decision to open an account at Pauli and to borrow (margin) funds against the "bonds" in the account up to \$6.4 Million and to loan these funds to a distinct and separate account at Pauli of Samuel L. Boyd P.C. Trustee. The funds at Mark Twain were also to be transferred to the NFCL account at Pauli.

Erwin personally edited a Bear Stearns Certificate of Corporate Secretary dated June 14, 1994, which limited the securities to U.S. Government bonds, notes and bills and contained broad borrowing power (X9). There was considerable emphasis in the hearing on the Customer Agreement and the Corporate Certificate being to a margin account. The protocol, as understood, required a margin account for NFCL to borrow funds so as to transfer "loaned"

funds to a collateralized trust account. The margin account of NFCL was never intended by NFCL for trading on margin account. In fact, the trading was to be conducted by Wilson in the Boyd Trust Account at Pauli.

NFCL and Wilson executed documentation which appears consistent with the protocol. The documentation includes a fully executed Euro Scotia (Wilson) Letter of Credit 1003 dated June 14, 1994 (X130) and a fully executed irrevocable instructions (X130) for the management of the U.S. Treasury bills, notes, bonds and cash placed on deposit with the Samuel L. Boyd P.C., Trustee account at Pauli. The Instructions reference the Letter of Credit 1003 and Note No. 1003. Of importance is Kenny's signature for Pauli which is evidence of knowledge of the requirement to trade "bonds" for NFCL in the Boyd Trust Account at Pauli and the requirements for collateral (X130).

A key document is the letter prepared by Kenny with a date of June 14, 1994 (X129, X10) which authorized Bear Stearns to transfer cash and securities (valued at \$5.56 Million) from NFCL account 914-03841-1-7 to the Sam Boyd P.C. Trustee U/A/D 5/6/94 Euro American designated NFCL account #914-03843-1-5. This letter for Bear Stearns (to be returned by NFCL to Kenny) was not in the Bear Stearns files as a received document (ARB X5). A Certificate of Corporate authority dated June 22, 1994 was in the Bear Stearns file. Bear Stearns testified that if the June 14, 1994 letter had been received, the NFCL funds would have been transferred to a Sam Boyd Trust account at Pauli after June 22, 1994. If the Certificate of the Corporate Secretary was not in place at Bear Stearns and was required by Bear Stearns, it is and was a routine function to obtain and to provide a certificate of a Corporate Secretary for corporate authority. This Sam Boyd Trust Account would have required collateralization and Kenny knew collateralization was required.

Kenny promoted transfer of the NFCL funds at Pauli to the Boyd trust account at Nations Bank in Dallas and told NFCL that Bear Stearns refused to make a third party transfer. Bear Stearns, as a matter of policy, would make third party transfers. Obtaining a corporate certificate was in process and a simple administrative function. Kenny's explanation is not credible.

In June 1994, Pauli and Bear Stearns were advised by Jack Burke, a CPA for Wilson for a financial statement of Wilson that the Wilson Euro Scotia note for \$200 Million for the trade credits was in default and the Wilson balance sheet was reduced by \$100 Million. A Samuel L. Boyd Letter of Guarantee was not honored. The CPA then advised Boyd, Pauli and Bear Stearns that Wilson was circulating a balance sheet showing 100 Million which was not there (X155). Pauli and Bear Stearns were made aware of the default by Wilson.

Also, in June 1994, Bear Stearns retyped the Certificate of Corporate Secretary which was re-executed on June 22, 1994 (X12). On June 24, 1994, Kenny advised NFCL of \$7.78 Million in bills and notes in account 914-03841 (X13).

Initially the NFCL account merely replaced maturing bonds with other bonds (X13).

However, Boyd supplied Kenny with a letter from a lawyer acquaintance of Erwin to the extent the investment protocol proposed by Boyd met compliance requirements of Texas Insurance Laws (X302.1). In supplying this letter, Boyd advised Kenny on June 29, 1994 that "this should allow you to start trading on that account on July 1, 1994" (X14). It is clear that Kenny had notice and appreciation of what the protocol required, i.e., a collateralized loan for the NFCL account and margin trading would be in a Boyd Trust account.

Other Protocol Documents

We summarize the Protocol documents for each quarter as follows:

a) The protocol for the quarter ending September 29, 1994 included Wilson's note for \$11.2 Million dated 7/20/94; a letter of credit requiring deposit of Treasuries in Boyd's Trust account dated 7/20/94; and irrevocable instructions dated July 20, 1994 signed by Boyd and NFCL but not by Pauli.

b) The protocol for the quarter ending December 30, 1994 included a Wilson Note dated 10/1/94 for \$10,809.15 together with references to a letter of credit and irrevocable instructions.

c) The protocol for the quarter ending March 30, 1995 included a Wilson Note dated 12/28/94 for \$9,967,515.03 secured by a "security agreement" and a "power of attorney" to Erwin which permitted Erwin to seize collateral held by a Wilson Associate as trustee and was dated 12/28/94. The security agreement refers to a specific bond in the amount of \$9,968,200.88 held by the trustee at Johnston Kent Securities. This document bears a signed name of Erwin but Erwin was out of the country the last week in 1994 and the first week in 1995 and could not have executed the document on that date, if it was Erwin's signature.

An undated note for \$1.1 Million due on March 30, 1995 is accompanied by a power of attorney dated January 23, 1995 to NFCL regarding securities and a security agreement also dated January 23, 1995 referencing bonds of \$1,130,158.11 at Johnston Kent Securities to collateralize the \$1.1 Million note. The document has a signature line but is unsigned by Tullis of NFCL. This series of documents occur several days after the in fact transfer of the \$1.1 Million from the NFCL account at Pauli.

d) The protocol for the period ending June 30, 1995 includes a Note 95156 due June 30, 1995, a power of attorney dated March 30, 1995 and a security agreement referencing a bond at \$11,605,031.25 held in trust at Johnston Kent Securities.

e) The protocol changed form after December 30, 1994 to a security agreement and a power of attorney and a referenced security agreement. The \$1.1 Million transfer of funds became included in note documents only after the, in fact, transfer to Wilson had been accomplished. We are persuaded by the evidence and the testimony that Erwin believed almost to the end that Wilson had the Treasuries to produce not only the NFCL funds but also enormous profits on the accounts.

