

Investigation of Investment Activities

Account of Clifford and Linda Smith

**National Association of Securities Dealers, Inc. Arbitration
Case Number 06-05124**

Clifford and Linda Smith
v.
Securities Alliance, Inc and Duane Johnson

Submitted To
William H. Jones, Esq.
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Prepared By
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1.0 INTRODUCTION

I have been retained by William H. Jones, Esq. to review and opine on the investment activities and related damages that occurred in Clifford and Linda Smith (“Smith”) joint brokerage account and annuity maintained with Securities Alliance, Inc. (“XYZ”) and Registered Representative Duane Johnson (“Johnson”) in XYZ’s Morton, Nebraska office. The transactions in question occurred between March 2000 and July 2004. My investigations were confined to a review of the documents listed in section 5.0 of this report, independent research, brokerage accounting, damage calculations, and a telephone interview with Clifford and Linda Smith.

2.0 PROFESSIONAL QUALIFICATIONS

Gregory B. Wood’s securities career spans 35 years. During that time, he has been a retail stock and commodities broker, a commodities exchange member, a commodities futures analyst, a branch manager, a regional training director, the retail head for a regional broker-dealer, a regional executive for the private client services group of a national bank, and a key member of a “corporate synergy” team. He is a NASD, NYSE and NFA Arbitrator and a NASD Mediator. Greg Wood has passed the following examinations or holds or has held the following licenses or their equivalents - Series 3, 7, 8 (9 & 10), 24, 63, 65, and Utah Insurance. Greg Wood’s complete CV is attached.¹

3.0 CASE OVERVIEW

Clifford and Linda Smith were retired when they opened their account with Johnson and XYZ. Cliff Smith is a high school graduate and Linda has a GED degree. Neither of them have further education and neither have had any investment education or training. Linda Smith is retired from the U.S. Postal Service. Clifford Smith, a retired railroad conductor, had received a settlement from a work related injury. He and Linda Smith had opened an account with Morgan Stanley Dean Witter (MSDW) in the

¹ Exhibit A - Greg B Wood CV

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early 1990's and added to the account in the late 1990's. MSDW had allocated their assets to match their moderately conservative retirement expectations.

A relative of Smith, Duane Johnson, had sold life insurance until August 1999. Then, without being securities licensed, he joined Securities Alliance. This office was in his home. There, he began taking and passing the securities license examinations. By June 2000, he had completed all of his securities licenses and was ready to pursue his new career.

Johnson was aware that Smith had investments at MSDW and began aggressively soliciting Smith's business. In the spring of 2000, Johnson sold Smith a variable annuity telling them that he "guaranteed it would double in ten years." In late 2000, Johnson "high pressured" Smith into opening a securities account with him and XYZ. Johnson told Smith that by not investing now, it would cost him \$200,000 by the end of the year. Johnson told Smith that part of the loss would be a decline in Mead's MSDW portfolio and the other part would be the lost opportunity cost from not investing with Johnson and XYZ immediately. Smith, believing that the market opportunity that Johnson and XYZ presented was time sensitive went to the local bank and borrowed \$100,000.

Johnson knew that the XYZ initial deposit was borrowed and went ahead with opening the account anyway. When the new account documents were completed, Johnson instructed Smith regarding the completion of the forms. Johnson told Smith to indicate investment objectives and risk tolerances that were inaccurate and overstated. These risk tolerances and objectives were much more aggressive than were appropriate for Smith or that they desired. Johnson told Smith that the new account documents "looked better filled out that way for what he wanted to do."

Going through the new account opening process, Johnson told Smith that he was setting Smith' account up as a margin account. Johnson told Smith that "we will have this on hand in case we want to use it." As they walked to the door, Johnson turned to

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Smith and said that he was going ahead with the use of margin. Cliff Smith said, “No, I have already done that.” Smith last comment referred to the fact that the money to open the account was borrowed from the bank. This put leverage on top of leverage and created a high risk, high volatility, speculative situation.

When the account was opened, Smith did not sign a power of attorney (limited or full trading authorization). Smith was not asked to sign a power of attorney (limited or full trading authorization). Smith did not understand that he should approve every transaction in advance of execution. Contrary to NASD Rule 2510, Johnson and XYZ immediately began using unauthorized discretion as they invested Smith’ borrowed money. Johnson had control over Smith’ account. Quickly, the market value of his mostly technology stock portfolio decreased. Though nearly all of the trades were marked solicited, Johnson never called Smith in advance of placing any of the trades.

Smith reports that Johnson asked him to sign an unspecified document. Johnson told Smith that the main office was asking him to get it completed. Johnson never produced this document. He told Smith “I don’t think it is necessary since we are family.” The only document missing for this account that would fit that description was a limited or full trading authorization. If this were the document to which Johnson was referring, this would be suggest that XYZ was aware of the unauthorized trading.

During September 2000, Smith deposited an additional \$200,000 with Johnson and XYZ. These funds were proceeds from a partial liquidation of Smith’ MSDW account. Clifford Smith reports that during the period September 15 to 19, 2000 he spoke with Johnson to see “how we were doing”. When Johnson reported to Smith that the account was down, Smith said, “How can it be down when the market is not down?” Previously, Johnson had assured Smith that there would not be any cost related to liquidating the MSDW investments and making new investments at XYZ. During the telephone call, Johnson told Smith that his account was down about \$14,000 due to “ticket charges. Smith felt he had been mislead and became very angry. Smith said

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“Duane, get me out and get me out now!” Johnson failed to follow Smith direct and very specific instructions to liquidate his portfolio.

