Securities Fraud and the Elderly

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The following are all true stories. They demonstrate how the elderly became victims of securities fraud. The narratives are meant to identify some of the more common abusive practices so that you and your clients won't also become victims.

1. Mrs. "R" (Promissory Note Scam)

Mrs. R was 74 years of age and retired. Her relationship with her broker went back almost fifteen years. While working as a secretary she had enrolled in a salary reduction plan so she could make weekly deposits into her IRA. She was a very conservative investor, never owning any stock.

When her IRA fluctuated, because it was invested in mutual funds, she became concerned and went to her broker. He recommended a "safe" investment earning 10% that was not subject to losses, like the stock market. He assured her that it was a good investment because the promissory note which secured her 10% "loan" was guaranteed by a reputable surety company. Unfortunately, he failed to conduct any due diligence on the promoters or the surety company. The program, purported ownership of a newly built hotel in Italy, was a scam, the promoters were convicted of fraud, and Mrs. R lost all of her money.

Narrative: The broker was duped, just like Mrs. R. Even his own relatives lost money. The substantial "finder's fee" was certainly an inducement but, indicative of these types of programs, he had been assured it was not a securities offering and therefore could be sold without the approval or knowledge of his employer. When his employer learned of the program, and his involvement, he was immediately terminated for cause. Because the employer did not know of or approve the investment, it constituted a "selling away" violation.[i] Mrs. R was lucky.

She commenced arbitration and was awarded a full return of her entire loss. Many investors in promissory note scams are not so lucky.

2. **Mr. "H" (Unsuitable Investment-Selling Away)**

Mr. H was the victim of a horrendous truck accident. He suffered serious burns which prevented him from working. He and his family struggled to make ends meet. Several years later he received a low five figure settlement from his personal injury lawsuit. His attorney advised him to get a financial advisor to properly invest this money.

Mr. and Mrs. H walked into the office of a large insurance company which also provided financial planning services. The agent they met sold them two life insurance policies and an annuity. Given their dire financial circumstances these investments were unsuitable, but the real wrongdoing was yet to come. Four months later that same agent recommended that they invest the remainder of the settlement in a local health fitness club in which he also had an interest. The investment promised a 12% return per annum. They invested a total of $100,000 for 10% ownership of the health club which declared bankruptcy that same year. The true investment risks were never explained to them by the agent. To add insult to injury, because the remainder of their settlement was not enough to reach the $100,000 figure, at the urging of the agent, a portion of their investment was funded by borrowing against the cash value of the annuity.

Narrative: The general rule is that when an investment sounds too good to be true, it usually is. Luckily, the agent was dually licensed with a broker dealer affiliate of the insurance company. The fitness club investment was a securities offering which should have been reviewed, approved, and sold through the broker dealer. Since neither the broker dealer nor the insurance company were aware of nor approved the investment, just like in the previous example, the agent committed a "selling away" violation.[ii] Because a securities offering was

involved, an arbitration was commenced against the broker dealer. The broker dealer was found liable, after a hearing, and ordered to reimburse Mr. and Mrs. H for their entire loss, plus interest and attorney's fees.

3. **<u>Mr. "W" (churning)</u>**

Mr. W, approximately 72 years of age, was diabetic, suffering from diminished mental capacity and dementia. He never personally met his broker who had cold called him. Mr. W had a trading account which was open for only 6 months. In that short period of time the account lost 60% of its value. Mr. W was institutionalized, but not before the account was "churned" and money was lost. Mr. W's broker engaged in "in and out" trading, churning the account at an annualized rate of 52 to 1. That means that the total turnover of securities bought and sold, if annualized, equaled 52 times the average monthly balance in the account. This was a staggering turn over rate by any rational standard. Churning is a serious violation of industry practices and standards.[iii] The SEC has ruled that an annualized turnover ratio as low as 2 to 1 can constitute churning.[iv]

Narrative: Churning is defined as excessive trading for the purpose of generating commissions. That is exactly what happened here. Churning often occurs when long time trusted financial advisors take advantage of the frailties of their aging customers. Family members and trusted professionals can help by identifying and hopefully preventing this type of unsuitable behavior. It is important to know that even if an account makes money, a broker can still be liable to repay commissions if the account was churned. In Mr. W's case an arbitration was commenced by his court appointed guardian and a settlement achieved.

4. **<u>Ms. "P" (unsuitable investments; over concentration in high tech mutual funds)</u>**

When Ms. P filed her claim in arbitration she was 65 years old and certainly not a sophisticated investor. She immigrated to this country when she was 15 years old and had never bought or sold any stocks in her life. She worked for 24 years as a machine operator. When she retired she received a lump sum retirement payment of $104,000. She also had a modest 401(k). All of that money was invested in two separate IRA annuities purchased through her bank.