July 1994

Returning to July, on July 19, 1994, Kenny provided Wilson with a letter stating that Wilson had accounts in excess of \$70,790,150 in the form of cash or securities (X15). On July

22, 1994, the bills and notes positions in the NFCL account 914-03841 (with the exception of the \$1 Million Bills due 10/31/94 and another \$1,020,000 bills due 12/15/94) were sold and heavy short term trading in bonds commenced (X50). On the same day, July 22, 1994, NFCL withdrew \$5 Million and transferred the funds to the Samuel L. Boyd Trust Account at Nations Bank in Dallas, Texas (X37, X38). Kenny faxed Tullis a detailed portfolio Appraisal dated 7/21/94 (X16).

Thereafter, authorized transfers by NFCL through its bank account at Town North National Bank to the Sam Boyd Trust Account at Nations Bank in Dallas, Texas were made as follows:

08/12/94 =	\$1,000,000	(X37,X38)
08/22/94 =	\$ 800,000	(X37,X38)
09/06/94 =	\$1,200,000	(X37,X38)
10/20/94 =	\$1,250,000	(X37,X38)
10/26/94 =	\$ 250,476.58	(X37,X38)

It was argued by the Respondents that the \$5 Million and other amounts were a personal "loan" to Wilson made by Erwin to meet a pressing need of Wilson for cash and this was a part of the Wilson Promissory Note to NFCL. The various promissory notes were for loans which were to be collateralized by Wilson under the protocol. The NFCL account at Pauli was transferred as directed by Wilson instructions to Erwin and ultimately to the Boyd Trust Account at Nations Bank in Dallas Texas. NFCL was led to believe that there were "free and clear" Treasury securities as collateral for the transferred funds.

On July 20, 1994, DeLeon wrote Boyd with a copy to Erwin a detailed listing of concerns regarding Wilson, Boyd and Kenny including reference to a letter regarding the Euro Scotia proposal, a request for a 10K Report and investor listings (X305). Erwin was negligent in ignoring those concerns.

Tullis (NFCL) was clear on the point that he repeatedly called the attention of Erwin to the prohibited margin trading in the NFCL account and that Erwin indicated that he would take it up with Wilson. There was some sort of explanation by Wilson to Erwin that the position needed to be unwound. It is reasonably clear to the panel that Erwin was relying upon Wilson to correct the margin trading situation at Pauli and NFCL did not contact Pauli to correct the situation. NFCL made no complaints to Pauli about the activities as unauthorized.

August 1994

Wilson became interested in an acquisition of the "Nickolson Group" in Florida in August 1994. Kenny, along with Wilson and other Wilson associates (including Sam Boyd) went to Florida to assess the acquisition possibilities for Wilson. Wilson found out that the Nickolson Group had no discretionary authority over the investment of funds of the Nickolson clients. Wilson is said to have lost interest after this discovery.

On August 5, 1994, Kenny and Pauli again exchanged an offer and counter offer for Kenny to invest \$1.21 Million and purchase shares of Pauli Stock. Pauli rejected Kenny's counter offer (X56). On the same day (August 5, 1994) Kenny advised Pauli that he was acquiring all of the assets of the Nicholson Group in Florida and would be a director and shareholder (X17). Pauli requested Kenny twice (on 8/16/94 and 8/31/94) (X18, X19) to provide specific details of the acquisition. Kenny did not respond. Whether or not the rules require such reporting is immaterial to the point that prudent management of a securities firm requires knowledge of outside business activities of an employee. Kenny signed a compliance agreement with Pauli on 7/6/92 not to enter outside business connections without Pauli's permission (X1). The lack of enforcement is but another indication of lack of control and supervision by Pauli.

On August 15, 1994, DeLeon addressed his concerns to Erwin regarding an acquisition of Coastal States Life Insurance Co. in Georgia in that there would be a regulatory review and he had no response to his due diligence requests to Wilson, Boyd and Kenny. His concerns also include a lack of confirmation that the NFCL account at Pauli is fully collateralized. DeLeon pointed out the possibility of regulatory supervision or conservatorship by failure to obtain written confirmations. Among the list of requirements, DeLeon wanted written confirmation that the NFCL account had a minimum balance of at least \$6,560,000 which can be withdrawn by NFCL without inquiry by Pauli (X306). Erwin did not follow up on these concerns. This was negligence on Erwin's part.

On August 31, Pauli requested Kenny to take the Series 24 Exam, in view of his increased volume of bond activity and the firm's shortage of principals to monitor the activity (X132).

On August 31, Boyd sent NFCL \$62,957.98 to reimburse NFCL for early withdrawal CD penalties (X131). Wilson previously had told NFCL to cash out its CD's with penalties so that NFCL could invest sooner in the bond trading program.

September 1994

There is an invoice from Kenny to Wilson for rental due on a Bloomberg lease (X157). Wilson had Pauli rent a Bloomberg machine which Kenny and Wilson utilized for bond quotes and prices. Kenny received \$25,000 from Boyd's Trust account in Dallas. The SEC again contacted Pauli, this time for the Australian Securities Commission regarding Wilson, and requesting trading activity in a Wilson account (X156). On September 7, 1994 Kenny advised Erwin that the account 914-03841 had \$14 Million bonds (CUSIP #912810ES3) long in the account (X20). But the account statement for 9/30/94 shows \$10 Million bonds (CUSIP 912810ES3) with only one being shown in the account #914-03841 (X53).

October 1994

Wilson provided NFCL with a note dated 10/1/94 to be due 12/30/94 for \$10,809,115 to be paid from the Boyd Trust account at Pauli (X405). Kenny advised NFCL the acct #914-03841 held a \$10 Million bonds and a \$1.1 Million notes long and that he was unwinding these positions (X21). A copy of the Kenny advisory was sent to Wilson. Kenny on October 18, next advised NFCL that as of September 30, 1994 the NFCL account #914-03841 held a \$9 Million bonds, \$1 Million notes, \$1,020,000 bills and listed the market values for the securities (X22).

