

## NASD REGULATION, INC. AWARD

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In the Matter of the Arbitration Between

Name of Claimant

Blanca V. DePaolo

and

Case Number 98-00089

Names of Respondents

PaineWebber, Inc. and  
Elam W. Wright

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### REPRESENTATION OF PARTIES

Blanca V. DePaolo (hereafter referred to as "Claimant") was represented by James R. Marlen, Esq. of The Law Office of James R. Marlen, located in Dallas, Texas.

PaineWebber, Inc. and Elam W. Wright (hereafter collectively referred to as "Respondents") were represented by Sandra D. Grannum, Esq. of PaineWebber, Inc., located in Weehawken, New Jersey and by Janiece M. Longoria, Esq. of Ogden, Gibson, White & Broocks, L.L.P., located in Houston, Texas.

### CASE INFORMATION

The Statement of Claim of Claimant was filed on or about January 9, 1998.

The Submission Agreement of Claimant was signed on December 19, 1997.

The Statement of Answer of Respondents was filed on or about March 17, 1998.

The Submission Agreement of Respondent PaineWebber, Inc. was signed by Sandra D. Grannum, Corporate Vice President on March 10, 1998.

The Submission Agreement of Respondent Elam W. Wright was signed on March 10, 1998.

### HEARING INFORMATION

Pre-hearing conferences were held on: -December 22, 1998 for one (1) pre-hearing session; and

-January 29, 1999 for one (1) pre-hearing session.

The hearing was held on:

-February 23, 1999 for two (2) hearing sessions;  
-February 24, 1999 for three (3) hearing sessions; and  
-February 25, 1999 for two (2) hearing sessions.

The hearing was held in Houston, Texas.

### CASE SUMMARY

#### Claimant submitted the following case summary:

According to the Claimant, she was a mother of two children with a six grade education. Prior to investing with Respondents she had absolutely no investment experience or understanding. She had never purchased a stock, bond, mutual fund or used margin.

The evidence showed that from 1992 to mid-1998, Claimant had maintained no other brokerage account and relied exclusively upon Respondents for financial counseling services. These services specifically involved Respondents providing a "home mortgage", implementing an appropriate asset allocation strategy, and selecting, evaluating and recommending specific investments in furtherance of her primary goal of safely growing the portfolio to provide for her needs during advanced age while also producing modest income.

Largely because he had been recommended by prior counsel, Claimant completely relied upon Respondent Wright for investment advice.

#### Intentional Inaccuracies on Claimant's New Account Form

Claimant alleged that Respondent Wright's intentional misconduct was reflected in the highly inaccurate and misleading manner in which he completed Claimant's new account forms. [Claimant's evidence showed that Respondent PaineWebber's own broker and manager manuals identify the new account form as the "primary supervisory tool". First, Wright listed Ms. DePaolo as self-employed, with the nature of her business as "investments". Actually, the evidence showed that Ms. DePaolo was a widowed mother and housewife. Respondent Wright also listed her annual income at \$100,000: Ms. DePaolo had no income. Additionally, Wright overstated her net worth by a factor of more than two.

Claimant asserted that these inaccuracies were intended to avoid sending "red flags" to management. For example, Claimant's presented evidence at the hearing that

Respondent PaineWebber maintained a comprehensive computer-based account monitoring program. This system grouped clients in two separate categories identified as "Group I" and "Group II".

Group one was comprised of three categories of clients: 1) "homemakers", 2) "widows" and 3) "retirees". Group two was comprised of all other clients. Claimant asserted that Respondent Wright intentionally failed to accurately identify Claimant as a widow/homemaker because the "red flag" criteria for Group I clients were much more stringent than the criteria for Group II clients. Claimant produced evidence showing that but for Respondent Wright's intentional misrepresentations on the new account form, her account would have been "red flagged" by management on numerous occasions relative to margin, portfolio concentration, commissions, size of trades, and losses.

Unauthorized Trade Loss of \$98,000

Claimant alleged that in December 1994, Respondent Wright unilaterally sold her the Alliance North American Government Income Trust ("NAGIT") fund without her prior consent for a loss of \$98,000. Claimant further alleged that she was first informed of this sale by her accountant several months later on or about April 1994. Claimant alleged at the hearing that she would never have consented to a loss of \$98,000. Claimant further alleged that she immediately confronted Respondent Wright and that he responded by telling her "don't worry you will make up the loss with the new and better fund". [The new fund was the Alliance Bond fund].

