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NEWS SERVICE

DOW JONES NEWS

August 24, 2007

Subprime Mess Could Hit Retail Brokers

By Jaime Levy Pessin

Stockbrokers may not be on the front lines of the credit crisis that's wreaking havoc in the markets, but they could get caught up in it.

The Financial Industry Regulatory Authority has "several investigations under way" into the sales and marketing practices around collateralized debt obligations.

The Securities and Exchange Commission is also homing in on sales practices for certain classes of collateralized mortgage obligations, securities in which mortgages are bundled together and then sliced by investment banks into pieces that bear different levels of risk, and other asset-backed securities.

The SEC is focused "primarily on the sales of the absolute riskiest tranches of product to retail investors... who were perhaps more conservative than the risk attributes of the products would warrant," said Lori Richards, director of the SEC's Office of Compliance Inspections and Examinations.

In a June "Compliance Alert," the SEC said a series of investigations had found that broker-dealers "had sold some of the most complex and riskiest classes of securities to their retail customers" and in some cases firms gave investors "unbalanced and misleading" sales literature that "generally minimized the risks of the securities."

Some industry observers say few retail investors were directly exposed to the kinds of products that have floundered during the credit crisis. But some individual investors have been hit.

One high-net-worth individual filed an arbitration claim earlier this month alleging that Bear Stearns Cos. (BSC) brokers deceived him by putting him into the Bear Stearns High Grade Structured Credit Strategies Fund, which the claim says was "far riskier and more speculative than represented."

Lawyer Jacob Zamansky, who is representing the investor, said he plans to file six related cases in September, and expects fallout from customers invested in mortgage-backed securities to be "the wave of the future."

Zamansky said he's starting to see cases where retail investors were put into CMOs and similar securities that were pitched as relatively conservative.

"Brokers are minimizing the risk in discussions with customers," he said, pointing to high commissions for brokers who sell products like CMOs and shares in hedge funds invested in them. "These brokers go with whatever the hot new product is."

Stuart Meissner, a lawyer who represents investors, is preparing a handful of claims against Brookstreet Securities Corp., the securities firm that shut down in June after the value of some of its mortgage securities fell sharply. He said his clients were heavily margined to buy products such as CMOs; some were left with negative account balances, he said.

Although Meissner said he wouldn't take on more than five claims, he said more than 20 investors have contacted him with similar cases.

"It appears these products were sliced and diced so they could eventually be sold...to regular individuals as if they were investing in safe, income-producing products," Meissner said. "They were basically sold to the opposite type of people who should be investing in these things."

Brookstreet officials could not be reached for comment.

Last year, a group of 22 individual investors won about $3.8 million in an arbitration claim against Los Angeles-based Wedbush Morgan Securities. A non-profit mental-health organization won more than $1 million from the firm. Both cases involved the brokerage house selling unsuitable CMOs.

This summer, Wedbush settled another claim involving a group of nuns, the Sisters of St. Joseph of Carondelet in California, said their lawyer, Philip Aidikoff. Their claim said Wedbush told them CMOs were "safe enough to put in trust accounts for widows and orphans."

Edward Wedbush, president of Wedbush Morgan, pointed out that the cases against his firm emerged well before the subprime fiasco took off. He said the firm had one broker who pitched CMOs to clients.

When looking at products like CMOs touting high yields, brokers should "dig deep," Wedbush said.

"The higher the yield, the deeper I would dig, the more careful I would be," he said. Even if a big-name firm put together the product, "I wouldn't rely on that as a basis for saying 'This is a good security,' " he said.

Aidikoff said he's "spending more and more time" on cases involving CMOs. He said he's working on claims against Bear Stearns on behalf of both retail and institutional investors, and has received calls from investors concerned about other hedge funds that had heavy subprime exposure.

"I expect over the next six to 18 months a tremendous number of those" kinds of cases, Aidikoff said. "Everyone from mom and pop investors to institutional investors."

Still, some industry observers are skeptical that the subprime mess will reach too many individual investors' brokerage accounts.

"I think that's going to be more rare than common," said Mark Maddox, who is working with Aidikoff on some of the subprime-fallout cases and who used to be the Indiana securities commissioner. "This is a segment of the market that has little retail contact."