However, NFCL's account statement shows a \$10 Million bonds, \$1 Million notes and \$1,020,000 bills listed market value (X53).

NFCL authorized the transfer of \$1,250,000 through its bank account to the Boyd Trust account in Dallas (X37). On the following day, the Boyd Trust Account at Nations Bank wired Nickolson \$913,000 in California in respect to purchase of the Nickolson Group by Kenny (X203).

Kenny opened a cash account on October 24, 1994 for NFCL at Pauli (914-03901-1-4) and had corporate documents executed which include a Certificate of Corporate Secretary dated 19 October 1994 (X23). No activity was ever made in the account (X303, X303.2, X303.3). On the same day the account was opened, October 24, 1994, Wilson sends Erwin a sample, bogus or counterfeit confirmation for 914-0391-1-4 for \$8,846,000 bonds bought on 9/26/94 (X54). On October 25, Wilson sends Erwin a counterfeit confirmation for sale of the bonds on 9/26/94 in account 914-03901 allegedly showing a gross profit of \$9,214.60 for the same day trade (X54). As stated above, there was no activity in this account.

November 1994

Tullis proposed a letter to Kenny which would unambiguously state that

"since July 1994 Pauli & Co has combined your account with another clients account. Your transactions were all cash transactions. The other client was into margin activity. ... The following securities should have been in your account. These securities were free and clear on any encumbrances and liens (X25)."

The letter got massaged and approved by Wilson before it was sent by Kenny in a form which was ambiguous and unclear as to the true status of the account (X27). It was obvious at this time to Pauli and Kenny that NFCL was attempting to confirm that there were, in fact unmarginated securities in the NFCL account. On the same day, November 15, 1994, Peter Dale, an associate of Wilson wrote Tullis a letter of apology for erroneous instructions given by them to Pauli & Co causing margin activity to take place in the NFCL account rather than the Euro Scotia account (X28). The gratuitous Dale letter evidences knowledge of the trading in the NFCL account by Wilson or a Wilson investment advisor. On November 16, 1994, Kenny faxed Boyd detailed account information on Erwin's IRA account #914-95085 (X135).

December 1994

Kenny, with a rich background in the NFCL go around concerning margin trading in the NFCL account and NFCL's concern with adhering to the requirements of the Texas Insurance laws, opens account #914-03920 for an insurance fund from North Carolina with the "Kenny/Nickolson Cap Mgmt" as the investment advisor. Kenny also opened account #914-03919-1-4 for the insurance fund of Florida with Kenny/Nickolson Capital Management as the investment advisor.

In a note bearing a date of 12/28/94 Wilson promised to pay NFCL \$9,967,515.03 on 3/30/95 and issued a security interest in a Treasury bonds held at Johnston Kent Securities in the same amount (X405). NFCL is given the power to seize the collateral.

Kenny receives a discretionary power to trade for the Florida account #914-03919 on December 19, 1994 and for the North Carolina account #914-03920 on December 28, 1994.

On December 21, 1994, Kenny resigns from the Executive Committee of Pauli (X136). On December 23, 1994, Kenny is instructed by USEC/FLA to transfer Florida Funds from their Pauli account 914-03919 to Wilson's Pauli account #914-03909 (X164). On December 24, Bear Stearns notifies Kenny on the Florida account #914-03919 that no signed Customer Agreement has been received on this margin account (X165). On December 30, 1994 Kenny advises Wilson that the North Carolina account 914-03920 was wired \$1 Million and on Tuesday January 2, 1995 Pauli would wire Wilson \$700,000 from this account.

On December 30, 1994, Kenny bought a \$11,400,000 bonds on margin in the NFCL account #914-03841 and faxed Tullis that

"the following securities are held in the
above reference account as of today
\$11,400,000 United States Treasury Note
7 1/2% due 11/15/2024 CUSIP 912810ES3." (X33)

There is considerable ambiguity and uncertainty about the Pauli order tickets because the date stamp machine was improperly functioning (a chronic condition) and was incorrect by at least one day and some hours so the timing of the orders was in question. We find that while NFCL expected "free and clear" bonds in its account on 12/30/94, NFCL did not authorize Kenny to enter an order to purchase \$11.4 Million bonds. We find further that Kenny entered an order for the purchase of \$11,400,000 bonds on margin which was not authorized by NFCL. We find that Kenny told Tullis on 12/30/94 that the bonds for \$11.4 Million were in the NFCL account and did not advise NFCL that it was not a cash transaction (X33). Tullis requested a cash/interest breakdown and Kenny subsequently faxed Tullis this information.

On the confirmation received by Tullis, he noted for Erwin:

"Bob, Rec in afternoon mail --

trade date and settlement date OK.
Bear Stearns will send monthly
statement. Clyde". (X35)

The record reflects general liquidation of the Florida securities transferred in a margin purchase of a \$7 Million bonds in December 1994. The account was closed out in January and the funds wired out to First Union Bank (X171).

On 12/30/94, Wilson wired in at separate times \$125,000 and \$1,000,00 to the Pauli NFCL account #914-03841 (X304.24).

January 1995

On January 3, 1995, Bear Stearns issued a maintenance margin call for NFCL Acct.#914-03841 for \$85,000 (X36). On the same day, Kenny faxed Tullis a principal and interest breakdown on the \$11.4 Million bonds requested by Tullis without noting the margin purchase (X34). On January 3 and 4, Bear Stearns issued a maintenance margin call on the USEC/Fla. Acct. 914-03919 (X168). On January 6, Kenny advised USEC/Fla "there is currently no margin position" which was true as the margin position was closed out on January 6 (X167). On January 10, 1995, Kenny tells USEC/Fla. that \$8.4 Million in bonds would be transferred into the USEC/Fla. account and \$1 Million in bonds would be transferred into the USEC NC account (X169).