Claimant presented evidence at the hearing, including multiple complaint letters and Respondent Wright's U-4 Disclosure Reporting Page, conclusively demonstrating that a Ms. Pic Rivers, an elderly lady client of Wright, also accused him of making the exact same unauthorized trade, during the same month, from the Alliance NAGIT fund to the Alliance Bond fund. Claimant further presented evidence at the hearing showing that Respondent PaineWebber offered to rescind this trade and compensate Ms. Rivers for her loss. Respondent Wright testified at the hearing that PaineWebber made this offer to Ms. Rivers because he "could not remember" if he obtained Ms. River's consent prior to the trade. Claimant alleged that Respondents refused to make a similar offer to her because she suffered a much greater loss than Ms. Pic Rivers.

Claimant alleged that she was prudent in following her account's balance and that she had discussions with Respondent Wright concerning the continuous decline in the value of the Alliance NAGIT fund. Claimant further alleged that Respondent Wright was motivated to make the unauthorized sale because he became disenchanted with continuing discussions about the decline in this fund. Claimant further asserted that

Respondent Wright believed the unauthorized trade would put an end to such discussions and that he believed he could appease her concerns over the loss. Claimant further alleged that Respondent Wright believed that this unauthorized trade would be without adverse consequence to him because he believed that Claimant, as an unsophisticated widow, lacked the life experience and confidence to seek recourse.

#### Unsuitable Fund

The evidence demonstrated that Respondent Wright invested almost \$250,000 in the Alliance NAGIT fund, representing approximately one third of Claimant's total deposit with Respondents. Claimant presented evidence demonstrating that this fund had been in existence less than one year and therefore had little or no proven track record. Claimant further alleged that the Alliance NAGIT fund was unsuitable for her because 1) it was a high-risk fund with 2) no growth component.

Claimant further alleged that Respondent Wright failed to disclose the speculative risks associated with the fund's considerable exposure (40%+) to risky Mexican and other South American emerging markets. With respect to this fund, and every other security in her account, Claimant alleged that Respondent Wright only told her that the fund(s) would be good for her. Claimant further alleged that she accepted each and every investment recommendation of Respondent Wright and that in each instance involving nearly twenty transactions, she would ask him if the fund was safe and would make money. Claimant further asserted that Respondent Wright would respond affirmatively to these questions.

Respondent Wright alleged both in his Statement of Answer and in testimony at the hearing that he "researched" the Alliance NAGIT fund and that the fund "was rated four or five stars by Morning Star". Claimant presented evidence at the hearing that Morning Star does not rate funds that have been in existence less than three years and that therefore Respondent's Wright testimony was false and inaccurate. In further support of her contention that Respondent Wright had no reasonable basis to recommend the NAGIT fund, Claimant also presented evidence at the hearing showing that investors in the Alliance NAGIT fund had an exchange privilege limited to only two funds, despite the fact that at the time Alliance had over thirty funds in its family.

Respondent Wright further alleged in testimony that his general investment policy was to invest his clients in funds rated four or five stars by Morning Star. Respondent Wright further alleged in testimony that he managed about 15 to 20 million dollars in client assets during 1993. In response, Claimant impugned Respondent Wright's credibility by presenting evidence that in 1993 alone Respondent Wright invested over

two million dollars or about ten to fifteen percent of his clients' money in the unproven and high risk Alliance NAGIT fund that had no Morning Star rating at all.

Similarly, Claimant further alleged that Respondent Wright's testimony was not credible on other material subjects. For example, Respondent Wright testified to the Panel that his total debts at the time of his voluntary bankruptcy were 2.5 million dollars. In response, Claimant presented Wright's own voluntary bankruptcy petition which identified his total debts as actually below \$50,000. In addition, on the issue of veracity and credibility, Claimant presented evidence that Respondent Wright violated NASD regulations by failing to disclose on his U-4, the fact that he had previously been sued three times for fraud, fraud in the sale of real estate and stock, and breach of fiduciary duty.