Her new broker knew that she was retired, withdrawing about $1,200 a month from her annuities to live on yet he recommended that she sell both of the annuities in order to buy mutual funds. He told her that her new investments would be safe and that the mutual funds would provide a better return than what she was receiving from the annuities.

When the broker went to Ms. P's house to do the paperwork, she found out that there would be a surrender charge of more than $6,000 to sell one of the annuities. The broker told Ms. P not to be concerned about this surrender charge because she would make back the entire amount and more by Christmas. He said that she would never lose any of her principal by buying the mutual funds. At his recommendation she liquidated the two annuities and purchased B shares in two high tech mutual funds.

Shortly thereafter the broker retired but not before both of the mutual funds experienced dramatic drops in value. The broker assured her that the drop in value was only a temporary market "adjustment". When her new broker told her that the two funds stood no chance of ever recouping all of their losses, she sold them. One of the funds had dropped from $50,000 to $8,705. The other from $106,000 to $32,218.

Narrative: The broker induced the sale of income producing annuities to buy B share mutual funds which were over concentrated in the tech sector. That "switch" was not in Ms. P's best interest. The mutual funds were not suitable for her because they did not generate income,

as did the annuities, and they were over concentrated in one sector of the market. They were also unsuitable because they were B shares. B shares pay the broker a higher commission than A or C shares and have significant back end surrender charges. B shares also charge the customer continuing management fees, a part of which is shared with the broker as 12b1 fees. Many brokerage firms now prohibit the sale of B shares because of their high "load." Back end surrender charges, sometimes in place ten years or more, negatively impact liquidity. What the broker did here was in his best interest, not Ms. P's. His recommendation enabled him to receive up front and continuing commissions. If the underlying investment mix was inappropriate, he could and should have changed the mix through the annuity companies, at no cost to Ms. P.[v] Ms. P commenced an arbitration and the matter was settled.

5. **Mrs. "T" (managed account)**

When Mrs. "T" filed her arbitration claim she was almost 72 years old and not a sophisticated investor. Many years before, her husband had left her and she was forced to raise their three children alone. Her trusted broker was a longtime family advisor. For a long time he was associated with a bank where her portfolio, mostly blue chip equities inherited from her father, was virtually inactive. When the broker moved to a retail broker dealer, she followed. Her account was now being managed for a "modest" annual fee. Almost immediately the broker sold virtually all of her existing blue chip equities to purchase high tech, speculative stocks. When the value of her account began to drop and she complained, the broker told her not to "micromanage". The market goes up and down but, he said, eventually it would come back up again. As the value in her account continued to go down, the broker assured her he was diligent in following the stocks. When Mrs. T closed the account it had dropped over 30% in value.

Narrative: Steering Mrs. T to a managed account is a trend now common with broker dealers. The goal of the broker dealer is to annuitize as many portfolios as it can. Instead of continuing the static buy and hold retirement account that Mrs. T previously had, with commission only compensation, her portfolio was now being managed for a fee that the brokerage firm would collect every year. By annuitizing accounts broker dealers can make money year after year, not just the commissions when securities are bought and sold. This allows them to also control the flow of billions of dollars in discretionary funds. What if the broker managing the account is not an experienced trader, as was the case here? No problem. Losses will be blamed on "the market". The public needs to know that when an account is managed, the broker is often pressured or incentivized into buying products that generate the most compensation for the brokerage firm, at the expense of objective advice for the benefit of the customer. This is illegal but exactly what happened here.

6. **Mr. and Mrs. "G" (Unauthorized Trading-Manipulated Stock)**

Mr. and Mrs. G opened an account with a broker whom they felt they could trust. They bought several penny stocks at the recommendation of the broker and made money. After several months, without their knowledge or authorization, the broker purchased additional shares of one of the penny stocks. When Mr. and Mrs. G found out, they directed the broker not to purchase any additional shares and to sell the unauthorized stock. The broker did not follow their instructions.[vi] The broker dealer was part of an underwriting group that had taken that company public, a fact not known to them until later.[vii]

Narrative: The penny stock purchased without authorization by the broker was being manipulated. Mr. and Mrs. G were victims. It is common, in boiler shop operations like this to have the investors make money on the one or two initial trades. This is done to gain the trust of

the new customers and position them for the inevitable losses to come. In this case Mr. and Mrs. G were more attentive than most new investors but it was too late. The most descriptive phrase to describe a boiler shop operation promoting manipulated stock, as here, was said once by a stock manipulator forced to testify: "The investors were in a roach motel: easy to get in but impossible to get out.". Mr. and Mrs. G did what they should have done. They put all of their orders in writing, by fax and e-mail, and complained immediately, in writing, to officers of the firm and the regulatory authorities. Only because of their documentary proof and prompt action were they able to settle their arbitration claim against the broker dealer. As a side note, the broker dealer went out of business very shortly after they settled their claim.

