

INTRODUCTION TO THE FINANCIAL SERVICES INDUSTRY FOR LIFE CARE ATTORNEYS

HOW AND WHY THEY ABUSE YOUR CLIENTS AND WHAT YOU CAN DO ABOUT IT

BY

Daniel I. MacIntyre, Esq.

Page Perry, LLC

Atlanta, Georgia

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THE SENIOR FINANCIAL ABUSE PROBLEM.

According to the United States Securities and Exchange Commission (the "SEC"), the government agency in charge of regulating the United States investment markets, "nearly one-third of all U.S. investors are between 50 and 64 years of age and approximately 5 million senior citizens succumb to financial abuse each year." (*See attached SEC webpage printout.*)

According to the National Association of Securities Dealers ("NASD") the self-regulatory organization of securities broker/dealers (to become the Securities Industry Regulatory Authority, or SIRA):

"Even if you have never been subjected to an investment fraud or sales pitch, you probably know someone who has. Following the legendary Willie Sutton principle, fraudsters tend to go 'where the money is' – and that means targeting older Americans who are nearing or already in retirement. Fraudsters also have in their sights on the millions of baby boomers who have been accumulating sizeable retirement nest eggs through company 401ks and personal accounts."

See attached NASD webpage printout.

According to the North American Securities Administrators Association ("NASAA") the organization of the securities commissioners of the fifty United States and the Provinces of Canada:

"With the first 'baby boomers turning 60 this year, state securities regulators warn today that investment fraud among seniors, which already accounts for nearly half of all investor complaints received by state

securities regulators, could grow significantly in coming years.

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The survey of state securities regulators shows that an estimated 44% of all investor complaints received by state securities regulators are made by seniors. In addition, the survey found that about one-third or 31% of all enforcement actions taken by state securities regulators involve senior investment fraud.'" See NASAA webpage attached.

According to Investment News, which advertises itself as the "homepage for today's leading financial advisers," "Regulators are turning the spotlight on companies that specialize in using high pressure marketing tactics to sell financial products and services to older Americans." See *Investment News* article attached hereto.

The bottom line is that your clients, seniors who have worked a lifetime to accumulate a nest egg for retirement, are the prime targets for both outright fraudsters and for the participants in the supposedly reputable financial services industry who put their own financial interest ahead of the interest of their senior clients.

I. Who Wants Your Clients' Money and How They Are Regulated.

1.1 National banks, federal savings banks and state banks.

Banks are, of course, primarily known for deposit products such as checking accounts, savings accounts, money market accounts and certificates of deposit. All of these deposit products are insured by the Federal Deposit Insurance Corporation ("FDIC") up to \$100,000 per customer.

In addition to deposit products, most banks now, sometimes directly and sometimes through registered securities broker/dealer affiliates, sell all manner of stocks, bonds and other investment products. These products are not insured. Customers, particularly the elderly, are often confused about this. Bank and brokerage affiliate employees, both from lack of knowledge and training and deliberately, often exacerbate this confusion. The result, which is sometimes the intended result, is that your senior clients have bought an investment from their bank that has market risk or even greater risk and they have no understanding that they can lose money.

A third mechanism that the banks use to get your client's money is the Trust Department. Most bank trust departments are no longer interested in small (under \$10M) trust accounts. There are, however, still a lot of wills that were written and trusts that were created decades ago which have much smaller

amounts of money than that. The banks do not like these small pools of money, because it costs as much to manage one of them as it does a much larger pool. The bank fees are based on a percentage of assets under management, so small accounts are money losers. This means that smaller trust accounts are very likely to be neglected if not abused. Banks have also, from time to time, used the funds that they manage in their trust departments to support their big borrowers, particularly those that are in distress. We saw that happen in the real estate industry collapse in the 1970s. I expect we will see some of that around the collapse of the sub-prime mortgage market in 2007 and 2008.

All FDIC insured banks are regulated and examined by the FDIC. National banks are additionally examined and regulated by the Federal Reserve. Federal savings banks are additionally regulated and inspected by the Federal Office of Thrift Supervision. State banks are regulated by state banking departments. The purpose of all of this regulation is to ensure the financial soundness of banks and the banking system. Protecting investors, particularly investors in other than deposit products, is a very low priority for these regulatory agencies. Except in situations of bank insolvency, little or no help should be expected from bank regulators when a bank has abused your elderly client.