Primary Investment Objective: Growth

Regarding her investment of \$901,500, Claimant alleged that she expressly informed Respondent Wright that she wanted safe, growth-oriented investments and that she was investing for the long-term. Claimant alleged that Respondent Wright understood this because he identified her primary investment objective on the client new account form as growth. In fact, Claimant presented evidence showing that PaineWebber's own new account forms and every monthly statement conspicuously confirmed the account objective of growth. Claimant alleged that her primary investment objective of growth and desire for modest income reflected the fact that she lived a very conservative and frugal lifestyle. Claimant alleged that Respondent Wright often acknowledged, that unlike many similarly situated investors, she never asked for more money and that he commended her aversion to purchasing luxury items. Claimant presented evidence showing that since leaving PaineWebber, her portfolio has 50% growth investments.

Respondents alleged that Claimant's primary investment objective changed from growth to income in the fourth quarter of 1992. [This was the first four-month period that Claimant's account was open and the time that she deposited funds into the account] In support of this allegation, Respondents alleged that during the fourth quarter of 1992 Claimant requested more income because she allegedly had no other income sources besides her PaineWebber portfolio. However, the facts presented at the hearing prove otherwise: Claimant had over \$140,000 which she did not deposit with Respondents and instead kept at her bank. Moreover, during 1992 Claimant withdrew only half the income produced in her investment account with Respondents. Consequently, Claimant alleged that she did not request more income and that she had other sources of income during the subject period.

Despite Respondents' allegations to the contrary, Claimant asserted that she never asked for additional income. In fact, Claimant produced evidence showing that during the five and a half year period, her account produced about \$250,000 in dividend income but she only withdrew \$240,000 for living expenses. The evidence showed that Claimant never invaded her principal and withdrew less income than her account generated. In support of this contention, Claimant alleged that she never completed or was asked to complete any standard periodic distribution forms evidencing a required minimum monthly income need or any increasing income needs. Claimant further observed that Respondents were consequently unable to produce distribution request forms to support their allegations to the contrary.

Claimant alleged that Respondent Wright disregarded her primary investment objective of growth and instead substituted his own judgment for the her portfolio. By doing so, Respondent Wright initially invested Ms. DePaolo's money in five separate taxable and tax-free fixed-income mutual funds within four different fund families. Each and every fund that Respondents sold Claimant was a "B" share fund. The funds apparently all had the same investment objective and very similar portfolios. Claimant asserted that Respondent Wright was negligent in selling her tax-free investments given her lower tax bracket. Claimant further asserted that Respondents were negligent in placing her tax-free investments in a margin account because doing so violated governing IRS regulations against "double - dipping".

Claimant further alleged that Respondent Wright led her to believe that her portfolio would provide both income and growth and that she relied upon these representations. Claimant further alleged that Respondent Wright continually advised her that her funds "were doing well". In further support of this assertion, Claimant further alleged that Respondent Wright advised her against purchasing a life insurance policy because she would have a significant amount of money during her retirement years and therefore not need life insurance.

Claimant alleged that Respondent Wright failed to disclose anything about the pricing structure of mutual funds, specifically including the difference between "A" and "B" shares. Claimant further alleged that Respondent Wright sold her only b-shares to avoid discussion of commissions and cost. Claimant further alleged that given the long-term nature of the investments, there was no justification for not purchasing more cost-effective "A" shares and securing "break-points" by investing in less than four fund families. In fact, Claimant demonstrated at the hearing that the Alliance Fund prospectus expressly advised against investing more than \$100,000 in b-shares. The evidence showed that Respondent Wright invested almost \$250,000 in b-shares of the Alliance North American Government Income Trust ("Alliance NAGIT fund").

Misrepresenting Margin as a Mortgage Loan

Claimant alleged that Respondent Wright's complete control over the subject account and Claimant's total reliance upon PaineWebber are perhaps best illustrated with Wright's egregious use of margin. Before depositing her funds with PaineWebber, Ms. DePaolo informed Mr. Wright that she was in the process of purchasing a home for about \$115,000 and that she needed to obtain a mortgage. Claimant alleged that she further advised Wright that an older relative had advised her to pay the entire purchase price of the home with cash. Claimant alleged that Respondent Wright rejected this idea as unwise because it would preclude her from obtaining tax deductible interest payments.