7. 7. **Mr. "D" (unsuitable investment-fraud)**

Mr. D's broker was the majority owner of his own small broker dealership. The broker recommended and induced Mr. D to purchase stock of the broker dealer with funds from his IRA. This was an unsuitable investment because the broker, knowing that Mr. D was about to retire, made a recommendation that was illiquid, overly risky and benefitted only the broker. A fraud count was added to the Statement of Claim because the broker failed to disclose significant operating losses by the broker dealer in the four years prior to the investment.[viii] The broker dealer went out of business less than two years after Mr. D's investment. As a result of this loss, Mr. D. was unable to retire and had to continue working.

Narrative: All brokers have an obligation to put the interests of their customers first. Obviously that was not done here. The broker took advantage of his relationship with Mr. D to try and bail out his failing broker dealer. Should Mr. D have been more diligent in investigating the proposed investment? Sure, but it was the broker's obligation to disclose all material facts

and to only recommend investments suitable for Mr. D. That was not done. After a full hearing the broker was held personally liable and ordered to repay Mr. D for all his losses.

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[i] In BMA Financial Services, Inc. v. Guin, 2001 U.S. Dist. LEXIS 18556 (W.D. La., 9/27/01) the investors purchased promissory notes from a purported financial planner who was in the process of becoming registered with an NASD member firm. The member firm was unaware of the sale of the promissory notes. The financial planner was terminated by the member firm after it learned of the transaction. The BMA court held the member firm liable for the acts of its "associated person.".

[ii] In {TA \s "Jairett v. First Monta " \c 2 \l "Jairett v. First Montauk Sec. Corp., 2001 WL 267869 (E.D. Pa. March 14, 2001)"}Jairett v. First Montauk Sec. Corp., 2001 WL 267869 (E.D. Pa. March 14, 2001), the court rejected a brokerage firm's claim that it was not liable for its registered representative's fraudulent, unauthorized recommendations. The court found the broker-dealer liable for failing to strictly supervise the acts of its registered agent. The court agreed with the earlier decision of {TA \s "Carroll v. Hancock" \c 2 \l "Carroll v. John Hancock Distrib., 1994 WL 87160 (E.D. Pa. Mar. 14, 1994)"}Carroll v. John Hancock Distrib., 1994 WL 87160 (E.D. Pa. Mar. 14, 1994), which held that the brokerage firm's representative had created the impression that the securities were offered through the firm and therefore the investors' claims could proceed on the theory that the persons selling the investments were not properly supervised.

[iii] Erdos v.SEC, 742 F2d 507 (9th Cir. 1984); Miley v. Oppenheimer & Co., 637 F.2d 318 (Fifth Cir. 1981).

[iv] In In the Matter of Gerald E. Donnelly, Securities Exchange Act, Rel No. 36690 (Jan 5, 1996), 61 SEC Docket 47, at pg. 50 n. 11., the SEC cited approvingly respondents' acknowledgement that turnover ratios of between 2-1 and 4-1 are presumptive of churning.

[v] FINRA Rule 2310 requires a registered representative, when making investments, to determine that such investments are suitable for the customer. Clark v. John Lamula Investors, Inc., 583 F.2d 594, 599-600 (2nd Cir. 1978); Clinton H. Holland Jr., 52 S.E.C. 562, 566 (1995) aff'd 105 F.3d 665 (9th Cir. 1997) "[A] recommendation can be unsuitable under the reasonable basis standard regardless of whether the transaction ultimately results in a profit or a loss."

[vi] In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Douglas T. Millar and Deborah T. Millar, the United States District Court in Pennsylvania (civil action 02-1408 decided May 20, 2003) affirmed an arbitration award in favor of Claimants for $7,741,305 in damages against Merrill Lynch for failing to act with "reasonable care and diligence in responding to the Millars' instructions" to sell a substantial portion of their stock holdings in Free Markets, Inc.

[vii] A stockbroker's duty to disclose material facts was discussed by the Second Circuit Court of Appeals in Chasins v. Smith Barney & Co., Inc., 438 F.2d 1167 (2nd Cir. 1970). In Chasins, an investor purchased 4 over-the-counter stocks based on the broker's recommendations. The firm only disclosed its role as principal on the trades. It did not disclose that it acted as market maker and underwriter for the stocks or the price it had paid for the stock it was selling to the retail customer. A firm's duty to disclose this information, the Court explained, is particularly important since it can reveal the motivations behind recommendations made to the customer.

[viii] The duty to disclose the personal interest that a broker (or broker dealer) has in a particular recommended security was reaffirmed in Prawer v. Dean Witter Reynolds, Inc. 626 F. Supp. 642 (1985). There the court explained that such disclosure was necessary to alert a potential purchaser to motivation issues. If the material information had been disclosed, the Court opined, "Prawer might perhaps have suspected that Cowan was hoping to stimulate market activity in those securities for his own benefit, and was not giving the disinterested advice he hoped to receive from his account executive.