

## SECURITIES ARBITRATION: DO YOU HAVE A CAUSE OF ACTION OR NOT?

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Have you, like your clients, recently lost money in the stock market? Do you blame yourself or is the "market" to blame? Perhaps you feel that you are the victim of sharp practices and are entitled to redress. Determination of whether or not you have a viable cause of action is dependent upon many factors, some factual, some legal. This article discusses just two of the more common fraudulent practices so that you can identify whether or not you, or your clients, have a cause of action.

### Churning

Churning is a synonym for overtrading. It occurs when a registered representative, exercising control over the volume and frequency of trading in a customer's account, abuses the customer's confidence for personal gain by initiating transactions that are excessive in view of the character of the account. Churning is a deceptive practice made actionable by Section 10(b) and Rule 10(b)(5). In many jurisdictions it is also considered a breach of the registered representative's fiduciary duty under the common law. Churning is a violation of the rules of the NASD which prohibit unfair dealing and unsuitable recommendations.

A registered representative may exercise control over a customer's account even if the account is non-discretionary. The degree of control must be of such magnitude as to establish that the account became, in effect, discretionary. By way of example, in one case a

77 year old widow with no previous investment experience opened a brokerage account with \$500,000 inherited from her husband. She was induced by her registered representative to trade excessively. The court found that the registered representative exercised a degree of control sufficient to warrant protection. Her age and lack of comprehension of market operations and business affairs were significant factors in the court's determination that her account had been churned.

### Suitability

A registered representative has a duty to make inquiry into a customer's financial situation and needs before making any recommendation to buy or sell a security. This is called the "know your customer" rule. A registered representative who fails to properly investigate a customer's financial situation does so in violation of the law. One concern, touching upon suitability, is the recent trend of brokerage houses to encourage customers to trade on margin. Brokerage houses benefit handsomely from the interest which they earn on margin accounts. They also benefit from the increase in commission income generated by the additional trading made possible by the funds borrowed on margin. Even if the account is a managed account, the brokerage house still benefits because its management fee increases as the assets under management increases. If your registered representative recommends that you open a

margin account to increase your trading profits, ask what happens if the value of your stocks drop. Customers may be unaware of the inherent risks of trading on margin while the net value of their portfolios remain substantially the same or increase. The risk of loss becomes painfully apparent when and if the value of the portfolio drops dramatically and the margin loan is called. The customer then needs to cover the margin call. If the customer does not have sufficient equity in his or her account to cover the call, the customer will need to obtain the necessary funds elsewhere or face a lawsuit from the brokerage house. If the account is over concentrated in one stock which drops precipitously, the customer will lose not only the value of the stock but also the collateral from which to pay off the margin debt. Did the customer really understand the risk of margin trading? Was over concentration in one or a few stocks suitable for that customer? These are factual determinations which need to be made in suitability/margin cases.

The NASD has a rule on suitability (2310) which does not include any requirement that the registered representative act with scienter. It specifically requires that prior to the execution of a transaction a member firm shall make reasonable efforts to obtain information concerning: (i) the customer's financial status; (ii) the customer's tax status; (iii) the customer's investment objectives, and (iv) such other information used or considered to be

reasonable by such member or registered representative in making its recommendations to the customer.

If that same 77 year old unsophisticated widow was induced to invest 100% of her portfolio in one stock, e.g. Enron, that recommendation would be inappropriate and unsuitable because of the over concentration of her portfolio in just one stock. If her registered representative recommended that she margin her account to buy an even larger position in Enron, that second recommendation would also be inappropriate and unsuitable.

### **Switching**

Switching occurs when one mutual fund is sold to buy another. When that happens, a switch letter should be signed. The switch letter should spell out why the mutual fund was switched and disclose the commissions earned by the registered representative. Some mutual funds may be unsuitable because they invest in aggressive, even speculative securities. Be careful about mutual funds sponsored by brokerage houses which invest in companies with which the brokerage house has an investment banking relationship. Always make sure that you receive and read the mutual fund prospectus to see what the breakpoint is for commissions and the degree of risk involved in that fund.

### **How to Protect Yourself or Your Client**

Prior to opening a brokerage account, call the NASD at 1-800-

289-9999 to determine whether your registered representative and his or her brokerage house has ever been the subject of any formal disciplinary action or lawsuit. You can order a written report if there is any disclosable information. You can also send a Freedom of Information Act request to the New Jersey Bureau of Securities at 153 Halsey Street, Newark, New Jersey 07102. Call 973-504-3600 for the form.

Never sign any new account or other forms in blank. When you sign a new account form make sure that the investment objectives and all of the other information on the form is already filled out and is accurate. If your registered representative suggests an investment objective that is more aggressive than you feel comfortable with, don't be swayed. Fill out the form truthfully and consistent with your trading experience. Don't exaggerate your net worth or income. Compliance departments of brokerage houses review these forms to make sure that your trading is consistent with your investment objectives and your financial circumstances. If the information is not accurate, you lose the benefit of that oversight protection.

When you first open your account, ask your registered representative to provide you with a detailed written financial plan including specific investment recommendations and goals. Show that plan to an independent third-party financial consultant (e.g. a registered investment advisor, certified financial planner,

accountant or lawyer) to get a second opinion. Retain the third-party financial consultant to review your portfolio on an annual basis. Tell your registered representative of the involvement of that third-party financial consultant. Having two experienced investment professionals keeping an eye on your account will, hopefully, prevent abuse while giving you the opportunity to participate knowledgeably in all investment decisions. Elderly investors would also be well served to have these reports, and maybe their monthly statements, simultaneously sent to a trusted family member or advisor.

If you feel that you have been the victim of a fraudulent practice you should immediately send a written letter of complaint to the compliance officer of your brokerage house detailing your grievance. It is important to promptly document your complaint.

### **Conclusion**

If you have a claim worth pursuing, pursue it. Although the arbitration process is not perfect, it is generally less expensive and faster than going to court. You will have a hearing before an experienced panel that will generally understand whether industry rules have been violated and render an award to you if your facts are compelling.

*This article was originally published in the February 2003 issue of New Jersey lawyer Magazine, a publication of the New Jersey State Bar Association..*