Claimant alleged that rather than referring her to a mortgage company to obtain a conventional mortgage, Wright instead told her that Paine Webber could handle her needs and specifically misrepresented PaineWebber's margin account as a "mortgage loan". To induce Ms. DePaolo to purchase PaineWebber's alleged "mortgage loan", Wright told her that PaineWebber was then offering better rates and that she could later "re-finance" when rates fell and conventional mortgage lenders provided better interest rates. Accordingly, Wright placed Ms. DePaolo on margin and paid off her house.

About two years later during 1994,, Claimant informed Respondent Wright that she wanted to re-finance her home and Wright referred her to a mortgage broker. After reviewing her file, the mortgage company informed her that she could not obtain a mortgage because the entire cost of her home had already been completely paid for.

Upon being confronted with this, Wright indicated that he did not realize his action had precluded Claimant from refinancing her home. At the hearing, Wright denied ever having referred Claimant to a mortgage broker to re-finance her house. This denial was impeached by Claimant's detailed testimony concerning same. Ultimately, Claimant alleged that Wright was motivated to put her on margin to enable additional security purchases and commissions. Claimant also alleged through her industry expert that the margin interest assessed against her account (\$29,000) represented one hundred percent profit to Respondent PaineWebber and therefore they were disinclined to inquire as to its suitability. Significantly, and in further support of Claimant's assertion that she was led to believe that Respondent Wright had provided her with a home mortgage, Claimant provided evidence showing that her CPA had deducted the majority of her margin interest as home mortgage interest on her income tax returns.

Failure to Supervise

Claimant alleged that her account was maintained at a problematic PaineWebber office that failed to supervise Respondent Wright. In support of this allegation Claimant offered evidence that this office had five different branch managers within five years; that the first three were no longer employed by PaineWebber; and that there was no branch manager for the period of 7/92 to 1/93. Claimant alleged that this six month time period was critical because it was the time during which her account was opened; the majority of transactions were made and her account placed upon margin.

Claimant alleged that Respondent PaineWebber was grossly negligent and reckless in failing to supervise Respondent Wright. Claimant produced evidence showing that PaineWebber managers ignored "red flags" in her account management on numerous occasions relative to margin, portfolio concentration, commissions, size of trades, losses lack of diversification and a portfolio inconsistent with her primary objective of growth.

Respondents submitted the following case summary:

Respondents denied any and all allegations that stated, or implied, any wrongdoing on their part with regard to Claimant or her accounts with PaineWebber. Claimant brought a claim alleging that Mr. Wright, her former broker, recommended that she purchase income-oriented mutual funds which were unsuitable for her because her investment objective was growth, not income. Claimant alleges that over the years she held her accounts with PaineWebber the accounts lost \$250,000 in value, and that she suffered lost opportunity of \$450,000.00 because her account was mismanaged.

Respondents alleged that contrary to the accusations made in the Claim and at the hearing, Claimant's accounts pursued investments that were in keeping not only with her articulated investment objectives but which also satisfied the maintenance requirements Claimant placed on her accounts. Continually, Claimant requested more and more income from her accounts. The accounts satisfied this purpose -- they provided her with income from \$3,000 to \$5,000 a month. Claimant withdrew over \$240,000 in income generated by her account in addition to the \$120,000 she withdrew to cover the margin debt she incurred to pay for her home. This was all the income generated by the account which was not used to pay her account fees and costs. This level of income was obviously required to maintain Claimant's lifestyle.

Respondents alleged that in 1992, Claimant (then Mrs. Villarreal) received approximately one million dollars in payment for a settlement of her first husband's wrongful death case. It was Respondents understanding that Claimant refused to accept a structured settlement and insisted that the proceeds of this settlement be delivered to



her in a lump sum. Her personal injury attorneys introduced Claimant to Mr. Wright at the time of her settlement.

