Published in the **Public Investors Arbitration Bar Association Bar Journal** – Vol. 9 No. 1 Spring 2002 – by James French

THE FAILURE TO RECOMMEND HEDGE STRATEGIES AS A BASIS OF STOCKBROKER LIABILITY

In recent years, we have seen the spectacular rise and fall of many IPO millionaires whose wealth disappeared seemingly overnight when the value of their company's stock plummeted. Similar financial disasters have befallen those who had exercised stock options, inherited large quantities of a single issuer's stock, or otherwise found themselves with a concentrated position they could not or preferred not to sell. Many attorneys who are approached by such a client know intuitively or have some rudimentary knowledge that something could have been done to protect the client's wealth, but don't know whether the client's broker or financial advisor bears legal responsibility. As will be discussed below, a broker's negligent failure to make defensive use of hedging strategies will sometimes be to blame for the plight of a riches-to-rags client.

Hedging: The Broker's Duty [1]

One must examine the facts of each case to determine whether a broker/financial advisor has a duty to provide hedging advice for a client's consideration. Based upon industry standards, the most important determining factor is whether the client had a concentrated equity position. A second, though much less crucial, factor for consideration is the volatility of the concentrated equity position.

What constitutes a concentrated equity position? The answer depends upon the degree to which true diversification exists in a given portfolio. Mathematically, the greater the number of stocks contained in a portfolio, the more optimal is the diversification. As a practical matter, a portfolio of ten different stocks generally is considered "diversified" and a portfolio of twenty different stocks generally is considered "well diversified", assuming the stocks are not highly, positively correlated. At a minimum, any portfolio with more than 10% of its total value in a single stock is considered to be non-diversified, both mathematically and intuitively. Such a non-diversified portfolio should alert the investment professional to the potential of excessive risk, and warrants a discussion with the client regarding that risk

The volatility of the concentrated equity position is important only on a comparative basis and as a matter of degree. A portfolio with 25% of its value in General Motors probably will not fluctuate as much as a portfolio with 25% of its value in Amazon. Yet a portfolio with 25% of its value in General Motors still is not diversified and contains excessive risk. Examples exist of blue chip equities that have suffered ruinous losses in value. For instance, no one thought Penn Central would go to zero. Thus, while volatility is relevant with respect to the broker's duty to discuss hedging strategies, the investor's

[1] See Randall H. Borkus, *A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques*, 36 Real Property, Probate and Trust Journal, 127, (2001) (a review of trust doctrine, fiduciary duties, modern portfolio theory, contemporary legal thought and case law as applied to fiduciaries).

counsel must educate the finder of fact to the reality that a portfolio with 25% of its value in any stock had excessive risk, even if that stock appeared highly stable at the time.

Most cases in which the investment professional owed a duty to present a hedging alternative to the client will be clearly evident and far beyond the baselines presented above.

Assume, for example, that a client had $5 Million of a highly volatile "tech stock," which stock represented 95% of his equity portfolio and 90% of his total net worth. The stock has subsequently lost most of its value and now is worth $500,000. The client's financial professional never mentioned "hedging", yet touted himself and/or his firm as having expertise in handling the accounts of high net worth individuals.[2] One hardly needs to be an expert to recognize that a duty and breach exists in this case. Even if the investment professional and his firm did not hold themselves out to be experts or specialists in handling the accounts of high net worth individuals, the standards of the industry would require them to have basic equity "hedging" knowledge and to share that knowledge with the client.

Consider another situation. The investment professional never mentions the concept of hedging, but convinces the client to "diversify" his equity holdings by buying numerous other stocks, purportedly to reduce the client's risk. If the client can't or won't sell some of the tech stock, the investment professional inevitably will introduce the client to the concept of margin, since the only source of funds to purchase these additional stocks is to borrow on margin, using the $5 Million value of the "tech stock" as collateral. The investment professional proceeds with the margin borrowing/stock purchase program. In our hypothetical case, he can buy an additional $5 Million worth of stocks on margin. The client now has $10 Million worth of stocks, but owes the brokerage firm $5 Million and is paying monthly interest on this margin debt.

This is not diversification, which reduces risk. It is pure leverage, which increases risk, and also increases the income of the investment professional and his firm. The client still has 50% of his portfolio in one highly volatile stock which he can't or won't sell. Under no standard in the financial industry does this constitute diversification. The margin debt of $5 Million constitutes leverage and presents dire risk should there be a sharp decline in the value of the tech stock.