1.2 Life Insurance Companies.

Historically, life insurance companies have sold straightforward insurance products such as whole life and term life. Things began to get somewhat more complicated in the 1970s with the introduction of universal life. In recent times, a plethora of highly complex mixed insurance and investment products have been developed by the insurance industry. These products go under names such as variable universal life (VULs), variable annuities (VAs) and equity index annuities (EIAs). These products (other than EIAs perhaps) can be sold legally only by registered securities brokers and their individual registered representatives who are dually registered in the insurance industry and the securities industry.

These new insurance investment products are investment pools that are similar to mutual funds that are wrapped in an insurance cloak. Historically, most of these insurance products have very high fees and expenses, very long required holding periods and very high redemption fees. To induce investment professionals to sell these undesirable products, the insurance companies pay very high commissions. To justify these undesirable investment characteristics, the financial professionals selling these investments have to promise high returns. That means these products are almost invariably invested in high-risk securities. These products are usually unsuitable investments for senior citizens.

State Insurance Commissioners as well as securities regulators regulate these insurance investments. State insurance laws and regulations are primarily concerned with maintaining the financial soundness of insurance companies. The State Securities Commissioner (usually an elected official) is often deeply in bed with the insurance industry that provides most of his or her campaign

contributions. State insurance laws typically provide little or no legal recourse for defrauded investors in these products.

1.3 Mutual Funds.

Mutual funds (also known as investment companies) are corporations that buy investments and manage them for the benefit of their shareholders. According to the Investment Company Institute, the trade association of the mutual fund industry, the total amount of assets held by all U.S. mutual funds is \$10.4 Trillion Dollars. This accounts for 48% of the \$21.8 Trillion in mutual fund assets worldwide. At the end of 2006, there were 15,638 investment companies.

Among these 15,638 companies, there are mutual funds that invest in any kind of investment that anyone might want (or not want) to invest in. Mutual fund portfolios range from extremely conservative to extremely risky. They vary from extremely broad to extremely narrow and specialized. To have any understanding of what your client is invested in with a mutual fund, you must know what investments that mutual fund is buying. The accepted authority on that question is Morningstar (www.morningstar.com). Mutual funds must publish all of their holdings at least semi-annually.

Not only are the investment portfolios of mutual funds widely variable, their costs and expense also vary widely. The first basic watershed on fees and expenses is the difference between a “load” and a “no-load” fund. Load funds are usually sold by securities broker/dealers who charge commissions that can range from one or two percent up to 5% or 6%. The commissions are set by the funds. Thus, the least desirable funds typically pay the highest commissions to induce brokers to sell their securities. No-load funds are generally sold to investors directly by mail, telephone or Internet or through investment advisers. There is no initial charge for investing in a no-load fund, except that many of the most reputable funds have instituted charges to discourage frequent trading of their shares.

In addition to the loads charged by some funds, all funds charge fees. Incredibly, the fees vary from 0.08% to 3% or 4% of the fund’s assets per year. Fees matter greatly. They dampen the gain in up years and severely exacerbate the losses in down years. Over the long term, a point or two differences in fees can result in a 100% difference in the value of an investment. There is a fundamental watershed in the area of fees between managed funds in which a manager picks the investments versus index funds where the fund simply invests in a pre-determined set of securities, such as the S&P 500 index. Index funds tend to have fees below 0.5%. Managed funds tend to have fees above, and sometimes much above, 0.5%.

All mutual funds are regulated as an initial matter by the Federal Investment Company Act of 1940. This act sets down requirements for how mutual funds are to be governed and empowers the SEC to regulate mutual funds. The Investment Company Act of 1940 provides no meaningful private right of action to an individual investor who is unhappy with his mutual fund.

A sub-category of mutual funds that is much in the news today is hedge funds. Hedge funds come in many flavors today, but they all have one thing in common. They are completely unregulated. They do not have to and usually do not disclose what they invest in. They have no regulatory oversight by the SEC or any other governmental agency. They have no self-regulatory organization like the NASD/SIRA. They are the wild west of investing. Only those with the financial clout to demand, and the financial acumen to conduct, a thorough due diligence investigation should even think about investing in a hedge fund.

