

Identifying Potential Claims Against Broker/Dealers: A Securities Claim Primer

By Eric E. Ludin



Shortly after I began my civil practice, a potential client came to my office with what I now realize was a classic “churning” claim against a stock broker. At the time I had no knowledge or experience with securities claims. As I considered his case, I only viewed it using a classic common law fraud analysis and declined to represent him. Today I am amazed that I turned the case away without further analysis. I wish I knew then the information that I will present in this article.

Practitioners should be aware of the basic duties and standards that apply to brokers so that they can identify potential claims worthy of further study. What follows is a brief description of the most common claims that a brokerage firm customer can bring against his broker. This is not intended to be an exhaustive list and does not refer to the less common claims that do arise.

Before an individual can be a broker, he or she must be a registered representative with the National Association of Securities Dealers (NASD), a self regulatory organization. At a minimum, a broker must pass the Series 7 Examination, which is the Qualification Examination for General Securities Registered Representatives. In addition to complying with state and federal law, a registered representative must comply with the duties imposed by the NASD. These duties are set forth in writing in the NASD manual.

Suitability

Probably the most commonly violated rule in the NASD manual is Conduct Rule 2310 entitled Recommendations to Customers (suitability). This rule states:

(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 the 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.

Because of this rule, if a potential client complains of losses in his or her brokerage account, one should first consider whether the transactions in the account were suitable for the customer and whether the transactions were exercised based on recommendations of the broker. The transactions' suitability depends on the specific facts of that case.

In order to identify a suitability claim, the attorney must learn about the clients, personal financial circumstances. One must find out the client's age, employment status, source of income, net worth, level of sophistication with regard to securities, and ability to assume risk. Whether the client is a high school dropout doing manual labor investing most of his or her net worth in the subject security or a CEO of a large corporation investing a small fraction of his or her net worth in the security will make a huge difference in assessing the merits of a suitability claim. Certainly the CEO should have had a greater ability to assume more risk when investing and a greater capability to assess that risk.

Violations of the Federal and Florida Securities Statutes

The most commonly violated Florida Securities Statute is § 517.310. Among other things, this statute makes it illegal to make any untrue statement of material fact or omit to state a material fact in connection with the rendering of investment advice or in the connection with the offer, sale, or purchase of any investment or security. Florida Statutes § 517.211 provides for the remedies of rescission or damages in case of violations of § 517.310. It also allows for attorneys fees to be awarded to the prevailing party “unless the court finds the award of fees to be unjust.”

In *Newsom v. Dean Witter Reynolds, Inc.*, 558 So2d 1076 (Fla. 1st DCA 1990), the court held that unsuitable trading and churning are not merely technical violations, they are statutory fraud. Since *Newsom*, it has been generally recognized that suitability and churning claims constitute violations of the Florida Securities and Investor Protection Act.

There are also Federal Statutes which provide causes of action for defrauded customers. These include the Securities Exchange Act of 1934 § 10(b) which has more stringent requirements than the Florida Statute in order to prove a cause of action. In order to prevail in a Rule 10b-5 action, the plaintiff must establish that the broker made a false statement or omission of material fact with scienter upon which the plaintiff justifiably relied that proximately caused the plaintiff's damages. *Bruschi v. Brown*, 876 F.2d 1526,1528 (11th Cir. 1989).

Unauthorized Transactions

The NASD conduct rules prohibit a broker from causing the execution of transactions which are unauthorized by the customer. NASD Manual Rule IM-2310-2 (b)(4)(iii)(CCH Inc. 2005).

Often times customers will complain that transactions occurred that they did not know about until after they reviewed their monthly statement or received a confirmation in the mail. Some brokers get in the habit of exercising trades without discussing them first with the client because of the relationship and level of trust that they have developed. However, unless the broker receives written authorization to handle the account in a discretionary manner, these unauthorized trades are improper.

After each transaction, the firm is required to send the customer a confirmation of the trade. This confirmation will indicate if the trade is unsolicited by the broker. If there is no reference to whether the trade is unsolicited, it is normally presumed to be solicited. Because a solicited trade is one that is recommended by the broker, the confirmation is critical evidence on the issue of whether a trade is unauthorized.

Churning

Churning claims are relatively rare today and are far less common than suitability claims. Because many brokers are paid on a commission basis, there is an incentive for them to exercise trades in an effort to generate fees and not because the trades are in the best interest of their customer. Churning is a claim that occurs when the following elements are proven: a) the trading in the account is excessive in light of the clients investment objectives; b) the broker in question exercised control over the trading in the account; and c) the broker acted with the intent to defraud or with willful and reckless disregard for the investor's interests. *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980).

These cases are less common today because many brokerage firms have fee based accounts. This means that the broker is not paid on a commission basis. Instead, he/she is paid a percentage of the total value of the account. This type of fee arrangement is purported to remove the incentive for churning. Also, discretionary accounts which give the broker discretion to trade without the client's authorization are not as common as they used to be in the 1980s. Therefore, it is often difficult to show that the broker had the requisite “control” over the trading in the account.

Other Important Considerations

Any attorney considering the merits of a securities claim needs to know that most brokerage firm contracts contain an arbitration provision. Every brokerage firm, as a member of the NASD, agrees to arbitrate any customer dispute with the NASD Dispute Resolution, Inc. or the NYSE pursuant to their codes of arbitration procedure. Therefore, these securities claims are usually not litigated in court. The NASD and NYSE filings fees are quite substantial.

Conclusion

Even if you do not intend to practice in the field of securities litigation or arbitration, it is important for any practitioner to recognize the basic types of claims that can be made against a

broker. Although this article is far from an exhaustive analysis of these types of claims (and fails to mention some of the most obvious claims such as theft) it should give you enough information so that you know when a case is worth further study or referral to another practitioner.

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