Smith’ account equity declined rapidly. By the end of November 2000, nearly \$190,000 of the Smith’ \$300,000 investment was gone. Smith still owed the bank \$100,000. During December 2000, Smith instructed Johnson and XYZ to liquidate enough stock to return him \$100,000 to repay the bank loan. Johnson persuaded Smith to leave some of the borrowed funds. Johnson told Smith’ “leave \$30,000 so I can get your money back.” Johnson assured Smith that he would watch the account closely and Johnson guaranteed Smith that the account would not go below \$30,000. At the end of December, Smith’ equity was \$46,406.65. As of that date, Smith still owed \$30,000 to the bank leaving only \$16,406.65 of the \$200,000 September investment.

Johnson and XYZ continued to make unauthorized trades and the account and lost more money. When the final positions were liquidated, Smith had lost \$225,144.41 and still owed the bank \$30,000. Johnson and XYZ had earned \$12,266.26 in commissions and another \$2,945.98 in margin interest.

4.0 CASE ISSUES

This report discusses the numerous factors that resulted in the Smith’ losses. Based upon my review of this matter, it is my opinion, based upon a reasonable degree of professional certainty, that the recommendations, transactions and activities in the Smith’ account were improper and caused the extreme losses. Four main issues are identified and discussed in this report. The primary issues are:

- A. Excessive Trading (Churning)
- B. Unauthorized Trading
- C. Unsuitability

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D. Failure to Supervise

5.0 **DOCUMENTS REVIEWED AND WORK TO DATE**

This report describes my work to date and summarizes my opinions and the basis for those opinions. Any sources that I specifically reference in this document are footnoted. My work is ongoing and I may update or modify the report later if additional information becomes available.

I reviewed the entire discovery provided by William H. Jones, Esq. In addition, I interviewed Clifford and Linda Smith, reviewed forensic accounting reports, and conducted my own research related to the matter at hand. The information that follows is based on data and facts that I collected and observed from the following sources:

Item Number	Description
1	Statement of Claim
2	Response to Statement of Claim
3	Forensic Accounting Reports
4	Independent Research
5	Licensing, CRD and Registration Information
6	Claimants' Discovery
7	Respondents' Discovery
8	Morningstar Reports and Analysis
9	Interviews with Clifford and Linda Smith

6.0 **SELECTED NASD RULE EXCERPTS**

A. **NASD RULE 2110**

"2110. Standards of Commercial Honor and Principles of Trade

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

B. **NASD RULE 2310**

"2310. Recommendations to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis

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of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under [Rule 3110\(c\)\(4\)](#)."

C. NASD RULE IM2310-2

"IM-2310-2. Fair Dealing with Customers

(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public.

(2) This does not mean that legitimate sales efforts in the securities business are to be discouraged by requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship. It does mean, however, that sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.

(b) District Business Conduct Committees and the Board of Governors have interpreted the Rules, taken disciplinary action and imposed penalties in many situations where members' sales efforts have exceeded the reasonable grounds of fair dealing. Some practices that have resulted in disciplinary action and that clearly violate this responsibility for fair dealing are set forth below, as a guide to members:

(2) Excessive Trading Activity

Excessive activity in a customer's account, often referred to as "churning" or "overtrading." There are no specific standards to measure excessiveness of activity in customer accounts because this must be related to the objectives and financial situation of the customer involved.

(iii) Unauthorized Transactions

Causing the execution of transactions which are unauthorized by customers or the sending of confirmations in order to cause customers to accept transactions not actually agreed upon."

D. NASD Rule 2330

"2330. Customers' Securities or Funds

(e) Prohibition Against Guarantees

No member or person associated with a member shall guarantee a customer against loss in connection with any securities transaction or in any securities account of such customer.

(f) Sharing in Accounts; Extent Permissible

(1)(A) Except as provided in paragraph (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided, however, that a member or person associated with a member may share in the profits or losses in such an account if (i) such person associated with a member obtains prior written authorization from the member employing the associated person; (ii) such member or person associated with a member obtains prior written authorization from the customer; and (iii) such member or person associated with a member shares in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such account by either the member or person associated with a member.

(B) Exempt from the direct proportionate share limitation of paragraph (f)(1)(A)(iii) are accounts of the immediate family of such member or person associated with a member. For purposes of this Rule, the term "immediate family" shall include parents, mother-in-law or father-in-law, husband or wife, children or any

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relative to whose support the member or person associated with a member otherwise contributes directly or indirectly.

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member that is acting as an investment adviser (whether or not registered as such) may receive compensation based on a share in profits or gains in an account if (i) such person associated with a member seeking such compensation obtains prior written authorization from the member employing the associated person; (ii) such member or person associated with a member seeking such compensation obtains prior written authorization from the customer; and (iii) all of the conditions in Rule 205-3 of the Investment Advisers Act of 1940 (as the same may be amended from time to time) are satisfied."

E. NASD RULE 2510

"2510. Discretionary Accounts

(a) Excessive Transactions

No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

(b) Authorization and Acceptance of Account

No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with [Rule 3010](#)."

F. NASD Rule 3010

"3010. Supervision

(a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) The establishment and maintenance of written procedures as required by paragraphs (b) and (c) of this Rule.

(2) The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required.

(3) The designation as an office of supervisory jurisdiction (OSJ) of each location that meets the definition contained in paragraph (g) of this Rule. Each member shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives, registered principals, and other associated persons in accordance with the standards set forth in this Rule, taking into consideration the following factors:

(A) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(B) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(C) whether the location is geographically distant from another OSJ of the firm;

(D) Whether the member's registered persons are geographically dispersed; and

(E) whether the securities activities at such location are diverse and/or complex.

(4) The designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.

(5) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(6) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

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(7) The participation of each registered representative and registered principal, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) and principal(s) are discussed. Such interview or meeting may occur in conjunction with the discussion of other matters and may be conducted at a central or regional location or at the representative's(') or principal's(') place of business.

(c) Internal Inspections

(1) Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable NASD rules. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.

(A) Each member shall inspect at least annually every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations.