1.4 Pension Plans.

There are two fundamentally different types of pension plans in the United States, Defined Benefit Plans and Defined Contribution Plans. The difference between the two is that a Defined Benefit Plan guarantees certain pension benefits and the retirement plan and its sponsor take the investment risk. In a Defined Contribution Plan, nothing is guaranteed, and the participant/retiree has the investment risk. The trend is very strongly away from Defined Benefit Plans toward Defined Contribution Plans. Within that overall trend, there is an equally strong trend in Defined Contribution Plans toward giving the participant/retiree more and more discretion and authority about what to do with his investments. Many Defined Contribution Plan participants are ill advised or not advised at all about their investment choices.

All pension plans are subject to regulation by the U.S. Department of Labor. This is one of the few regulators in the financial services industry who will really go to bat for the abused investor. If you run into a pension plan problem, you should immediately contact the nearest office of the U.S. Department of Labor. There also are often securities law remedies for pension plan participants who have been abused.

1.5 Investment Advisers.

Investment advisers are defined as persons who, for compensation, are engaged in the business of advising others regarding the investment of securities. They are regulated under the Investment Advisers Act of 1940 if they have \$25M or more under management. They are regulated by state securities commissioners if they have less than \$25M under management. Assets under management with registered investment advisers increased from \$23.4 Trillion Dollars in 2004 to \$26.8 Trillion Dollars in 2005, according to the Investment Advisor Association. On April 5, 2005, a total of 8614 investment advisers were registered with the SEC.

From the standpoint of the investor, the difference between an investment advisor and a mutual fund is that an investment adviser presumably tailors his advice or asset management for the needs of a specific client. A mutual fund, on the other hand, is managing its portfolio with the objective of meeting its stated investment goals. Investment advisers vary in size from huge to one-person shops.

Investment advisers have a fiduciary duty to their clients, just like a trustee. Though the Investment Adviser Act of 1940 provides certain limited remedies to clients who are abused by their investment advisers, reliance on state laws concerning fiduciary duties is usually a better legal basis for recovery.

1.6 Stockbrokers.

The U.S. securities brokerage industry includes fewer than 4000 companies with combined annual revenues over 100 Billion Dollars, according to Hoover's, a Dun and Bradstreet subsidiary. There are large full service financial brokers such as Merrill Lynch, Citigroup Global Markets (formerly Salomon Smith Barney), A. G. Edwards, Wachovia (formerly Prudential Securities and many other companies) and UBS (formerly Paine Weber). There are also big on-line and limited service brokers such as Schwab, T.D. Waterhouse, and E-Trade. There also remain a few regional and even smaller broker/dealer firms. There is additionally a large cadre of "independent" brokers. Independent brokers are typically also registered investment advisers and tend to operate small operations that provide individualized attention and clear their securities transactions through a larger broker/dealer such as Pershing or Fidelity's National Financial Services.

All securities brokers have access to the same stocks on the same markets. They are all regulated by the SEC and are members of and subject to regulation by NASD/SIRA. They are also registered by various state securities commissioners. The purpose of this elaborate regulation is to create an honest brokerage industry. This effort at regulation often fails miserably in meeting this goal.

Many investors' first instinct when they come to accept the fact that they have been financially abused is to contact one of these industry regulators. All of the regulators have elaborate systems for receiving, evaluating, investigating, and sometimes prosecuting the subjects of such complaints. The bad news is that such regulatory activity hardly ever returns any money to the aggrieved investor. Even worse, the regulators almost never tell the complaining investor or his attorney what they have learned in their investigation or what their intentions are.

1.7 Scam Artists.

The world is full of scam artists. They are typically bright, articulate, persuasive and very charming people. If they do not have those personality characteristics, they do not succeed in the scam artist business, and they gravitate to another criminal enterprise. The bottom tier of this category of the financial services industry just takes your client's money and spends it. The next slightly more elaborate method of theft is the Ponzi scheme. Here, the scamster takes money from later investors to pay off early investors and thus develops a reputation for being able to perform his outrageous and impossible promises. The SEC and state regulators shut down hundreds of Ponzi schemes every year.