There was considerable argument that the NFCL funds going to Wilson, including the \$1.1 Million, was part of a personal loan from Erwin to Wilson. Erwin's notes reflect the following entry on 1/7/95:

1. What is the real deal
 spent - lost - tied up, etc.
2. Virtually everything in Jeopardy -
 Ins. Co -
 Mkt. Co.-
 Coastal -
3. I have spent money based upon what we were told about profit flow, etc.-
4. Need to know real situation so I can see what I need to do to float Company -
 -Sell Dallas house
 -Sell Cayman Condo-
 -Sell part of Company - etc
 -[unknown] etc.
 -can you pay anything toward the note? (Neal money?)

Also on the same day, this entry:

1/7/95 Wilson

- 18 Wires
- Everything by Wednesday
- Will call Monday
- New Confirmations - Wednesday to Dallas
- Personal Deal - Wire Monday Afternoon

This entry reflects on Erwin's state of mind of confusion, jeopardy of everything Erwin was interested in and what Erwin had to do to float the company (X339)

On 1/8/95 Erwin's notes reflect:

1. Make arrangements to sell Wilson Note with my personal guarantee.
 - A. Put up personal assets, Ins Co, etc.
 This will clear up NFCL deficit.
2. Get Wilson to pay something toward note -
 - 2-3 Million over a period of time
 - pay full amount.
 Use Wilson payments to repay personal note -
 - or
 repay as necessary on required basis -

On 1/9/95 Erwin's notes reflect in part:

(Bear Stearns currently shows about 1 Mil equity -
(X340)

These handwritten notes are not the note taking of a willing lender to Wilson. We absolutely cannot accept the proposition that Erwin loaned Wilson the \$1.1 in the NFCL account at Pauli by alleged NFCL directions on January 19, 1995.

On January 10, 1995, while an employee of Pauli, Kenny entered into a correspondent broker Agreement as Kenny Security Corporation (X210). The \$250,000 was wired into Kenny's Bank account by Wilson on January 13, 1995 (X203).

As mentioned in the Background & Case Overview, above, from January 17 through January 20, 1995, a frenzy of communication occurred to all concerned with transferring \$1.1 Million from the NFCL Pauli account to Acct. #58390102 at Cohig & Associates in Denver, Co. (Account #58390102 was opened at Cohig on September 7, 1994 for Russell McCart, Trustee of Newco Trust located in Long Beach, Calif. (Ex.47)) The communications are depicted as follows:

- 1) 1/17/95 Dale Baker (a Wilson associate) writes Cohig about Acct.#58390102 and requests 3 letters for one account as follows:
 - a) for Newco Trust FBO DGC/usec FL for \$8.4 Million and for

Newco Trust FBO DGC/USES NC for \$1 Million,
b) for Newco Trust FBO DGC/NFCL for \$11,100,000,
c) for Newco Trust FBO DGC/NAC for \$15 Million (X173).

- 2) 1/18/95 Cohig replies about Acct. #58390102 and says he has available Securities on two tranches: one for \$12.1 Million (3 instruments) and one for \$15 Million (4 instruments). Cohig notes Newco Trust is the account holder and the securities are not "owned" until paid for (X174).
- 3) 1/18/95 Wire transfer instructions to the First Interstate Bank of Denver with Account No. 58390102 at Cohig and the Clearing House Hanifen, Imhoff, Inc. ABA and account Number (X39).
- 4) 1/18/95 Dale Baker (Newco Trust) letter to Wilson that he
 - a) has assigned Cohig Account #5839012 "for the benefit of Family Care Life Insurance Co.";
 - b) he will put \$11,100,000 cash value of Treasuries into the account "on the condition we have discussed" and deliver a deed of assignment to said account concurrent therewith (X175).
- 5) 1/19/95 Pauli authorizes Bear Stearns to wire \$1,100,000 from the "National Family Care Life Insurance Company Account #914-03841-1-7" for the account of Hanifen, Imhoff, the Brokerage Account of Cohig and for the customer account "National Family Care Life Insurance Acct. #58390102" (X40).
- 6) 1/19/95 Bear Stearns wire transfer at 9:27 of \$1.1 Million to Hanifen, Imhoff, Cohig & Associates for "NTL Family Care Life Ins. Acct. 58390102" (X44).
- 7) 1/19/95 Kenny (stamp signature) letter to Cohig that he had wired \$1.1 Million for the account of Hanifen Imhoff, the brokerage firm account: Cohig and Associates; for Customer Acct. "National Family Care Life Insurance Acct. #58390102" (X41).
- 8) 1/19/95 Bear Stearns listing of confirmed wires listing #01771 at \$1.1 M to NFCL Family Care Life Inc. Acct.#58390102 (X301.1).
- 9) 1/19/95 Kenny (stamped signature) Fax to Cohig Trust that Fed Wire Confirm Number is 01771. (X42, X44)
- 10) 1/19/95 A Kenny Fax to Cohig Trust that Fed Wire No. 01771 is for "National Family Care Life Insurance Company/NEWCO" (Fax Time 3:22p.m.)(X44). Exhibit 43 is a clean copy of the fax with no marking. (See also Exhibit 45)
- 11) 1/19/95 A Cohig note re wire received for Acct. 58390102 from Brenna Longwith at Cohig to Hanifen Imhoff with an authorization stamp to accept the \$1.1 Million

wire referencing the NFCL Family Care Life Insurance "into Account 58390102/NEWCO" (X44).