(B) Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office, the firm shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. If a member establishes a more frequent inspection cycle, the member must ensure that at least every three years, the inspection requirements enumerated in paragraph (c)(2) have been met. The non-supervisory branch office examination cycle, an explanation of the factors the member used in determining the frequency of the examinations in the cycle, and the manner in which a member will comply with paragraph (c)(2) if using more frequent inspections than every three years shall be set forth in the member's written supervisory and inspection procedures.

(C) Each member shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the firm shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The schedule and an explanation regarding how the member determined the frequency of the examination schedule shall be set forth in the member's written supervisory and inspection procedures.

Each member shall retain a written record of the dates upon which each review and inspection is conducted.

(2) An office inspection and review by a member pursuant to paragraph (c)(1) must be reduced to a written report and kept on file by the member for a minimum of three years, unless the inspection is being conducted pursuant to paragraph (c)(1)(C) and the regular periodic schedule is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written. The written inspection report must also include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the following areas:

- (A) Safeguarding of customer funds and securities;
- (B) Maintaining books and records;
- (C) Supervision of customer accounts serviced by branch office managers;
- (D) Transmittal of funds between customers and registered representatives and between customers and third parties;
- (E) Validation of customer address changes; and
- (F) Validation of changes in customer account information.

If a member does not engage in all of the activities enumerated above, the member must identify those activities in which it does not engage in the written inspection report and document in the report that supervisory policies and procedures for such activities must be in place before the member can engage in them.

(3) An office inspection by a member pursuant to paragraph (c)(1) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). However, if a member is so limited in size and resources that it cannot comply with this limitation (e.g., a member with only one office or a member has a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office manager), the member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The member, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.

A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or

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works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.

(d) Review of Transactions and Correspondence

(1) Supervision of Registered Representatives

Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and for the review by a registered principal of incoming and outgoing written and electronic correspondence of its registered representatives with the public relating to the investment banking or securities business of such member. Such procedures should be in writing and be designed to reasonably supervise each registered representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available to the Association upon request.

(2) Review of Correspondence

Each member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (i.e., non-electronic) and electronic correspondence with the public relating to its investment banking or securities business, including procedures to review incoming, written correspondence directed to registered representatives and related to the member's investment banking or securities business to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with firm procedures. Where such procedures for the review of correspondence do not require review of all correspondence prior to use or distribution, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(3) Retention of Correspondence

Each member shall retain correspondence of registered representatives relating to its investment banking or securities business in accordance with [Rule 3110](#). The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records and the retained records shall be readily available to the Association, upon request.

(e) Qualifications Investigated

Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been registered with the Association, the member shall review a copy of the Uniform Termination Notice of Securities Industry Registration (Form U-5) filed with the Association by such person's most recent previous NASD member employer, together with any amendments thereto that may have been filed pursuant to Article V, Section 3 of the Association's By-Laws. The member shall review the Form U-5 as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. In conducting its review of the Form U-5 and any amendments thereto, a member shall take such action as may be deemed appropriate.

Where an applicant for registration has been previously registered with a registered futures association ("RFA") member that is or has been registered as a broker/dealer pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer") with the SEC to trade security futures, the member shall review a copy of the Notice of Termination of Associated Person (Form 8-T) filed with the RFA by such person's most recent previous RFA member employer, together with any amendments thereto. The member shall review the Form 8-T as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. In conducting its review of a Form 8-T and any amendments, a member shall take such action as may be deemed appropriate."

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7.0 CLIFFORD AND LINDA SMITH

It is my opinion, based on a reasonable degree of professional certainty, that Clifford and Linda Smith were inexperienced and uneducated investors. Further, because the broker was a relative, they placed a higher than normal level of trust in him. I base those opinions on the following:

- A. Clifford Smith is a high school graduate
- B. Linda Smith Has a GED degree
- C. Neither Clifford nor Linda Smith have taken any financial or investment training courses.
- D. Both Clifford and Linda Smith are retired
 - 7.D.1 Clifford – Railroad Conductor
 - 7.D.2 Received a personal injury settlement from a 1997 railroad accident.
 - 7.D.2.1 Invested \$500,000 with Morgan Stanley Dean Witter
 - 7.D.3 Linda – U.S. Postal Service (retired)
- E. Smith did not have the ability to replace their retirement savings if lost.
- F. Smith needed conservative investments. Cliff Smith told Johnson that his investment goal was to provide enough return to buy a new pickup truck every year or about 10% annually.

8.0 DUANE M. JOHNSON

It is my opinion, based upon a reasonable degree of professional certainty that Duane M. Johnson was inexperienced, unlicensed and untrained as a stockbroker when he was hired by XYZ in August 1999. I base that opinion on the following:

- A. Johnson's employment and licensing history is as follows²:
 - 8.A.1 Employed 8/1999 to 8/2003 - Securities Alliance, Broken Bow, Nebraska
 - 8.A.1.1 Series 7³
 - 8.A.1.1.1 General Securities Registered Representative

² NASD CRD Information

³ XYZ 613

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8.A.1.1.2 May 31, 2000

8.A.1.2 Series 65⁴

8.A.1.2.1 Uniform Investment Advisor Law Examination

8.A.1.2.2 November 2, 1999

8.A.1.3 Series 63⁵

8.A.1.3.1 Uniform Securities Agent State Law Examination

8.A.1.3.2 October 6, 1999

8.A.1.4 Series 6⁶

8.A.1.4.1 Investment Company Products / Variable
Contracts Representative Exam

8.A.1.4.2 October 6, 1999

8.A.2 09/1995 to 07/1999 Bankers Life and Casualty

8.A.2.1 Not registered with a broker dealer

8.A.2.2 No securities licenses shown on NASD records.

8.A.3 05/1972 to 08/1995 dairy farming business

8.A.4 Business failed resulting in multiple bankruptcy filings and tax liens.