Respondents further alleged that between August and December of 1992, Claimant deposited \$901,519.48 into an account with PaineWebber. During one of her initial consultations with Mr. Wright, at PaineWebber's branch office in Houston, Claimant informed him that she wanted her money to grow, but she also needed a monthly income for her maintenance. Respondents alleged that Mr. Wright recommended that Claimant pursue both growth opportunities as well as income opportunities through her investments. Claimant was amenable to this strategy and, therefore, on PaineWebber's account forms her investment objectives in order of preference were growth, income, investment grade and speculation. However, Respondents further alleged that as the relationship progressed, every time Mr. Wright would suggest growth investments, Claimant would reject this suggestion and insist that she needed income. In fact, she often indicated she needed additional income and on several occasions even rejected suggestions of reinvesting a portion of her dividends. In fact, Respondents alleged that when Claimant and her second husband met with PaineWebber's branch manager in July of 1996 they told him that Claimants' main investment objective was preservation of capital.

Respondents alleged that in December 1992, Claimant told Mr. Wright that her portfolio was not providing her with enough income. Mr. Wright researched and discovered Alliance North American Government Income Trust, Class B in order to address Claimant's income needs. In December 1992, Mr. Wright discussed the Alliance North American Government Income Trust investment with Claimant. He informed her that the yield was high on this fund because the portfolio contained Mexican and Canadian Government Bonds. He explained to Claimant that she was receiving a higher yield for a higher risk. He also explained to her that approximately 10% of her portfolio would be holding foreign government bonds. He provided Claimant with a copy of the Prospectus for the Fund and they discussed its contents. Claimant understood the risks and insisted on the purchase of Alliance North American Government Income Trust. Respondents further alleged that in the spring and summer of 1993, Claimant increased her holding in Alliance North American Government Income Trust because she wanted additional income.

Respondents alleged that in 1994, the bond market suffered a significant downturn. Claimant's portfolio (along with many other bond investors) suffered as a result. Claimant's only out of pocket loss, Alliance North American Government Income Trust, occurred during this period. Alliance North American Government Income Trust reacted not only to the overall poor performance of the bond market, but also decreased in value due to the devaluation of the Mexican Peso, which occurred in the fall of 1994.

Respondents alleged that Claimant had purchased the fund for between \$9.80/share and \$10.07/share for a total expenditure of \$247,652.88. Claimant and Mr. Wright discussed the fact that the net asset value ("nav") of the Fund was decreasing. They agreed Claimant was unwilling to chance a further decrease in the value of the Fund. In fact, the nav of the Fund did decrease further, in 1995. In December 1994, Claimant switched from Alliance North American Government Income Trust, at \$6.13/share resulting in total proceeds of \$151,625.15, for Alliance Bond Fund. The Alliance North American Government Income Trust Fund yielded income of \$42,009.93 over the period in which she held it and, consequently, her losses on that fund were reduced to \$54,017.80. Alliance North American Government Income Trust was the only net loss in Claimant's accounts.

Moreover, Claimant's PaineWebber accounts had an overall profit of over \$150,000. Claimant's \$250,000 alleged loss was not a loss but rather a figure that reflected the cash withdrawals Claimant made from her accounts.

Respondents further alleged that Mr. Wright and Claimant fully discussed her holding Class B shares of her mutual funds rather than Class A shares. Claimant desired B shares because she did not have to pay the commission up front, she intended to hold the mutual funds long term, and she believed the restrictions on early withdrawals would dissuade relatives and friends who sought to borrow money from her.

Claimant also alleged that Mr. Wright made misrepresentations to her with regard to the financing of her home. Claimant purchased her home in cash by margining her securities account. Respondents alleged that Claimant suffered no damages as a result of the method she used to purchase her home. In fact, Respondents alleged that Claimant 1) was fully and accurately advised of the pros and cons associated with using a margin loan to purchase her home; 2) owned her home free and clear; 3) was given a discounted margin interest which resulted in her receiving a lower margin interest rate (variable 6-9.1%) than the prevailing mortgage rates (9% conventional mortgage in December 1992); 4) paid less total interest by margining her PaineWebber account (total \$25,000) than she would have with a 30 year conventional mortgage; 5) had her accountant deduct her margin interest from her tax returns as mortgage interest and margin interest; and 6) could with the newly passed amendment to the Texas Constitution, refinance her home at any time.