Why does the investment professional have a duty to present a hedging strategy to a client with a concentrated equity position? Because the concentrated equity position is an asset at risk and that risk is insurable through methods that are commonly known or

[2] See *Levy v. Bessemer Trust Company, N.A.,*
1997 WL 431079 (S.D.N.Y.) Motion to Dismiss (Contains the Background) 7/30/1997
1999 WL 199027 (S.D.N.Y.) Defendant Motion for Summary Judgment – 4/8/1999
2000 WL 1300402 (S.D.N.Y.) Motions in Limine – Defense – 9/14/2000

should be known by every investment professional and investment firm – methods that have been in common usage for a number of years.[3]

The existence of a duty to discuss and recommend implementation of a hedging strategy can best be illustrated by analogizing to a situation in which the investor's sole or primary asset is not a stock, but rather is a building. Assume that our hypothetical client owns, free and clear, a commercial building worth $5 Million, (ignoring, for this Illustration, the value of the land.) A competent investment professional advising the client would be under a duty to caution the client that the building must be properly insured against loss. Why? Because the risk of loss is easily insurable and it is a standard practice in the industry to insure buildings against risk of loss. It is illuminating to further assume that the investment professional or his firm convinces the client that he should diversify his investments by purchasing a portfolio of common stocks. The client's only asset is the building, which he won't or can't sell, so the investment professional sends the client to the bank that owns the brokerage house to obtain a loan using the building as collateral. Will the bank make the loan if the building is uninsured? Of course not, any more than the brokerage house should make the $5 Million loan using the "tech stock" as collateral if the stock is uninsured.

"Insuring" A Concentrated Stock Position

Three common methods of hedging concentrated equity holdings are the use of Exchange Funds, Equity Swap Contracts, and Put & Call options. In most cases, the preferred method for the client is the use of Put and Call options contracts, a method any competent investment professional should know.

There are two sources of equity Puts and Calls -- Exchange Traded Options and Custom Options. Exchange Traded options are those traded on the regulated option exchanges, such as the Chicago Board Options Exchange, and have preset strike prices[4] and expiration dates (except for FLEX options). Custom Options are created by private contract between the client and a broker/investment bank. Custom Options can have any terms the parties agree upon, and are usually the preferred method of "insuring" the risk of a concentrated equity position. This preference may be dictated because the client's stock does not have options listed on any regulated Exchange, because of the margin requirements of Exchange Traded options, or because of the flexibility of terms of the private contract.

The two most common "stock insurance" strategies are discussed below, with the warning that the universe of strategies is far greater than could be discussed in this article. Also, tax issues are not presented in this article, but be aware that they are important and may affect the client's case. Finally, this article does not reach the question of the legality

[3] *Too Much Money in Just One Stock? Get Rid of the Risk, Not the Stock*, BARRON'S, August 1, 1994, at 7 (an advertisement by Banker's Trust Company promoting the use of privately negotiated transactions with a derivatives broker/dealer or bank for estate planning dilemmas of non-diversified portfolios.)

[4] The price at which a call (put) buyer can buy (sell) the underlying instrument (equity).

of the client entering into the hedge based upon federal/state securities laws. The attorney must be confident and prepared to prove that a particular transaction would have been legal in the time frame contemplated.

To describe the two strategies, we will consider a hypothetical client who owns $6,900,000 (100,000 shares @ $69/share) of "tech stock" (with the same volatility as Microsoft) and illustrate using Custom Options. The values presented below are approximations and for purposes of illustration only.

Buy Custom Puts:

The client would enter into a contract with the broker/investment bank to purchase 1,000 Custom Put options (representing 100,000 shares) with a strike price of $60 per share and an expiration date two years in the future, at a cost of $800 per Put option for a total cost of $800,000. The client has thus insured a value of $6,000,000 (87% of current value) for his "tech stock" for the next two years at a cost of $800,000 (annual premium of 5.8%). The advantage of this strategy is that the client retains all of the appreciation in the stock. The disadvantages are that the client still has $900,000 of risk ($69 current price less $60 insured price times 100,000 shares) and must pay the insurance "premium" (i.e., the cost of purchasing the puts).