B. Based upon information and belief, it is my opinion, based upon a reasonable degree of professional certainty, that Securities Alliance does not customarily hire and train unlicensed stockbrokers.

8.B.1 It is my further opinion that XYZ does not have a new broker-training program.

C. Bankruptcy and Tax Liens⁷

8.C.1 Duane M. Johnson filed for bankruptcy on 6/ 1994 and 9/14/1995.

8.C.2 First reported on the NASD CRD on 8/31/1999

8.C.3 CRD reports seven Nebraska State and IRS tax liens

8.C.3.1 Filed between 1/22/1993 and 1/12/1998

8.C.4 These were first reported to the NASD when Johnson was hired by XYZ

⁴ XYZ 612

⁵ XYZ 615

⁶ XYZ 614

⁷ Exhibit B - Duane Johnson CRD

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- D. The knowledge, training and skills required to sell securities are different from those required to sell life insurance.

9.0 DUANE JOHNSON HAD RECENTLY PASSED THE SERIES 7 EXAM

Johnson had passed the Series 7 exam about three months prior to opening Smith account at XYZ. He successfully tested on the issues and violations that occurred related to his conduct in this matter. It is my opinion, based upon a reasonable degree of professional certainty that Johnson was aware of his improper conduct as it occurred.

10.0 DUANE JOHNSON'S MISSTATEMENTS TO SMITH

Duane Johnson aggressively pursued Smith account and in the process of convincing Smith to move their assets from MSDW made numerous misstatements. An interview with Clifford and Linda Smith on November 2, 2005 brought these to light.

- A. Johnson sold Smith a \$12,000 variable annuity in March 2000.
 - 10.A.1 Johnson told Cliff and Linda Smith that the annuity was guaranteed to double in value in ten years.
 - 10.A.2 Such guarantees are contrary to securities law, the XYZ compliance manual and good business practices.
 - 10.A.3 When Smith opened his XYZ account, Johnson told Smith "I can guarantee that you will have your farm paid for in six months".
- B. Smith often asked Johnson how he could be protected from loss.
 - 10.B.1 Johnson told Smith that he had traded commodities futures for years and used stops.
 - 10.B.2 Johnson told Smith that he would use stops on Smith' account.
 - 10.B.3 There is no evidence of stops ever being used.
 - 10.B.4 Later, Johnson told Smith that he did not realize that the market could drop through the stop price over night, so he did not use them.
- C. Johnson told Smith that there would be no costs related to the moving of his money from MSDW to XYZ

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- 10.C.1 Johnson represented to Smith that it not cost anything to move assets to XYZ.
- D. Johnson and XYZ overcharged Smith' securities commissions.
- 10.D.1 Between 2.5% and 2.9% of the transaction amount for securities transactions during September 2000.
- 10.D.2 The estimated and actual overcharge total was \$5,234.17.⁸
- E. In an undated letter to Smith believed to have been between September 19, 2000 and September 30, 2000, Johnson promised to get the commissions back by not charging Smith for future transactions.
- 10.E.1 Rebating commissions is contrary to NASD rules.
- F. On or before September 19, 2000, Smith asked Johnson how they were doing.
- 10.F.1 This was about three weeks after the account had been opened.
- 10.F.2 Johnson told Smith that the account was down about \$14,000 due to "ticket charges".
- 10.F.3 Investigation shows that "ticket charges" range from \$25.00 to \$40.00 per transaction.
- 10.F.4 An Investigation shows that there were less than 20 transactions from the account opening to September 19, 2000.
- 10.F.5 The maximum total ticket charge expense would have been below \$800.00.
- 10.F.6 At the end of September 2000, the account equity was down (\$31,485.55).
- G. Johnson wrote Smith a long, rambling and disjointed letter (not compliance approvable) following Smith' September instructions to liquidate the account.
- 10.G.1 In an excerpt from the September letter Johnson said the following:

⁸ Exhibit C - Overstated Commission Spreadsheet

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nothing. If because of this miscommunication you would rather do something different with your money I will gladly get you your money out of these stocks and get you your commissions back, but it might take me a month or two to do it. This market is not in trouble, it just isn't ready to move yet. In fact if we get back to the 4,200 range on the NASDAQ composite I will probably consider taking profits if it is in late September or early October on some of the stocks. There will be no ticket charges or commissions on the money coming out of the stocks or going back into the stocks after the market pulls back.

Looking forward to seeing you ~~to seeing you~~ soon. I'll go over your stocks with you then.

Just remember, emotion will take this market lower than it should be and give us a very good opportunity to gain some additional profitability in your stock portfolio.

10.G.2 The securities that were in the XYZ account were all liquid investments.

10.G.3 The portfolio could have been totally liquidated either the business day that the order was received or the following business day depending upon the time of the conversation.

H. When Smith confronted Johnson about the losses, Johnson told Smith "One way or another, I'll get your money back".

10.H.1 The sharing of customer profits or losses is contrary to NASD rule 2330.

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11.0 ACCOUNTS EXCESSIVELY TRADED (CHURNED)

It is my opinion, based on a reasonable degree of professional certainty that Johnson and XYZ excessively traded (churned) Smith' account number STL-423670. I base that opinion on the following:

- A. The turnover ratio based on equity value was 13.00
 - 11.A.1 For reference, the average turnover of all 17,127 mutual funds in the Morningstar database as of August 2004 was 1.12⁹
- B. The cost maintenance factor based on equity was 14.88%
 - 11.B.1 This means that the portfolio would have needed a 14.88% annual return just to break even.
 - 11.B.2 For reference, from 1926 through the end of 2004, the average annual stock return was 10.4%.¹⁰
- C. Johnson was shorting technology issues.
 - 11.C.1 This required the borrowing of stock.
 - 11.C.2 Prior approval
- D. Johnson was going long and short the OTC market by exchanging UltraPro OTC Pro Fund Investor Shares and UltraShort OTC Pro Fund Investor Shares.
- E. The average days held for all securities was only 28
- F. There were 111 completed transactions over the life of the account.
 - 11.F.1 A transaction is considered one buy matched with one sell.