- 12) 1/19/95 Disclosure Agreement of Understanding made by Wilson
 - a) that Newco Trust is the client of Cohig -- Wilson is not the client;
 - b) that if the accounts contain Treasury Securities, they are not owned by Wilson but only Rented/Lent;
 - c) that Wilson can buy the Treasuries in the account at any time;
 - d) that NEWCO Trust is not involved with any third party; and
 - e) that Wilson is acting as a Principal (X176).
- 13) 1/19/95 A debit advice of the transfer out was made by Bear Stearns to NFCL (X48).
- 14) 1/19/95 The Russell McCart Trustee FBO NEWCO Trust FAO TELESIS TRUST (located in California) Acct. No. 58390102 shows a wire deposit of \$1.1 Million on 1/19/95 (X46).
- 15) 1/19/95 Baker (NEWCO TRUST) writes Cohig to change the name of NEWCO TRUST for the benefit of TELESIS TRUST to Newco Trust for the benefit of Family Care Life Insurance Company and credit the \$1.1 Million to this account (X177).
- 16) 1/20/95 Cohig faxes Baker re. 5839012 (sic 58390102) about confusion at Hanifen Imhoff as to the exact title in view of an initial request of "For the Benefit of Debenture Guarantee Corporation" and a current request "For the Benefit of Family Care Life Insurance Co." The funds are in the account (X178).
- 17) 1/20/95 Baker advises Cohig that Newco has "assigned" account 5839012 to National Family Care Life Insurance Co. (X183) (clarified at the hearing as not a legal "assignment" but only a title designation of the Newco account).
- 18) 1/20/95 Cohig writes Wilson that Newco has requested that Acct. 58390102 be re-titled to reflect "For Benefit of National Family Care Life Insurance Co." and has requested purchase of \$11.316 Million in Treasuries (X184).
- 19) 1/20/95 Baker requests Cohig to send \$25,000 to Wanda Baker in Scottsdale, Az. (X182).
- 20) 1/20/95 Cohig writes Wilson that Newco is the client. In other respects the letter is identical to the letter of Exhibit 184. (X185)
- 21) 1/20/95 Baker authorizes Cohig to deliver confirmations to Wilson (X181)

- 22) 1/20/95 Baker advises Cohig re USEC/NC (X179).
- 23) 1/23/95 Baker wires Cohig about retitling the various NEWCO accounts (X186) and purchases.
- 24) 1/23/95 Cohig faxes Baker of confusion because 1/20/95 order for 58390102 was \$13 Million for Family Care Life and current request is for \$1 Million; also a purchase in USEC/NC account requires a \$1 Million deposit (X187).
- 25) 1/25/95 Baker faxes Cohig to send confirms and account balances (X188).
- 26) 1/26/95 Cohig advises Baker regarding opening a USEC/FLA account (X189).
- 27) 1/27/95 Cohig writes Wilson that Baker requested all cash and securities in the USEC Fla. and USEC NC accounts be transferred to Wilson and to title the account Wilson FBO National Family Care Life Insurance and to purchase \$11.078 Million in Treasuries for the account (X190).

On January 27, 1995, Wilson writes Erwin regrets over not attending a meeting with him; Wilson states "The confirms will be issued which show the bonds are held free and clear along with the loan documents", and that he will purchase the bonds in the account over the next several weeks (X108).

On January 28, 1994, Baker transfers all of the securities in the Cohig accounts 58390041 and 5839012 (sic 58390102) to Wilson (X191).

On January 31, 1995, Signer of Cohig wrote a memo to the file about a meeting with Wilson on January 19, 1995. According to the memo Wilson said he was a client of NEWCO and negotiated with NEWCO for a week before NEWCO assigned the two accounts to Wilson. Signer did a phone check on the credentials of Wilson which seemed to be in order. In a discussion with Wilson, Signer expressed reservations about insurance companies doing bond trading (X198).

On 1/31/95 Cohig opens a Wilson account #24300070 (X196). The account did active trading through March 31, 1995.

February 1995

On February 10, 1995, Pauli announced Kenny's promotion to Senior Managing Director and noted production of \$600,000 in 1993 and 1994 (X137).

On February 13, 1995, Kenny Capital Management leased space in Florida in the offices

of Bear Stearns (X211).

On February 21, 1995, Kenny while still a Pauli employee directed Boyd to wire \$115,000 to Kenny Capital Management Inc. and discussed tax ID numbers (X52).

On February 21, 1995, Kenny declined the promotion to Senior Managing Director at Pauli (X138).

On February 22, 1995, in response to an NFCL inquiry, Cohig wrote DeLeon that Cohig never had an account established for NFCL, never received \$11 Million, never contacted NFCL and had no NFCL money (X201).

On February 23, 1995, Boyd wrote Erwin that Wilson would guarantee repayment of \$750,000 loss incurred with respect to Ken Mitchell PO transactions. Boyd expressed hope that "the two of you are back on track" (X119).

On February 27, 1995, Wilson gave Erwin a check for \$11,278,944.25 (X109). Wilson told Erwin that the check was not good.

On February 28, 1995, a CPA firm in St Louis, Missouri invoices "Kenny Securities Corporation c/o Samuel L. Boyd & Associates" in Dallas for professional services including

"Discussion with Bob Wilson concerning capitalization of Kenny Capital Management & Kenny Securities.

Discussion with Joe Galda and Jack Kenny pertaining to capitalization of Kenny Securities.

Telephone discussion with Gary Long regarding need for clarification on capitalization.

Discussion with Jack Kenny regarding cash or securities as capitalization.

Discussion with Bob Wilson regarding cash or securities as capitalization." (X104)

March 1995

On March 16, 1995, Kenny resigned from Pauli (X139).

On March 19, 1995, Wilson wrote Erwin regarding "Disbursement of Profits" and promised release of the Treasuries in place for you by March 30 (X110).

In a set of documents labeled Exhibit 107, are a collateralized note bearing a printed due date of 30 March 1995, a Special Power of Attorney with a printed date of January 23, 1995 and a Notary date of May 15, 1995, and a Security Agreement with a printed date of January 23, 1995.

April 1995

In a memo dated April 17, 1995, Wilson advises Erwin that Johnson and Kent cannot confirm their Treasuries and he will open a special account (X111).

On April 19, 1995, Erwin writes Wilson to clear up all of the accounts now; clear up the Coastal thing. In the attached accounting, Erwin calculates as of 12/31/94 that NFCL is due \$11,418,603 and that Erwin is due \$9,526,816 in profits (X112).

On April 24, 1995, Erwin wrote Wilson requesting "Free and Clear" letter and confirmation from Johnson Kent on \$13,690,158.91 cash value Treasury. Erwin asks for assistance on how to trade once the money is returned (X113).