One solution to the high cost of insurance (put premium) is to purchase lesser amounts of insurance, or in other words, purchase puts with a lower strike price. For example, as an alternative to $6,000,000 of insurance above, the customer could purchase:

$5,500,000 (80% of current value)	Cost = $600,000 (annual premium of 5.8%)
$5,000,000 (72% of current value)	Cost = $450,000 (annual premium of 4.3%)
$4,000,000 (58% of current value)	Cost = $200,000 (annual premium of 1.5%)

Custom Collar Contract:[5]

A collar is a combination of options in which the client has bought one out-of-the-money puts and sold one out-of-the-money calls for each 100 shares to be hedged. This locks in the minimum and maximum price that the client will realize in the underlying stock at expiration.

The type of collar most commonly employed in hedging a large, low cost equity position is a "zero cost" collar. The strike price of the put purchased is normally set at or lower than 90% of the market price of the equity. A mathematical model determines the value of this put. The same model then mathematically determines the strike price of the call sold, so that the value of the call sold equals the value of the put purchased. The money received from the sale of the call equals the money paid for the put. Thus, there is no out-of-pocket cash cost to the client in utilizing a "zero cost" collar.

[5] See *Private Banks Tout More Aggressive Strategies* - The Wall Street Journal - July 2, 1997; *Collars Give Insiders Way to Cut Risk* - The Wall Street Journal - September 17, 1997; *WorldCom Director Uses Exotic Play to Hedge Stake* - The Wall Street Journal - October 15, 1997

In our “tech stock” example, the client purchases 1,000 puts with a strike price of $60 per share that expires in two years, at a cost of $800,000 (the same as “Buy Custom Put”). In addition, the client sells 1,000 call options on his “tech stock” with the same expiration date as the purchased puts, with a mathematically determined strike price that will generate cash proceeds equal to the $800,000 cost of the puts. The client has initiated a “Custom Collar Contract”. It is the author’s experience that the majority of clients overwhelmingly prefer this strategy.

In our case, the mathematically derived strike price is $90 per share. A two year call option with a strike price of $90 per share will sell for $800, which is exactly equal to the $800 paid for each two year put with a strike price of $60 per share. The client has now “collared” his risk/return between a downside risk to $6,000,000 (87% of current value) and limited his potential upside return to $9,000,000 (130% of current value) at zero cash cost. The client has traded any stock appreciation above $9,000,000 over the next two years for the cash to pay the insurance premium to insure a minimum value of $6,000,000 for the next two years.

The Broker/Investment Bank Perspective

The above illustrations are presented from the client’s perspective. The broker/investment bank assumes the risk that the client has transferred through the implementation of the “Custom Collar Contract” or the “Buy Custom Put” strategy. In virtually all cases (with a possible rare exception) the broker/investment bank must “short” some quantity of the “tech stock” in order to hedge their own position. The broker/investment bank may attempt to raise such issues as the inability to borrow stock, lack of liquidity in the client’s stock, or other technical reasons as a defense that it would have been impossible to provide a “Custom Collar Contract” or the “Buy Custom Put” strategy to the client. These defenses should rarely be successful, but preparation must be made to meet them.

Calculation Of Damages

The calculation of damages should normally be based upon an insured value of 90% of the market value at the time the “Custom Collar Contract” would have been initiated. The 90% number is a standard used in the industry based upon interpretation of IRS Reg. 1259 that the taxpayer be “at risk” to avoid a constructive sale.

This calculation is not as simple as it first appears. In most cases, a hedge involved in a “Custom Collar Contract” cannot be completed in one or two days. Depending upon the circumstances, it may take two weeks, and possibly even a month or more, to complete a hedge. Prices will vary over this time period and an analysis of the circumstances at the time of the contemplated hedge must be undertaken to determine potential damages.

The damages will vary depending on the trier of fact’s determination of the date that the client would have initiated the hedge, had the client been advised to do so. Since the client's case usually is based on the investment professional's failure to present hedging information, the time frame could be from day one up until disaster struck. The determination will be fact driven. However, it is easy to point to one significant occurrence – namely, the act of borrowing money on margin using the client's stock as collateral-- as a time trigger to initiate a hedge in a minimum amount, equal to the amount borrowed.

Conclusion

The following is a quick, though unscientific, method to determine if your client may have a case against a broker for breach of duty to present a hedging strategy. In order to have a case, the answer to number 1 must be "yes" and the answer to number 2 must be "no." For numbers 3 through 14, each "yes" answer indicates a stronger case, but negative answers will not "knock you out of the box". All of these questions (3 through 14) carry different weights and are not listed in any particular order of importance.