12.0 UNAUTHORIZED TRADING

NASD rule 2510 requires that the customer approve all transactions in advance of the order being placed. Further, in any account where the client grants discretion to the brokerage firm and registered representative, such discretion must be approved by the brokerage firm in writing in advance of any trading. In the securities, business there is no such thing as a verbal power of attorney. It is my opinion, based upon a reasonable degree of professional certainty that all of the transactions in the Smith account with XYZ were unauthorized.

⁹ Forensic Accounting Report

¹⁰ Forensic Accounting Report

Sample Report

13.0 USE OF MARGIN

Margin is leverage. The use of margin is appropriate for the most, highly capitalized, sophisticated, high-risk tolerant and speculative accounts. Many limit the use of margin to a specified portion of their investment assets. This sophisticated tool enhances profits when the market is moving in the client's favor and enhances losses when the market is going against the client.

Margin lending is also one of the most profitable services that a brokerage firm has to offer. In short, for the brokerage firm, a margin account is a fully collateralized loan that has a generous profit margin and very limited risk. The margin interest rates charged to the customers are negotiable. Some firms charge the unsophisticated client the maximum rate unless the client asks for a rate reduction. Registered Representatives are often paid on margin loans. Often the wider the spread over the base rate (greater the profit margin), the greater the payout is to the broker.

Registered representatives and brokerage firms have an incentive to recommend margin. A margined account can purchase more securities than a non-margined account and thus generate more commissions. Added to this is the payment to the representative that relates to the brokerage firm's profit on the lending activity.

It is my opinion, based upon a reasonable degree of professional certainty that the use of margin was unsuitable for Smith. I base that opinion on the following:

- A. Smith was unsophisticated and did not understand margin or the implication of leverage.
- B. Clifford Smith is disabled and could not replace the funds invested with Johnson and XYZ if they were lost
- C. Johnson was making unauthorized trades in Smith' account
- D. Smith did not understand the paperwork including confirmations and statements when they arrived.
- E. Smith instructed Johnson to liquidate Smith account in September 2000.
13.E.1 Johnson failed to follow Smith' instructions.

14.0 MARGINING BORROWED FUNDS

Borrowing from broker-dealers to purchase securities is governed by Regulation T of the Federal Reserve Board. This regulation sets the initial margin requirement. Currently it is 50%. The companion regulation for banks is Regulation U. This regulation governs the lending from banks for the purpose of purchasing securities. The requirements for both entities are similar.

It is my opinion based upon a reasonable degree of professional certainty that Johnson was aware that the opening deposit to the XYZ account was borrowed from Smith' bank. By leveraging it again with margin, Johnson exposed Smith to an extremely high-risk level. This contributed to the demise of Smith' account.

- A. Three months earlier Johnson had taken and passed the Series 7 examination. Margin is one of the sections on the examination. Johnson understood the potential impact of his actions.
- B. The use of Margined borrowed funds was unsuitable for Smith.

15.0 SECTOR CONCENTRATED PORTFOLIO

It is my opinion, based upon a reasonable degree of professional certainty that Johnson and XYZ placed Smith in a highly speculative, extremely risky situation. It is my further opinion that this situation was caused by an over concentration of technology and communications issues in Smith' portfolio combined with the high turnover and double margin. I base my opinion on the following:

- A. The securities purchased over the life of the account were highly concentrated in technology and communications issues.
 - 15.A.1 These were highly speculative and extremely risky.

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Sample Report

Stock Sector Analysis

Prepared by Greg B. Wood

5-Nov-05

Company	Profit / Loss	Income	Total Return	%	Sector
NATURAL MICROSYSTEMS CORP	(\$24,332.97)	\$0.00	(\$24,332.97)	-63.50%	Technology – Software*
SDL INC	(\$12,360.69)	\$0.00	(\$12,360.69)	-41.80%	Technology – Software*
SIEBEL SYSTEMS INC	(\$5,623.24)	\$0.00	(\$5,623.24)	-8.70%	Technology - Software
ALTERA CORP	\$678.53	\$0.00	\$678.53	4.90%	Technology - Hardware
APPLIED MICRO CIRCUITS CORP	(\$35,488.18)	\$0.00	(\$35,488.18)	-14.80%	Technology – Hardware*
APPLIED MICRO CIRCUITS CORP	(\$2,283.79)	\$0.00	(\$2,283.79)	-4.10%	Technology – Hardware*
BEA SYSTEMS INC	(\$3,228.47)	\$0.00	(\$3,228.47)	-6.70%	Technology – Hardware*
EMC CORP-MASS	(\$2,150.51)	\$0.00	(\$2,150.51)	-22.10%	Technology - Hardware
INTEGRATED DEVICE TECH INC	(\$23,554.21)	\$0.00	(\$23,554.21)	-63.10%	Technology – Hardware*
JUNIPER NETWORKS INC	(\$13,982.98)	\$0.00	(\$13,982.98)	-22.30%	Technology – Hardware*
LINEAR TECHNOLOGY CORP	(\$113.16)	\$0.00	(\$113.16)	-1.50%	Technology - Hardware
NETWORK APPLIANCE CORP	(\$15,766.32)	\$0.00	(\$15,766.32)	-32.90%	Technology – Hardware*
SUN MICROSYSTEMS INC	(\$15,602.93)	\$0.00	(\$15,602.93)	-20.90%	Technology – Hardware*
GENERAL ELECTRIC CO	(\$2,030.48)	\$24.00	(\$2,006.48)	-12.20%	Industrial
POWER-ONE INC	(\$16,964.24)	\$0.00	(\$16,964.24)	-33.80%	Industrial*
NASDAQ 100 TRUST UNIT SER 1	(\$11,400.65)	\$0.00	(\$11,400.65)	-5.10%	Index Fund
NASDAQ 100 TRUST UNIT SER 1	\$1,202.99	\$0.00	\$1,202.99	1.80%	Index Fund
AMGEN INC	(\$5,543.81)	\$0.00	(\$5,543.81)	-10.00%	Healthcare
LEHMAN BROS HLDGS CORP	(\$9,982.27)	\$8.25	(\$9,974.02)	-25.10%	Financial*
EXODUS COMMUNICATIONS INC	(\$14,985.02)	\$0.00	(\$14,985.02)	-40.70%	Communications*