1.8 The Current Favorite Scams.

According to NASAA, the top ten current scams are:

1) Affinity Fraud. Con artists target religious, ethnic, cultural and professional groups. The scam artist is often a member of the group. The affinity provides an opening level of trust that scam artists are expert at exploiting.

2) Foreign Exchange Trading. This is risky business at best, and is often a Ponzi scheme or other scam when offered to an individual investor.

3) Internet Pump and Dump Schemes. The scamster buys up a bunch of unknown stock, publishes a mountain of false information about how great it is, and sells his stock into this overheated market that he created.

4) Investment Seminars. These will be discussed in detail below.

5) Oil and Gas Scams. These are old standbys that never go away. They always surface more prominently when gas and oil are in the news.

6) Prime Bank Schemes. These promise high yield, risk-free and tax-free returns. Promoters of these schemes offer to let the "little guy" in on what they claim are the financial instruments of the elite that are offered by overseas banks only to the wealthiest investors. Prime banks do not exist. The scam artist has no intention of creating a profit for anyone other than himself.

7) Private (unregistered) Securities Offerings. There are certainly legitimate unregistered securities offerings, but only the financially sophisticated should be playing in this arena.

8) Real Estate Scams. The real estate scam de jour seems to be buying property at foreclosure and tax sales. Get-rich-quick-in-real-estate seminars and rallies are also proliferating.

9) Unlicensed Individuals and Unregistered Products.

10) Sales of "Legitimate" Securities to Person for Whom They Are Not Suitable.

1.9 Credentials.

Everyone in the financial services industry has credentials. Every stockbroker and every banker who has advanced beyond the level of intern is at least a vice president. There is also an alphabet soup of credentials that are designed to look like degrees. Many of these can be purchased over the Internet for a few hundred dollars.

Credentials relating to seniors are particularly proliferating. According to the New York Times, July 8, 2007, "Tens of thousands of financial advisers, working hand in hand with insurance companies to market themselves to older Americans, use impressive sounding credentials like 'Certified Elder Planning Specialists,' 'Registered Financial Gerontologist,' 'Certified Retirement Financial Adviser' and Certified Senior Adviser.'" Many of these titles can be earned in just a few days or a few hours on the Internet from for-profit businesses. They are designed to sound similar to established and widely respected credentials like "Certified Financial Planner" (CFP) that require years of study and difficult examinations and extensive background checks. See *New York Times* article which is attached.

II. The Economics of the Financial Services Industry.

The fundamental truth of the financial services industry is that the only way that sellers of, and advisers concerning, investments make money is to take money out of their customers' pockets. There are two basic ways that the financial services industry gets paid. The first is by commissions. The second is by fees. Stockbrokers have traditionally charged commissions on every transaction that they effect for their customers. Commission rates used to be set by a legalized cartel. Since commission rates were freed in the 1980s, they have come to vary widely from hundreds or even thousands of dollars per transaction to pennies per share.

As previously mentioned, load mutual funds charge commissions that they then pay to the brokers who sell their funds. If there is a 6% commission charged for a \$1,000 mutual fund purchase, only \$940.00 actually gets invested. This is not a loss of \$60.00. This is a loss of \$60.00 compounded over the life of the investment. The mutual funds' answer to this problem is the "B" Share that, unscrupulous brokers will tell their customers, is a mutual fund that charges no commission. This is literally true, but an economic lie. The fund more than makes up for the commission with the excessive fees that it charges and with redemption charges if the investment does not stay long enough to have the commission recouped by the excessive fees.

Insurance-based products typically have a disclosed commission. Unfortunately, that disclosed commission is only the beginning point for the money they take out of the investor's account. The only way to find out what these hugely complex insurance industry investment products really cost is to do a detailed line-by-line analysis of the 50+ page prospectus. Better yet, have that analysis done by someone who knows how to read the incomprehensible insurance industry gobbledygook. These investments often wind up charging the economic equivalent of 10% or 12% upfront commissions and 3% or 4% per year going forward. They have huge penalties if you try to get your money out before they have sucked out all of their fees.

Another mechanism that the securities industry has developed, with the blessing of the SEC, to suck money out of customers' accounts is the 12b-1 fee. These are monthly fees that are charged, in addition to the operating expenses,

the adviser's fee and the initial commission. These 12b-1 fees can be charged by mutual funds and insurance industry investments. To find out about the 12b-1 fee, you must root deeply into the bowels of the prospectus.