1. Did your client have a concentrated equity position?
2. Did your client's investment professional ever discuss "hedging" this concentrated equity position with the client?
3. Was this concentrated equity position a significant percentage of his total net worth?
4. Had this concentrated equity position significantly increased in value from his initial investment?
5. Was this concentrated equity position eligible for long-term capital gains treatment during the period in question?
6. Did your client express concern about a price decline in this concentrated equity position to his investment professional?
7. Did your client specifically ask if there was a way to protect this concentrated equity position against a price decline, except by selling the stock?
8. Did your client's investment professional or firm hold themselves out to be experts or specialists in handling high net worth individuals?
9. Did your client borrow money on margin using this concentrated equity position as collateral?
10. If your client borrowed money on margin, was it on his investment professional's recommendation?
11. Did your client use this borrowed money to purchase additional stocks?
12. If so, were these purchases portrayed as diversification of risks by the investment professional?
13. Did the investment professional know that your client could not or would not sell his stock?
14. Was the client's stock actively traded during the time period when a hedge would have been considered?

ADDENDUM to "The Failure to Recommend Hedge Strategies as a Basis for Stockbroker Liability" - Public Investors Arbitration Bar Association Bar Journal – Vol. 9 No.1 Spring 2002.

By: James French

I wrote an article entitled "The Failure to Recommend Hedge Strategies as a Basis for Stockbroker Liability" which was published in the Public Investors Arbitration Bar Association Bar Journal – Vol. 9 No.1 Spring 2002. The conclusion of that article is printed below.

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Since the article was published, I have received numerous inquiries regarding question #2 above, “Did your client’s investment professional ever discuss “hedging” this concentrated equity position with the client?” The inquiries focus on the word “discuss” and what constitutes “hedging”. The following is presented as clarification in response to those inquiries.

“Discuss” means a professional presentation of available hedging strategies specific to the needs and goals of the client. Every major brokerage firm has material addressing concentrated positions and explanations of hedging/protection strategies that are available to Financial Consultants and to their clients. Every major brokerage firm has a department which will prepare a detailed customized “term sheet”, that presents various hedging alternatives to the client, in writing. This same department will arrange to speak with the client and the Financial Consultant to explain the “term sheet” and discuss the flexibility of the terms so that a hedge can be designed to fit the client’s goals.

When a Financial Consultant is making a professional hedging presentation to a client he should present the following strategies in detail, as a minimum:

1. The purchase of puts.
2. Collars – the most common being “zero premium collars”.
3. Variable Prepaid Forward Contracts – Firms have proprietary names for these products.

This is only the beginning of a complete professional hedging presentation and the following is often required for a Financial Consultant to fulfill the duty undertaken. The list below is not meant to be all inclusive. The flexibility of hedging strategies provide almost unlimited variations of these strategies for recommendation to a client.

1. The purchase of puts can be expensive and the client may not want to bear that much expense, but still desire total upside participation. The Financial Consultant (or the “hedging” department expert) should present puts with lower levels of protection or put spreads that will lower the cost.
2. The disadvantage of most collars is that the upside participation in a stock price increase is limited by the calls sold. The Financial Consultant (or the “hedging” department expert) should present collars with lower levels of protection (which increases upside price participation) or “participating collars” (where all stock is protected but only part of the stock is capped on the upside) or “put spread collars” (which decrease the cost of the put portion of the collar and increases the upside participation).
3. Variable Prepaid Forward Contracts also have flexible terms that should be presented to the client if such a product meets the client’s hedging goals.

A professional hedging presentation is **NOT**:

1. A verbal presentation, even with handwritten illustrations.
2. A part of a presentation promoting the Financial Consultant's and/or firm's overall expertise.
3. A part of a presentation promoting the firm's other financial products.
4. A presentation of hedging with the purchase of protective puts or protective collars or Variable Prepaid Forward Contracts ALONE without presenting each strategy and the advantages and disadvantages of each strategy.
5. Only providing the client with a "brochure" on hedging strategies, no matter how detailed the information.
6. A "one time event", it is an ongoing obligation.
    a. Because of price movements in the concentrated position. For example, if a concentrated position increases in value from $1,000,000 to $5,000,000, consideration of a hedge is more critical.
    b. Because of an increase in borrowing (margin or bank) pledging the concentrated stock position as collateral, either directly or indirectly.
    c. Because of a change in the client's financial condition (outside financial commitments) or changing personal or family circumstances.
    d. Because of actual or potential tax obligations.