MUTUAL FUNDS

Fund	Profit / Loss	Income	Profit / Loss	%	Morningstar Rating
ULTRA OTC PRO FUND					
INVESTORS SHARES	(\$9,278.95)	\$0.00	(\$9,278.95)	-14.60%	1 of 5 Stars
ULTRASHORT OTC PRO FUND					
INVESTORS	(\$457.62)	\$0.00	(\$457.62)	-0.90%	None

B. Considering all of the purchases made between 8/31/2000 and 9/27/2000.

a. Johnson and XYZ purchased \$547,392.36 of securities.

b. The purchases between 8/31/2000 and 9/27/2000 are marked with an

“*” .

c. Some of the purchases during this period were sold to allow for additional purchases.

C. The real account equity was \$200,000

D. Smith never authorized any of these transactions.

Sample Report

- E. Communications and technology stocks represented 83.56% of the dollars invested.¹¹
- F. The sector allocation of the S&P 500 compared with Smith initial
- a. Portfolio purchases were:

S&P 500 Closing Date	S&P 500 Sector	S&P 500 Percentage	Smith Portfolio Buys
12/29/2000	Basic Materials	2.29%	0.0%
12/29/2000	Communications	15.22%	6.73%
12/29/2000	Consumer, Cyclical	7.98%	0.0%
12/29/2000	Consumer, Non-Cyclical	22.17%	0.0%
12/29/2000	Energy	7.58%	0.0%
12/29/2000	Financial	17.48%	7.27%
12/29/2000	Industrial	10.01%	9.17%
12/29/2000	Technology	14.52%	83.56%
12/29/2000	Utilities	2.76%	0.0%

16.0 UNSUITABLE TRANSACTIONS

Based on a reasonable degree of professional certainty, it is my opinion that the securities transactions, activities, and recommendations made by Johnson and XYZ were unsuitable. I base that opinion upon the following:

- A. The transactions made by Johnson and XYZ were unauthorized.
- B. Johnson knew Smith real objectives and risk tolerance when he completed the new account forms for Smith XYZ account
- 16.B.1 Johnson misrepresented Smith' information to allow Johnson to aggressively trade stocks and mutual funds
- C. Johnson and XYZ churned Smith account.
- D. Johnson and XYZ concentrated Smith account in high-risk technology securities.
- E. Johnson and XYZ knew that Smith opened his account with borrowed money.

¹¹ Exhibit D – Portfolio Buys From 8/31/2000 through 9/27/2000

Sample Report

- F. Johnson and XYZ margined the borrowed money to create margin on top of margin.
 - 16.F.1 Extremely high risk
- G. Johnson and XYZ canceled and re-billed Smith transactions to increase the commissions to excessive rates.
- H. Johnson and XYZ Shorted Stock
- I. Johnson and XYZ exchanged high-risk (low rated) long and short OTC mutual funds.

17.0 UNUSUAL TRANSACTION PATTERN

It is my opinion, based upon a reasonable degree of professional certainty, that Johnson's lack of experience in investment matters and XYZ's lack of supervision resulted in a telltale transaction pattern that should have raised "red flags" to supervisors at all levels within the XYZ organization. This is discussed in the supervisory issues section of this document.

18.0 SUPERVISORY ISSUES

It is my opinion, based upon a reasonable degree of professional certainty,, that Securities Alliance Inc. failed to supervise Duane Johnson and the activities related to Smith' account. I base that opinion on the following "supervisory red flags":

- A. Duane Johnson should have been on "heightened supervision".
 - 18.A.1 Johnson was not securities licensed and was not trained in investment matters when XYZ hired him.
 - 18.A.2 At XYZ Johnson had only taken courses focused on passing the securities licensing examinations.
 - 18.A.3 Johnson, a new registered representative, worked from his home without any on-site supervision or guidance.
 - 18.A.4 Johnson had filed for bankruptcy twice and had seven un-settled tax liens when Securities Alliance hired him.
- B. XYZ approved and accepted contradictory information on Smith new account forms that Johnson completed just months apart.

Sample Report

Item	03/22/2000 Form ¹²	08/22/2000 Form ¹³	09/02/2000 Premier Select IRA
Annual Income	\$50,000	\$60,000	\$60,000
Net Worth*	\$500,000	\$1,000,000	\$1,000,000
Liquid Net Worth	\$150,000	\$800,000	\$800,000
Investment Objective	Growth and Income	Maximum Growth	Maximum Growth
Risk Tolerance	Speculation	Speculation	Speculative
Experience Mutual Fund	5 Years	10 Years	Form Blank
Investment Knowledge	Good	Good	Limited
Experience Stocks	6 Years	3 Years	10 Years
Experience Bonds	6 Years	3 Years	Form Blank
Occupation	Retired	Farm/Ranch - Retired	Self Employed/Retired
If Not Employed	Retired	Form Blank	NA
Source of Income	Retirement Pensions	Form Blank	Form Blank
Family Member Employed By Broker?	Form Blank	Form Blank	NA

*Exclusive of home and farm

18.B.1 On the back of the new account form, the instructions say
“FOR RETIRED CLIENTS, A SOURCE OF INCOME MUST INDICATED”

18.B.1.1 Johnson left the boxes related to Smith’ retirement and source of income blank on the 8/24/2000 form.

