



Securities Arbitration Awards Highlight Issues Surrounding Hedging Concentrated Stock Positions Resulting From the Exercise of Employee Stock Options

Since 2000 a number of securities arbitration awards have addressed whether or not a brokerage firm can be held liable to its customers for failing to recommend appropriate hedging strategies. Hedging is a means of protecting the value of a stock position when an investor is unwilling or unable to sell that stock position. The hedging issue has arisen in the context of concentrated stock positions resulting from the exercise of employee stock options, where employees at companies such as Microsoft, Cisco and WorldCom became paper millionaires, for a time, only to see their wealth disappear (and large tax bills appear) in the wake of the "Tech Wreck" that followed.

Although brokerage firms argue that they have no liability for failing to recommend an appropriate hedging strategy, it seems clear that arbitration panels examine the facts to determine the parties' relationship, and what the customers reasonably expected their hired professionals would do on their behalf. Certainly, customers can cite the recent court opinion, *Merrill Lynch v. Millar*, in which the court confirmed an arbitration award for \$7.7 million against Merrill Lynch liable for failing, among other things, to formulate, explain and implement suitable hedging strategies. There the court stated:

[A]fter selling the Millars on its experience and ability to advise, manage and achieve their financial objectives, Merrill Lynch contends its only duty was to act with diligence and competence in the execution of an order. The Court finds such contention untenable.

Customers have won and lost other arbitration awards involving the brokerage firm's failure to hedge. In one 2004 award, the owners of a business won over \$5 million against Citigroup. The owners had sold their company in return for restricted stock in another company, which a Citigroup subsidiary promised to hedge. The hedge was supposed to be a "collar", which involves buying put options and selling call options on the stock position to obtain downside protection in return for limited upside potential on the position. The Citigroup subsidiary failed to implement that hedging strategy.

Other customer victories have included arbitration awards against Merrill Lynch, in one case for \$6.4 million involving Allegiance Telecom stock, and in another case for \$1.7 million involving Ariba stock. Like the Millar case discussed above, the customers had exercised their employee stock options, acquiring concentrated stock positions. In those cases, the brokerage firms had failed to hedge the concentrated position, failed to diversify the account, and had allowed the customer to place the concentrated stock position in a margin account to pay the option exercise costs and (initial) taxes.

Other arbitration awards are "mixed" awards for customers. One arbitration panel awarded a partial victory to an Edward Jones & Co. customer. The customer was a Microsoft employee whose account did hold other stock positions, in an effort to diversify, but those stocks were technology stocks like Microsoft. Similarly, in an arbitration claim against Salomon Smith Barney, the award partially compensated for the account losses. There one witnessed forced margin call liquidations of a concentrated Cisco stock position that the brokerage firm had recommended using as collateral for its "Express Credit" loan sold to enable the customers to purchase a second home.



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Lastly, other arbitration awards brokerage firms have won outright. One discerns a pattern in the facts which arbitration panels seem to rely upon. That is, the arbitrators' find that the customer was aggressive, and willing to risk great losses, especially after branch office managers had intervened to provide meaningful guidance and alternatives to alleviate the risk of the concentrated stock position. So, for example, in an arbitration involving another Microsoft employee, Morgan Stanley successfully defended by claiming that the brokers were experienced financial advisers who repeatedly recommended hedging with options and diversifying the concentrated position in Microsoft stock, but the customer simply refused to implement any of their recommendations.

As time passes, one should expect to see more cases involving hedging strategies that indeed were implemented but, arguably, were ill-advised hedging strategies. Already, in 2003, arbitrators awarded a Morgan Stanley customer approximately \$1.8 million in connection with a hedging strategy known as POEMS. While this strategy freed up \$5 million from a concentrated AOL stock position, the broker then invested those proceeds in other stocks that apparently were not suitable for the customer. The \$1.8 million award appears to compensate the customer for the losses on those other stocks.

This high stakes area certainly will continue to grow and mature, as arbitration panels navigate through the various fact patterns, claims and defenses of the parties.

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