The perverse incentives that commissions give to the financial services industry are obvious. Every time there is a transaction, they get to take some of their clients' money. Frequent transactions are almost never a good investment strategy - if for no other reason than the commission costs. The results of the perverse financial incentive provided by commission compensate is brokerage account churning and mutual fund and insurance product switching.

In lieu of or in addition to commissions, much of the financial services industry charges fees. The most straightforward of these are per hour or per project fees charged by investment advisers. More commonly, fees are a percentage of assets under management. Fees are charged by mutual funds, by insurance companies and by investment advisers.

The stockbrokers, not wanting to miss out on this fee bonanza, have created the "wrap fee." For a single monthly fee, typically a percentage of assets in the account, they will allow unlimited transactions. Since a stockbroker (who is not also a registered investment advisor) cannot legally charge a fee for investment advice, they will tell you that they owe no responsibility to the investor because of this fee.

Finally, in addition to fees and commissions, major amounts of money are made in the stockbrokerage industry simply by selling securities at a higher price than when they were bought. This is one thing if you take some investment risk. What the brokerage industry does, however, is buy at a lower price and sell at a higher price virtually simultaneously. This is not possible on an exchange market and is getting more and more difficult on the NASDAQ. This practice has been notorious in the bond market where there is not nearly so much visibility on prices, though there are regulatory efforts under way to make bond prices more transparent. This practice is, and always has been, rampant in the "pink sheet" markets and other markets for very thinly traded securities where there is no instantaneous reporting and publishing of transaction prices.

III. The Economics of Investing/Modern Portfolio Theory.

Modern Portfolio Theory is really not so modern. Harry Markowitz introduced the terminology in 1952. Thirty-eight years later, he shared a Nobel Prize with Merton Miller and William Sharpe for the Broad Theory For Portfolio Selection that has come to be summarized under the description of Modern Portfolio Theory. Through the years, the validity of Modern Portfolio Theory has been demonstrated again and again by academic studies. Every year, sixty to seventy percent of actively managed mutual funds fail to reach their target unmanaged benchmark. See Barton Malkiel, *"A Random Walk Down Wall Street"* (1973). When expert stock pickers have contests against people or chimpanzees throwing darts at the Wall Street Journal, the dartboard almost always wins.

I analyze Modern Portfolio Theory into three basic principles. The first is that there is an invariable and inverse relationship between risk and return. To get a higher return, you must take a higher risk. If any investment professional or scam artist tells you or your client that his investment will provide a higher than average return at a lower than average risk, he is lying.

The second basic principle is that the actions of the stock market are random and no one can predict them. Sixty to seventy percent of managed mutual funds under-perform their target unmanaged index every year. Almost no one outperforms his or her target index over an extended period of time.

The third basic principle is diversification. How you deal with the randomness and the invariability of the risk return relationship is to diversify your assets widely. Diversify among asset classes (stocks, bonds, cash, real estate). Diversify within asset classes (large cap, mid cap, small cap in stocks, different maturities and credit quality for bonds). Diversify among industry groups and internationally.

If you succeed in properly allocating and diversifying your assets, when some assets are going down, others will be going up. The secret of successful long term investing is never to have your assets so decimated by a downturn that you have no assets left to invest and cannot benefit when the market turns around.

The U.S. and world economies are growing. The basic assumption of an investment plan based on modern portfolio theory is that this growth will continue. This growth is not linear, however. There will be down years and sometimes a series of down years in any specific market. The secret of long-term success is never to have all of your eggs in the same basket, but to invest in all of the baskets in a disciplined way. That enables you to take advantage of the power of dollar cost averaging. You will always be buying more of the lower priced investment than you are of the high priced investment. That is how you buy low and sell high without knowing what is going up, what is going down or when anything will happen.