18.B.2 XYZ approved this document.

18.B.3 XYZ approved all transactions made in Smith account.

18.B.4 Initial Smith’ portfolio that was invested (concentrated)

18.B.4.1 83.56% in technology stocks.

¹² XYZ047

¹³ XYZ048

Sample Report

- C. Short Sales – 10 Shorts and 10 Short Covers
 - 18.C.1 Short sales have limited profit potential and unlimited risk.
 - 18.C.2 The client is short the dividend.
- D. Mutual Fund Exchanges between the ProFunds Ultra OTC and the Pro Funds Ultra Short OTC
 - 18.D.1 10 transactions
- E. Unusual transaction / cancel and re-bill pattern
 - 18.E.1 Between August 31, 2000 and September 1, 2000 Johnson purchased securities in Smith account using the initial \$100,000 (borrowed money) deposit and margin
 - 18.E.2 The commissions on these trades about 1% of the trade total
 - 18.E.3 Between September 7, 2000 and September 27, 2000, Smith deposited additional funds and Johnson purchased additional securities.
 - 18.E.4 The trades made on September 7, 2000 were all cancelled and re-billed increasing the commissions substantially.
 - 18.E.5 Seven trades priced at industry average retail commission were canceled.
 - 18.E.5.1 Canceled commissions totaled \$1,202.11
 - 18.E.5.2 Canceled per share rate averaged \$0.90
 - 18.E.5.3 Canceled average percentage of investment, 0.84%
 - 18.E.6 Seven trades were re-billed to commission rates substantially above industry norms
 - 18.E.6.1 Re-billed commissions totaled \$4,133.44
 - 18.E.6.2 Re-billed per share rate averaged \$3.27
 - 18.E.6.3 Re-billed average percentage of investment, 2.50%
 - 18.E.7 Cancel and Re-bills are closely monitored by the securities industry. This activity should have been caught and questioned by XYZ.
 - 18.E.7.1 There is no evidence of this happening.

Sample Report

18.E.8 From September 8, 2000 through September 19, 2000, five additional trades were made.

18.E.8.1 \$3,220.00 additional commission was generated for Johnson and XYZ.

18.E.8.2 \$4.05 per share

18.E.8.3 2.95% of the value

F. From September 19, 2000, through the end of the account, Johnson and XYZ made approximately 155 additional transactions.

18.F.1 All Additional transactions were either at a zero commission rate or at a nominal rate, that just covers \$25 to \$40 ticket charge.

18.F.2 This should have been detected and questioned by XYZ.

18.F.2.1 There is no evidence that this happened.

G. The “outstanding NIGO” report for Duane Johnson dated 09/07/2000 shows that 11 accounts had been rejected for document related deficiencies.¹⁴

18.G.1 Two of the eleven were rejected because Johnson tried to open accounts for unsuitable clients.

18.G.2 One was rejected because “Suitability – Investment Experience”

18.G.3 The second was rejected “NOT ENOUGH ANNUAL INCOME OR NET WORTH TO HAVE MARGIN. PLEASE ADVISE US TO WHAT YOU WANT US TO DO”.

18.G.4 These additional “red flags” should have caused XYZ to question what Johnson was doing.

H. Active Account Review

18.H.1 According to documents provided by XYZ there were four active account letters sent to Smith by XYZ.

18.H.2 Three of the letters were identical form letters

18.H.3 None of the letters discussed actual losses, commissions, turnover or other deficiencies

¹⁴ XYZ484

Sample Report

18.H.4 None of the letters were preceded or followed by a phone call from XYZ to Smith.

18.H.4.1 Nobody from XYZ at any time called Smith to discuss the account and potential problems.

18.H.4.2 Nobody from management ever contacted Smith to schedule for a face-to-face meeting to discuss the problems in Smith account

I. The following table compares the active account letter dates and prior month end losses:

Letter Date	Prior Month Account Cumulative Loss
October 23, 2000*	(\$31,485.55) – September 30, 2000
February 13, 2001	(\$186,597.21) – January 31, 2001
March 12, 2001*	(\$193,707.04) – February 28, 2001
October 9, 2001*	(\$212,223.79) – September 30, 2001

*These letters are identical form letters.

J. There is no evidence that Johnson or Johnson's office was ever audited by XYZ.

18.J.1 NASD Rule 3010 requires periodic office inspections of every branch and non-branch location

K. Correspondence review of letters written to Smith by Johnson

18.K.1 Two of the letters were not dated

18.K.2 There is no evidence of approval by XYZ.

18.K.3 Letters contain promises, guarantees, puffery and unsupported claims.

18.K.4 The letters lack proper disclaimers.

18.K.5 The letters discuss mutual funds without offering a prospectus.

18.K.6 The letters discuss mutual fund performance.

18.K.7 The letterhead reflects that he is an OSJ office.

18.K.7.1 Johnson was not properly licensed to be an OSJ office

19.0 MSDW ACCOUNT ALLOCATION AND PERFORMANCE

It is my opinion, based upon a reasonable degree of professional certainty, that Smith's were in a well-diversified equity portfolio at MSDW. I base that opinion on information from a (2000 dated disk) Morningstar portfolio snapshot:

- A. A sector allocation close to the S&P 500
 - 19.A.1 15.93% overweight in technology
 - 19.A.2 15.6% more speculative than the S&P 500
- B. Approximately 5% cash
- C. Approximately 5% bonds
- D. Approximately 90% equities
- E. Portfolio rated 5 star (highest) by Morningstar
- F. Pre-tax portfolio return from 1995 to 2000 was 21.66% annually

20.0 DAMAGE CALCULATIONS

There are several ways to evaluate the damages to Smith caused by Johnson and XYZ. This section presents each.¹⁵

A. Out of Pocket Loss

Deposit from Bank Borrowings	\$100,000.00
Deposit from Morgan Stanley DeanWitter	\$200,000.00
<hr/>	
Total Deposits	\$300,000.00
Less Cash Withdrawn	\$ 70,000.00
Less Ending Balance	\$ 4,855.36
<hr/>	
Total Balances and Withdrawals	\$ 74,855.36
Out of Pocket Loss	(\$225,144.64)

B. Loss from the September Liquidation Request to the Account Closing

¹⁵ Note: None of the calculations includes the interest on the \$100,000 borrowed from the bank.