On April 25, 1995, Boyd writes NFCL that retirement of the NFCL Note is hopefully soon (X114).

On April 30, 1995, Wilson writes Erwin about a complex loan arrangement made for over \$200 Million and they will start releasing the funds on May 11 (X115).

May 1995

Mr. Erwin dies at home of a heart attack.

On May 22, 1995 after Erwin's death, Wilson writes Ms. Erwin and promises buying the NFCL bonds in a week (X117).

On May 26, 1995, Wilson writes NFCL that he will liquidate Treasury obligations and retire the note in full next week (by May 31) (X118).

June 1995

On June 6, 1995, Wilson sent NFCL 11 checks totaling \$11,660,000 noting there are insufficient funds to cover the checks and he will advise them when to cash the checks. He will call each day (X120, X121).

For the fiscal year-end of December 31, 1994, NFCL listed collateral loans of

\$9,967.818.

The SEC examiner determined that between July 22, 1994 and June 30, 1995 \$9,480,476 derived from the NFCL account at Pauli, \$250,000 derived from the USEC/FLA account at Cohig and \$25,000 derived from the USEC/FLA bank account were deposited in the Boyd Trust account at Nations Bank (X203).

FINDINGS OF FACTS & DISCUSSION

In furtherance of the request for an reasoned award, the foregoing findings are supplemented by the following specific findings.

The Claim by NFCL against Respondents Pauli, Kenny and Bear Stearns for unauthorized trading in NFCL's account at Pauli:

1. We find that the margin bond trading in NFCL account #914-03841 at Pauli was not authorized by NFCL for the period of June through October 30, 1994.
2. We find that the margin bond trades in the NFCL account #914-03841 in the period of June through October 30, 1994 were made by Kenny.
3. We find that failure to supervise by Pauli during the period of June through October 30, 1994 enabled, fostered or contributed to Kenny's unauthorized margin trading in NFCL account #914-03841.
4. We find Kenny's testimony that Erwin, by conference call or by separate call, authorized each and every margin bond trade is not creditable. Not one of the authorized NFCL signatories on the NFCL account #914-03841 knew anything about bond trading or the bond trading programs of Wilson. There is no evidence that Wilson ever intended NFCL to provide input or approval of bond trades for the bond trading program. From the characteristics of note taking by Erwin, if he had been involved with the bond trading program, he would more than likely have made notes and more than likely would have calculated the profit or loss of the trades. Erwin's notes reflect only that Erwin believed Wilson's representation that there were substantial profits (32%) from the trading.

The bond trading was to be conducted by Wilson in a separate collateralized Trust Account at Pauli controlled by Wilson which was known by Kenny. Wilson had a Bloomberg machine at Kenny's desk. The relationship between Erwin and Wilson evidenced complete and blind trust by Erwin. See for example, the discretionary power of attorney in their IRA accounts and an unlimited power of attorney to acquire Coastal States.

The relationship between Wilson and Kenny was dictated by substantial financial gain to Kenny because of the relationship. There is no significant or credible evidence that Kenny ever

adopted NFCL as his client. Kenny had a fiduciary duty of loyalty and due care to NFCL. The evidence is sufficient to establish that Kenny's collaboration with Wilson with respect to activity in the NFCL account was a breach of this duty. We find Kenny's actions to be intentional, gross and wanton, involving acts or omissions that evidence reckless and callous disregard or indifference to NFCL's rights.

5. Ordinarily, unauthorized trading permits recovery of interest, losses and commissions which in this case were sizeable. NFCL never made a single complaint to Kenny or Pauli about any unauthorized trade that occurred in this time period. NFCL received trade confirmations and monthly statements from Bear Stearns and had notice of the trading activity. However, NFCL failed to contact Kenny, Pauli or Bear Stearns in respect to the unauthorized bond trading and the complaint was raised against them only upon filing of litigation. Instead, NFCL was relying upon Wilson as its representative.

6. We find that NFCL raised a complaint with Wilson more than once that margin trading was occurring in the wrong account. NFCL had no complaint about Wilson doing the margin trading but only that the margin trading was conducted in the wrong account. Wilson was the wrong person to contact if the complaint was unauthorized trading. Wilson was not an employee or agent of Pauli or Bear Stearns.

7. We find that NFCL had been cautioned by its legal counsel to utilize due diligence in respect to the bond trading protocol and Wilson and that NFCL ignored the advice of counsel to be prudent.

8. We find that NFCL's failure to raise a complaint of unauthorized trading in Acct. #914-03841 at Pauli with respect to the margin trading activity for the period of June through October 1994, as well as failure to exercise due care by NFCL is a bar to recovery by NFCL from Bear Stearns, Pauli and Kenny for unauthorized trading.

Lack of Suitability

9. With respect to suitability, we find that aggressive margin bond trading per se would not be suitable for NFCL, an insurance company. Kenny knew the aggressive bond trading in the NFCL account was not intended and was not suitable. Kenny was able to accomplish the unsuitable margin trading because of the lack of supervision and control by Pauli.

10. With respect to Bear Stearns, there would not be a question of suitability if Bear Stearns functioned solely as a clearing Agent for Pauli. In the present case, Bear Stearns crossed the line from being a clearing firm and enabled a minimum capital brokerage firm to conduct an aggressive bond trading program with an insurance company funds without question or qualms. NFCL, as the client, signed a Bear Stearns New Account Opening form which states "BRANCH OFFICE/CORRESPONDENT COPY" and a Bear Stearns Certificate of Corporate Secretary. Besides the traditional clearing house function and extending credit, Bear Stearns was selling

from its own bond inventory to its client, NFCL. Further, we view the relationship of Pauli to Bear Stearns to be highly dependent upon Bear Stearns enabling credit financing and conducting bond trades with Bear Stearns as the Bond Dealer. Bear Stearns knew early on that Kenny was involved with Wilson and that Wilson had defaulted on his trade credits. Even if Bear Stearns did not know of Wilson's involvement, Bear Stearns permitted Kenny to aggressively trade millions of dollars in day and short term trading with the entire asset base of a small insurance firm without raising a question as to suitability. That the Kenny/Bear Stearns relationship was beyond the normal pale is exemplified by the subletting of Bear Stearns office space to Kenny and by setting up Kenny as a brokerage firm while Kenny was still an employee of Pauli and concealing this fact from Pauli. Bear Stearns had knowledge that an insurance company with limited assets was conducting a highly aggressive bond trading strategy through a correspondent broker and Bear Stearns was trading from its bond inventory. Bear Stearns and Pauli had a duty to confirm the suitability of trading strategy with its client NFCL. In making an award on this point, we are equally mindful of NFCL's negligence in failure to properly implement the protocol.

