FINRA ARBITRATION: IT’S BAAACK!

Dallas Bar Association
Alternative Dispute Resolution Section

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The Rescue Plan
POR FAVOR!
LEMMME GO HOME!

LOOKS LIKE
THE U.S. ECONOMY
IS WORSE OFF
THAN WE
THOUGHT.

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SUN SENTINEL
"They're out of money, so you lose."
OVERVIEW OF FINRA ARBITRATION PROCESS

1. Filing of claim and answer along with Uniform Submission Agreements; FINRA which has exclusive jurisdiction, usually arising out of the arbitration agreement between customer and broker;

2. Selection process of the 3-member arbitration panel (2 public and 1 non-public; one of whom is chair);

3. Initial Pre-hearing Conference (IPHC) between counsel and the panel;

4. Discovery of documents and information as permitted by FINRA rules and the arbitration panel:
   • Discovery Guide;
   • Other discovery, including panel-issued subpoenas, tailored specifically to the particulars of the claims and defenses;
5. Hearing on the merits before the FINRA arbitration panel:
   (a) Ordinarily involves a less stringent application of rules of evidence than in court cases;
   (b) Almost unfettered discretion of the panel to admit or exclude evidence;

6. Written arbitration award issued by the panel, usually within 30 days of the final day of hearing:
   (a) Ordinarily not a “reasoned” award;
   (b) Ordinarily a product of both law and equity in which principles of equity are often controlling;

7. Confirmation or challenge of the award in court

8. Award as final and not ordinarily appealable. Exceptions include:
   “Evident partiality” of panel, usually accompanied by:
   (a) Failure to disclose material information which would tend to show bias or partiality of panel member(s) or;
   (b) Fraud in the arbitration process which would warrant vacatur of the award.
HYPOTHETICAL CASE:
“GONE, BABY, GONE!”

• Al Gone is a 55 year old “trust baby” whose parents created a family trust, The Al Gone Trust, in 1998 with a principal of $1.5 million.

• The Trust has helped to sustain Al who is its sole beneficiary. Al is an unsophisticated investor with a learning disability who has a high school diploma and has held clerical jobs.
• At Al’s request in 1999, his 77 year old mother, the trustee of The Al Gone Trust, places its principal in an Account with Mr. Risker (Risker) a broker who has been affiliated with three brokerage firms while handling the Account.

• Risker’s most recent affiliation, in 2006, is with BenBroke Brokerage Firm (Benbroke) a nationally reputed, full-service retail brokerage firm.

• All transactions in the Account are cleared through Clearing Co.
• Al receives unrelated income totaling $100,000 each year from his family’s investments which are not a part of the Al Gone Trust.

• Because of the current recession, that income will likely be reduced during at least 2009-2010.
• In 2006 and 2007, Risker has the Account’s funds almost fully invested in large-cap and mid-cap common stocks and, from time-to-time, in options including covered calls, other calls and puts.

• There is no signed agreement authorizing options trading other than covered calls in the Account.
• Risker also trades the Account on margin, using margin funds “borrowed” from ClearingCo to buy stocks.

• While he signed a margin agreement for the Account, Al does not understand that by his trading the Account on margin, Risker has caused the Trust to borrow monies that amount to 25% of the value of the assets in the Trust’s account.

• This creates leverage that will increase profits or losses in the Account by 25%. The Trust must pay interest on the borrowed money.
• Beginning in 2006, Al’s long-time CPA tells both Risker and Al repeatedly that she is concerned the Account is “over-margined.” Thus, it is subject to undue risk that in a falling market it will sustain heavy losses in the event of a series of margin calls.

• Nonetheless, the amount of margin risk in the Account remains unchanged.
• With the oral consent of both the trustee and Al, Risker “takes discretion” in the Account.

• Although there is no written agreement authorizing him to do so, he buys and sells stocks and options in the Account without first consulting Al Gone or anyone else.

• Risker trades the Account heavily. He reports almost daily to Al by phone, telling him whether the Account “made money” or “lost money” that day.
• Al tells Risker that:
  – he trusts him completely with his investments,
  – he has kept the Account with Risker as he moved from one brokerage firm to the next
  – his goal has always been “to make money but not to lose my investments.”

• The Account opening papers state that its purpose is primarily for “growth and income” and, secondarily, for “speculation.”
• Al opens a “mirror account” with a U-Trade, an online broker which does not give investment advice.

• Al buys and sells in the U-Trade “mirror account” exactly as Risker does in the Trust Account at BenBroke, except that the size of Al’s trades are proportionately smaller.
• During 2006 and up to October, 2007, the Account appreciates substantially in value as the stock markets continue their march upward.

• Most of the stocks which Risker buys on margin go up and so contribute to its increased value.
• In October, 2007, the stock markets peak and begin a decline which continues through the rest of the year and into 2008.
• The declines then accelerate rapidly in the fall of 2008, as Risker ramps up the margin exposure in the Account to almost 50% of its value.
• Sensing a low-cost investment opportunity in both REITs and financial stocks, Risker meets with Al and the Trustee and, with their consent, reallocates the Account holdings toward those two sectors.
• The Account loses almost half of its $1.5 million dollar value as margin calls are made against it.
• During the markets’ plummet, its options bets are mostly losers.
• Its overall losses total almost 70% of its value when Risker began handling the Account, i.e. it is now worth $495,000.
• Al is panicked when he realizes the extent of his losses – most of which are fixed by the margin calls -- in the Account; also in the U-Trade account which he opened.

• He is further panicked when he hears news reports that:
  – BenBroke is financially distressed and
  – It has told the Congress and Treasury that it will likely go out of business if it does not immediately receive government “Bailout funds.”
• Al hires a lawyer who files a statement of claim for both Al Gone and the Al Gone Trust against BenBroke and Risker for
  – Negligence
  – Negligent Investment Advice
  – Breach of contract
  – Breach of fiduciary duty
  – Fraud
  – Unsuitable Investments
  – Unauthorized trading and
  – Churning in the Account.
• The statement of claim seeks $2.5 million in damages for losses in the Account, margin interest paid, commissions earned and punitive damages and attorneys fees.

• He also files claims against ClearingCo for its continuing part in putting the account at risk by “excessive margin.”
• Both BenBroke and Risker, as Respondents, are represented by the same counsel who files an answer denying any wrongdoing and denying that either Risker or BenBroke had any fiduciary duty to Al Gone or his Trust.

• Respondents counsel also points to the broad market decline as “exceptional, widespread and without parallel in market history.”
• ClearingCo. denies all alleged misconduct
• Its answer states that, under both its agreements with BenBroke and under the law, it had no duty either to Al or to the Al Gone Trust other than to clear the transactions involved in a complete, accurate and timely manner and that it did so.
Restatement (Second) Torts § 552 provides:

"Information Negligently Supplied for the Guidance Of Others"

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
• 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 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.
Rule 405. Diligence as to Accounts

Every member organization is required through a principal executive or a person or persons designated under the provisions of Rule 342(b)(1) [¶2342] to:

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervision of Accounts - Supervise diligently all accounts handled by registered representatives of the organization.
(3) Approval of Accounts - Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a principal executive or a person or persons designated under the provisions of Rule 342(b)(1) [¶2342]. The member, principal executive or other designated person approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.
Rule 472 - Communications With The Public

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(j) Specific Standards for Communications
(1) Recommendations

A recommendation (even though not labeled as a recommendation) must have a basis which can be substantiated as reasonable.

When recommending the purchase, sale or switch of specific securities, supporting information must be provided or offered.

The market price at the time the recommendation is made must be indicated.