Sample Report

During September 2000, Clifford Smith contacted Johnson and instructed him to liquidate the XYZ account. Johnson failed to follow Smith instructions.

By the end of September 2000, the account was funded with \$100,000 of bank borrowed money and \$200,000 that came from MSDW. The account was margined and Smith was being charged margin interest. The following calculations show damages based on a liquidation on September 30, 2000.

Deposit from Bank Borrowings	\$100,000.00
Deposit from Morgan Stanley DeanWitter	\$200,000.00
<hr/>	
Total Deposits	\$300,000.00
Month End (September 30, 2000) Equity	\$268,514.45
Cumulative Profit & Loss at September 30, 2000	(\$ 31,485.55)
<u>Less Total Out of Pocket</u>	<u>(\$225,144.64)</u>
Damages at Liquidation Request	(\$193,659.09)

C. **MSDW Asset Allocation***

This calculation is based upon the Smith account asset allocation on the July 31, 2000 MSDW Statement. The asset allocation developed using a Morningstar Portfolio Snapshot that included all assets on Smith July 31, 2000 MSDW statement. The snapshot report was prepared with, year 2000, Morningstar disks.

The asset allocation was 5% cash, 5% bonds and 90% equities.

Deposit from Bank Borrowings (8/24/2000)	\$100,000.00
<u>Deposit from Morgan Stanley DeanWitter (9/5/2000)</u>	<u>\$200,000.00</u>
Total Deposits	\$300,000.00

\$70,000 Ending Value from 8/24/2000 to 12/21/2000 \$ 65,527.00

Sample Report

\$30,000 Ending Value from 8/24/2000 to 7/29/2004	\$ 26,371.00
<u>\$200,000 Ending Value from 09/05/2000 to 7/29/2004</u>	<u>\$166,375.00</u>
Total Ending Value	\$258,273.00
MSDW Asset Allocation Loss	(\$ 41,727.00)
<u>Out-of-Pocket Losses</u>	<u>(\$225,144.64)</u>
MSDW Asset Allocation Damages	(\$183,417.64)

D. Well-Managed Portfolio*

Based upon my conversation with Clifford and Linda Smith on 11/2/2005, it is my opinion, based upon a reasonable degree of professional certainty, that a proper asset allocation for them at the time they opened the account with XYZ and Johnson would have been 65% bonds and 35% equities. For the calculations, I used Vanguard Index Funds. Had Johnson invested Smith portfolio using the above allocation, the results would have been as follows:

Deposit from Bank Borrowings (8/24/2000)	\$100,000.00
<u>Deposit from Morgan Stanley DeanWitter (9/5/2000)</u>	<u>\$200,000.00</u>
Total Deposits	\$300,000.00
\$70,000 Ending Value from 8/24/2000 to 12/21/2000	\$ 70,178.00
\$30,000 Ending Value from 8/24/2000 to 7/29/2004	\$ 34,183.00
<u>\$200,000 Ending Value from 09/05/2000 to 7/29/2004</u>	<u>\$221,987.00</u>
Total Ending Value	\$326,348.00
Well Managed Portfolio Profits	\$ 26,348.00
<u>Out-of-Pocket Losses</u>	<u>(\$225,144.64)</u>
Well-Managed Portfolio Damages	(\$251,492.64)

*In the MSDW allocation and the well-managed portfolio damage calculations, the following proxies were used:

Sample Report

Cash = 3 Month CD Index

Stock = Vanguard 500 Index Fund

Fixed Income = Vanguard Total Bond Index Fund

21.0 COMPENSATION

My billing rate is \$250.00 per hour. I also utilized staff for proofreading and clerical functions.

22.0 CONCLUSION

It is my opinion, based on a reasonable degree of professional certainty that Johnson and XYZ mishandled the Smith' account. It is my further opinion that XYZ failed to supervise Johnson. I base my opinions on the following:

- A. Johnson had known Smith (a relative) for years and knew that both Clifford and Linda Smith were retired and could not have replaced their assets if lost. Yet, they placed Smith in an extremely risky and volatile situation.
- B. Johnson and XYZ accepted borrowed money as an initial account opening deposit and then margined it creating excessive leverage beyond that allowed by Regulation T or Regulations U.
- C. Johnson and XYZ did not have a signed discretionary trading authorization. Johnson and XYZ aggressively traded Smith account without authorization.
- D. The initial portfolio construction was 83.56% concentrated in technology issues.
- E. Johnson and XYZ purchased an unsuitable portfolio of securities in Smith' account then they continued to add risk by short selling securities and exchanging long and short OTC mutual fund shares.
- F. Johnson and XYZ failed to follow Mead's instructions to liquidate the account.
- G. Securities Alliance Inc. failed to supervise Johnson.
- H. Johnson and XYZ excessively traded Smith account.

Sample Report

- I. Securities Alliance failed protect Smith from Johnson.
- J. When the Smith relationship with Johnson and XYZ ended, Smith had lost (\$225,144.64).

Respectfully Submitted,

Gregory B. Wood
Securities Litigation Support, LLC
44 Anthem Creek Circle
Henderson, NV 98052
702-253-9663

Sample Report

Exhibits

- A. Greg B. Wood CV
- B. Duane Johnson CRD
- C. Overstated Commission Spreadsheet
- D. Portfolio Buys from 08/31/2000 to 09/27/2000