Lack of Supervision

11. We find Pauli failed to exercise suitable control and supervision of Kenny (See Finding #3). This may well be due to a lack of experience of the principal Chris Pauli as we do not find any personal involvement of Chris Pauli with Kenny, Wilson or Boyd with respect to NFCL. In fact, we find just the opposite, that Chris Pauli as the principal should have exercised control and supervision of Kenny and failed to do so. The lack of supervision by Chris Pauli and the firm created an environment where misdeeds could occur and did occur.

a) Correspondence by Kenny was routinely without supervision and without control. Kenny did not even have a series 24 license until October 1994. It appears to the panel that incoming and outgoing mail was not routinely reviewed or controlled by Pauli.

b) Kenny opened accounts without securing additional approvals.

c) Pauli knew of numerous Wilson unkept promises which raise a question of the motivation and the integrity of Wilson and yet Pauli failed to monitor the trading activities of Wilson or Kenny.

d) The trading volume and frequency of Wilson should have been monitored and checked out for suitability for the client. While Wilson may have suitably traded big volumes, the suitability for an insurance company should have been closely checked.

e) Pauli was not aware of the documentation requiring a collateralized trust account.

f) Pauli did not follow up on the detail of Kenny's purchase of Kenny Capital Management. Moreover, Pauli should have been alerted to an unusual Kenny/Wilson

relationship by the offers to purchase a share of Pauli which would include participation by both Wilson and Kenny.

g) Pauli had knowingly permitted a malfunctioning date/time stamp machine to be used which is contrary to proper accounting of trade orders.

12. Pauli had several attempts by Wilson and Kenny to buy into the Pauli firm. Warning flags about the Kenny/Wilson relationship were abundant. The fact that Wilson accounted for over 80% of Kenny's commissions and over 50% of the income of Pauli should have required Pauli to monitor Wilson particularly in view of the numerous investigations and questionable conduct of Wilson.

13. We find the documentation record before us clearly establishes negligence on the part of Pauli in the supervision of Kenny and the NFCL account. We further find that the conduct set forth above and related in the Statement of Facts is such that we hold Pauli as grossly negligent in the supervision and control of Kenny and his client Wilson. The lack of supervision was gross and wanton, involving acts or omissions that evidence reckless and callous disregard or indifference to NFCL's rights. In our opinion, the present controversy would not have arisen in a properly controlled firm with checks and safeguards. Kenny was in an environment which enabled Wilson and Kenny to manipulate a client's funds freely without any protective safeguards.

14. We find the negligence of Pauli with respect to supervision of Kenny to be a proximate cause of the unauthorized trading and activity in the NFCL account.

The Claim by NFCL for the unauthorized purchase of bonds on margin on December 30, 1994 and the transfer of \$1.1 Million from the NFCL account without authorization brought against Pauli, Bear Stearns and Kenny and the cross-claim for Indemnity brought by Bear Stearns and Pauli against Hanifen/Imhoff and Cohig:

15. In respect to the approximately \$1.1 Million transferred in and out of the NFCL Account #914-03841 in December 1994 and January 1995, we find that, under the facts of this case, the deposit by Wilson of \$1,125,000 into the NFCL account irrevocably transferred the deposited funds to NFCL.

16. We find that the purchase of \$11.4 Million bonds on margin by Kenny in the NFCL account 914-03841 at Pauli on December 30, 1994 was not authorized by NFCL. NFCL is entitled to commission, interest and loss, if any, on the transaction.

17. We find that the transfer of \$1.1 Million from the NFCL account 914-03841 on January 19, 1995 was not authorized by NFCL and was made by Kenny for the benefit of Wilson.

18. We find Pauli and Kenny are responsible to NFCL for the wrongful transfer of \$1.1 Million to the account at Cohig.

19. In the transfer of NFCL funds, Bear Stearns acted solely in a clearing house function of wiring the funds as instructed by Kenny and Pauli and had no further involvement with the transfer. Bear Stearns is not liable to NFCL and the Bear Stearns cross-claim is moot.

20. Hanifen-Imhoff as the clearing house for Cohig received the wire transferred funds and requested instructions from Cohig. Upon Cohig instructions, Hanifen-Imhoff deposited the funds into the account designated by Cohig. We find Hanifen-Imhoff had no liability to Bear Stearns or Pauli as they only performed the function of a clearing house with no further involvement with the transfer.

21. We find that Cohig negligently accepted the wire transferred funds in that the account number and owner of the account did not match the designated account number and owner of the account of the wire transferred funds. Given this discrepancy, the size of the transfer, and the confusion of communications to Cohig, Cohig should have refused the transfer for the lack of an exact match of account number and account owner.

22. We cannot, however, find Cohig fully liable to Pauli for accepting the wired transfer because the transfer initially originated from Pauli and the wrongful deposit was aided and abetted by Kenny as an employee of Pauli by subsequent actions of Kenny. As such, we will apportion the liability of Cohig to Pauli.

