A Primer on Bringing Claims Against Stockbrokers and Brokerage Firms

By **Benjamin R. Picker, Esq.**

An elderly couple who have been retired for years walks into your office and tells you that their stockbroker at a mid-size brokerage firm – a person they had trusted for several years – invested their entire nest egg in high-commission, closed-end mutual funds without their permission, and did so shortly before a major "correction" in the stock market. As a result, these good people lost half of the money they intended to live off of during their golden years. Would you know how to handle such a matter? Where would you bring suit? What types of claims would you assert?

Handling disputes between members of the securities industry and their customers is a specialized area of the law. A customer who has been harmed by the acts or omissions of a securities brokerage firm (known as a broker-dealer in the securities industry) and/or by a stockbroker (known as a registered representative) are ordinarily required to adjudicate their claim in arbitration before the dispute resolution arm of the Financial Industry Regulatory Authority (FINRA). The arbitration process is governed by the FINRA Rules of Arbitration Procedure for Customer Disputes, which are available on FINRA's website. The arbitration process is initiated by the filing of a Statement of Claim, which FINRA serves on the respondent(s). A fee, which is determined by the amount of the claim asserted, must be paid by the claimant to initiate the arbitration process. The respondent(s) then have forty-five days after service to file an Answer. Motions to dismiss are discouraged in FINRA arbitration. The respondent(s) must also pay a fee to FINRA.

After the arbitrators are selected and an initial pre-hearing telephone conference is held, the parties proceed with discovery. Discovery is generally limited to the exchange of relevant documents (FINRA provides a list of documents that are presumptively discoverable in all cases), with information requests being very limited, and depositions being prohibited unless a party or crucial witness is near death.

At least twenty days prior to the hearing, the parties must exchange lists of the witnesses they intend to call and the documents they intend to introduce at the hearing. The arbitrators have the power to issue "notices to appear" to members of the securities industry, and the arbitrators may also issue subpoenas to those who are not members of the securities industry. The arbitration hearing is usually held at a FINRA hearing site nearest to where the claimant resided at the time of the transactions in question.

Typically, a customer in FINRA arbitration is complaining about unsuitable investments, excessive trading, or unauthorized trading, although there are many other types of actionable conduct. While it is not necessary to set forth legal causes of action in the Statement of Claim, such claims are often framed as causes of action for negligence, breach of fiduciary duty, fraud, conversion, violation of the Pennsylvania Unfair Trade Practices and Consumer Protection Law, and violation of the Pennsylvania Securities Act. Expert witnesses are often necessary to prove wrongdoing and to accurately calculate damages.

Whether a particular investment is "unsuitable," or whether a particular investment portfolio has been "unsuitably" invested, is a highly factual determination that depends on factors such as the customer's risk tolerance, investment objectives, needs, time horizon, age, income level, and net worth. An investment is generally "unauthorized" where it has not been sanctioned by the customer in advance. If a customer has given his or her stockbroker "discretion" to manage the investments in an account, a trade can nonetheless be "unauthorized" if it does not comport with the customer's written instructions or stated investment objectives.

Excessive trading, also known as "churning," is frequent trading by a broker in a customer's account largely to generate commissions. Churning does little to meet the client's investment objectives and often results in substantial losses and trading costs in the client's account. There are two generally-accepted benchmarks for churning: cost-to-equity ratio and turnover rate. Cost-to-equity ratio is the annualized ratio of the costs (fees, commissions, etc.) associated with an account divided by the average equity in the account during a given period of time. A cost-to-equity ratio of 10 means that an account must earn a 10% return before the customer will actually make any money because 10% of the account is being eaten up by fees, commissions and other charges. Turnover rate is the ratio of the annualized amount of securities purchased in an account over a period of time divided by the average equity in the account during that same period of time. The higher the turnover rate, the greater the indicia of churning.

Although securities litigation can be complicated, when that elderly couple walks into your office, you will now hopefully have a starting point for evaluating the case and understanding the procedure that will govern when arbitrating the dispute. ■

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