#### **RELIEF REQUESTED**

Claimant requested actual damages of \$100,000; margin cost of \$29,000, opportunity cost of \$385,000; attorney fees of \$75,000 and punitive damages of \$1,000,000. Claimant further

requested that Respondent Wright redact from the U-4 the statement that Claimant's account had a net profit of \$750,000 and that he disclose, as required by industry regulation on question 22 of his U-4, the three prior law suits alleging breach of fiduciary duty and fraud.

Respondents requested that the Statement of Claim be dismissed in its entirety and the costs and expenses of the arbitration be assessed against Claimant. Respondents further requested that the Claimant's Claims be expunged from Mr. Wright's Central Registration Depository ("CRD").

### **OTHER ISSUES CONSIDERED & DECIDED**

On or about March 17, 1998, Respondents PaineWebber, Inc. and Elam W. Wright moved for a dismissal of this proceeding. The undersigned arbitrators reviewed all relevant submissions and heard oral arguments on the issue. After careful consideration, the undersigned arbitrators denied the motion.

The parties have agreed to receive conformed copies of the award while the original remains on file with the NASD Regulation, Inc. Office of Dispute Resolution.

### **AWARD**

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

1. The Statement of Claim submitted by Blanca V. DePaolo against Respondents PaineWebber, Inc. and Elam W. Wright is denied in its entirety and dismissed with prejudice;
2. Other than forum fees addressed below, all claims and relief requests not specifically awarded are denied in their entirety and dismissed with prejudice.

### **FORUM FEES**

Forum fees are calculated at the rate of \$1,000.00 per hearing session and \$300.00 for each pre-hearing conference, if any. There were two (2) pre-hearing sessions x \$300.00 plus there were seven (7) hearing sessions x \$1,000.00 = \$7,600.00 in forum fees. Pursuant to Rule 10332(b) of the Code of Arbitration Procedure (the "Code"), a hearing session is any meeting between the parties and the arbitrator(s), including a pre-hearing conference with an arbitrator, which lasts four (4) hours or less.

Pursuant to Rule 10332(c) of the Code, the NASD Regulation, Inc. Office of Dispute Resolution shall retain the non-refundable filing fee in the amount of \$250.00 and shall retain as forum fees

NASD Regulation, Inc. Office of Dispute Resolution  
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the hearing session deposit in the amount of \$1,000.00 previously deposited with the NASD Regulation, Inc. Office of Dispute Resolution by the Claimant. Respondent PaineWebber, Inc. is liable for and shall pay to the NASD Regulation, Inc. Office of Dispute Resolution the sum of \$6,600.00 in forum fees.

The NASD Regulation, Inc. Office of Dispute Resolution shall retain postponement fees in the amount of \$1,000.00 previously deposited with the NASD Regulation, Inc. Office of Dispute Resolution by the Claimant.

**OTHER COSTS**

Pursuant to Rule 10333 of the Code, Respondent PaineWebber, Inc. has paid to NASD Regulation, Inc. the \$2,500.00 member surcharge previously invoiced. Furthermore, Respondent PaineWebber, Inc. is liable for and shall pay to NASD Regulation, Inc. the \$600.00 pre-hearing processing fees and \$4,500.00 in hearing processing fees.

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

Arbitrators' Signatures:

Dated:



William F. Erwin, Jr., Esq.  
Public Arbitrator, Presiding Chair

3/19/99

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Walter J. McCoy, PhD  
Public Arbitrator, Panelist

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Thomas A. Thornhill, Jr.  
Industry Arbitrator, Panelist

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Date served:

NASD Regulation, Inc. Office of Dispute Resolution  
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*Walter J. McCoy, PhD*  
Walter J. McCoy, PhD  
Public Arbitrator, Panelist

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*3-23-99*

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Thomas A. Thornhill, Jr.  
Industry Arbitrator, Panelist

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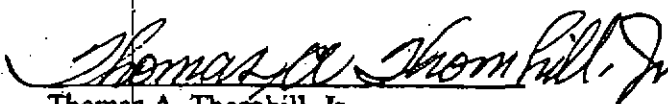
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William B. Erwin, Jr., Esq.  
Public Arbitrator, Presiding Chair

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Walter J. McCoy, PhD  
Public Arbitrator, Panelist

  
Thomas A. Thornhill, Jr.  
Industry Arbitrator, Panelist

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