23. Our findings are based upon the lack of credibility of Kenny. Kenny and Wilson have a relationship dating back seven years prior to NFCL including one where Kenny and Wilson would participate in ownership of the Pauli firm. When the \$9.4 Million from NFCL was entrusted to Kenny, Kenny's allegiance remained with Wilson and did not extend to NFCL. Under the circumstances of over \$500,000 in commissions with Wilson, Kenny became a willing tool of Wilson. In October 1994, Kenny acquired Kenny Capital Management by virtue of Wilson advancing \$913,000 to Nicholson without so much as an I.O.U. It is not surprising to us that in December, Wilson deposited the money in the NFCL account to buy a \$11.4 Million bonds on margin because Wilson had to convince NFCL as of December 30, 1994 that the NFCL account held a free and clear bonds in that account in the Pauli account. Wilson had told NFCL that the bonds would be in the account in December 1994 and NFCL was expecting the bond(s). Kenny withheld the margin information on the bonds from NFCL and left it to Wilson to explain to NFCL why the bonds were not there. Subsequently, Wilson again advances \$250,000 in funds for a securities firm for Kenny without so much as an I.O.U. Kenny's relationship and cooperation with Wilson is the proximate cause of NFCL's loss.

24. We find Kenny's conduct in respect to these transactions to be intentional, gross and wanton, involving acts or omissions that evidence reckless and callous disregard or indifference to NFCL's rights.

25. We find Pauli's conduct in respect to this transaction to be gross and wanton, involving acts or omissions that evidence reckless and callous disregard or indifference to NFCL's rights.

26. We reject the argument of ratification by NFCL of the transfer. NFCL, after the fact of transfer occurred, was in a position of: (a) not knowing the facts; and (b) Kenny was not ignorant of the true facts. It was not by choice or direction of NFCL that Wilson wrongfully got the \$1.1 Million from the NFCL account at Pauli and ratification was not made by NFCL under the circumstances.

**The Claim by NFCL against Kenny for \$1,333,000 Dollars
as NFCL funds received by or for the benefit of Kenny.**

27. With respect to the NFCL claim for \$1,333,000 from Kenny, the panel is troubled by the legal aspects of funds transferred into the Boyd Trust account and Debenture Guarantee Corporation (Wilson) as those entities are not parties to this arbitration. It seems to the panel that NFCL cannot support this claim for funds benefitting Kenny when the NFCL funds were transferred by direction of NFCL to its account without restrictions or directions. The NFCL transferred the funds to the Boyd Trust account at Nations Bank. It would necessary to involve at the very least, testimony from both Boyd and Wilson in any resolution of this question. Moreover, the Florida and North Carolina parties have money which went into Boyd's account for which they also asserts claims. Thus, we conclude we lack the proper jurisdiction over the funds going into the Boyd Nations Bank account. Additionally, we note the \$913,000 went direct from Boyd's Trust Account at Nations Bank to Nickolson in California. Nickolson is also not a party to this arbitration.

AWARD

UNAUTHORIZED TRADING

1) NFCL shall take nothing on its claim for unauthorized trading for the period up to October 1994.

UNSUITABLE TRADING

2) NFCL shall be awarded the sum of Five Hundred Seventy Thousand, Three Hundred Forty Four Dollars (\$570,344) to be paid two thirds (2/3) by Bear Stearns and one third (1/3) by Pauli and Kenny, jointly and severally. This sum is \$259,612 commissions; \$217,827 margin interest; and \$92,905 principal loss.

3) No interest, no attorney's fees and no punitive damages are awarded on this claim.

THE UNAUTHORIZED PURCHASE OF BONDS ON MARGIN ON DECEMBER 30, 1994 AND THE \$1.1 MILLION TRANSFER

4) NFCL is awarded the sum of Eighteen Thousand Four Hundred and Sixty Dollars (\$18,460.00) to be paid by Pauli and Kenny, jointly and severally, for the unauthorized bond purchase on December 30, 1994.

5) NFCL is awarded the sum of One Million one Hundred Thousand Dollars (\$1,100,000.00) to be paid By Pauli and Kenny, jointly and severally, for the transfer to Cohig & Associates;

6) NFCL shall take nothing in their claim against Bear Stearns and Hanifen/Imhoff for the transfer to Cohig & Associates.

7) NFCL is awarded Thirty Two Thousand Eight Hundred Dollars (\$32,800) in attorney's fees on this claim to be paid by Pauli and Kenny, jointly and severally;

8) NFCL is awarded the sum of One Hundred Thousand Dollars (\$100,000.00) in punitive damages to be paid by Pauli.

9) NFCL is awarded the sum of Five Hundred Fifty Thousand Dollars (\$550,000.00) in punitive damages to be paid by Kenny.

THE CLAIM FOR INDEMNITY

10) The Bear Stearns claim is moot;

11) Pauli is awarded Three Hundred Sixty Six Thousand, Six Hundred and Sixty Six Dollars (\$366,666.00) in the indemnity claim against Cohig & Associates for the wrongful transfer of NFCL funds.

THE CLAIM FOR \$1,333,000.00

12) This claim by NFCL is dismissed, without prejudice.

INTEREST

13) All amounts and sums awarded herein shall accrue interest at the rate of Eight (8%) percent per annum commencing thirty (30) days following the date of this award.

OTHER REQUESTS FOR RELIEF

14) That other than forum fees, which are addressed below, all other claims and requests for relief not specifically awarded here are, and each of them, hereby denied with prejudice.

FORUM FEES

Forum fees are calculated at the rate of \$1,000.00 per hearing session and \$300.00 per pre hearing session. There were twenty eight (28) sessions x \$1,000.00 + one (1) prehearing session x \$300.00 = \$28,300.00 in forum fees. Pursuant to Section 43(b) of the NASD Code of Arbitration Procedure, a hearing session is any meeting between the parties and the arbitrator(s) including a prehearing conference with an arbitrator which lasts four (4) hours or less.

Pursuant to section 43(c) of the Code, the National Association of Securities Dealers, Inc. shall retain the non-refundable fees of the parties and shall retain as forum fees any hearing session deposits previously deposited with the NASD by the Parties.

Arbitrators Signature:

/s/ Donald H. Fidler Date: July 10, 1998
Donald H. Fidler, Esq.

/s/ Daniel Kile Date: July 17, 1998
Daniel Kile, Esq.

/s/ Jack C. Payne Date: July 17, 1998
Jack C. Payne

Date served by the NASD: July 23, 1998