IV. Where Things Go Wrong for Investors.

4.1 Early Retirement Scams.

Unfortunately for many seniors, there is a provision in the Internal Revenue Code that allows a retiree to take distributions from his IRA before he reaches the age of 59 ½. To qualify for this provision (called 72t), the investor must commit to take and then actually take a fixed amount from his IRA every year. Investors who are approaching retirement are often targeted by brokers and insurance agents and invited to free investment seminars. Tragically, employers often sponsor these seminars. In some cases, the broker encourages investors to take some or all of the following actions: (1) retire earlier than they might otherwise have done; (2) opt out of the company's retirement plan and take a lump sum payment; (3) open a traditional IRA at the broker's firm; (4)

invest the IRA in variable annuities, equity index annuities, Class B mutual funds or other high commission securities that are substantially riskier than the fixed benefit pension they gave up.

The senior is often encouraged to go along with these recommendations by the broker's false promise that the investor can receive a higher monthly retirement income than he would under his pension plan and can grow the investment with little or no risk. As a result of this type of bad advice, many investment professionals have become millionaires and many seniors have lost their entire nest egg.

4.2 "Free" Lunches, Dinners and Seminars.

Smart financial service professionals know their target market. Most of the investable wealth that they can get their hands on belongs to seniors who are getting ready to retire or are retired. Many seniors are, understandably, nervous about this new responsibility and uneasy about their competence for that responsibility. They are thus very susceptible to the influence of someone who can persuade them that he or she has an easy answer to their concerns.

For this reason, and because many seniors are lonesome for the interactions of the workplace that they have recently left, the idea of a "free" meal or seminar at which they can become better educated on retirement investments is very attractive. What the seniors do not know, and often do not realize until it is too late, is that the whole purpose of this get together is to lock them in a room, lower their defenses with good food and wine, and hot box them. The investment seller has no agenda to provide appropriate education. He has something to sell, and the entire presentation is designed to lead the senior down the primrose path to concluding that the investment for sale that night is the answer to all of his problems.

4.3 Unsuitable Recommendations and Investments.

For seniors who put their wealth into brokerage accounts, there are a number of pitfalls. They are all deviations from the basic modern portfolio theory principles of diversification and allocation.

Many brokers fall in love with a stock or a class of stock and overload their customers' portfolios with it. Often, the brokerage company is pushing the individual representatives to sell a stock or class of stocks for the brokerage firm's benefit, such as to support an initial public offering until they can sell out the insiders at a profit. In any case, brokerage accounts often get overloaded with an excessive concentration in one or two stocks or one asset or industry class. This leads to complete disaster rather than a minor setback when that stock or asset class goes into a tailspin.

Another favorite type of security for brokers that is almost always bad for investors is options. What is so good for the broker and bad for the investor about options is that they regularly and periodically expire, and the money must

be reinvested, thus earning the broker an additional commission. Another problem with options is that they are highly leveraged. Some option transactions can create risks that are hundreds of times the size of the transaction.

Another great risk that is often seen in seniors' accounts is margin. It is possible to borrow up to 50% of the value of a portfolio to buy more stocks. The brokers love it when customers do that. Not only do they earn an interest spread on the margin balance, they also get to buy and sell twice as many stocks. If the account is fee based, they have an asset base that is twice as big against which to charge their percentage fee.

Mutual funds, though they should be a core investment of any properly diversified portfolio, can also be abused. Problems with commissions, expenses and B-Shares have been discussed above. The other problem that we often see with mutual fund portfolios is that all of the mutual funds in the portfolio are buying the same stocks. Thus, the mutual funds become a vehicle for over-concentration, not for proper allocation and diversification. Over-concentration inevitably, sooner or later, leads to precipitous and disastrous losses.

Variable annuities and other insurance products are almost always wrong for seniors. Funds that the senior might need because of an illness or other unanticipated event are available only by paying exorbitant redemption fees. While the funds continue to be held in this investment, the myriad of fees and charges are bleeding it to death by a thousand cuts. To try to make up for this, the advisor almost invariably recommends an excessively risky underlying investment portfolio. All of this is a recipe for disaster at the first market downturn.

For commission compensated brokers, a common abuse is excessive transactions. In a brokerage account, this is called churning. Churning is trading that is excessive in amount for the investment objective of the account. Index mutual funds typically have a turnover ratio (total purchases divided by net account equity) of .25 or less per year. Actively managed funds seldom significantly exceed 1.0 turnover per year. Any amount of trading in excess of two times per year is highly suspect. Turnover in excess of six times per year is presumptively churning. On the mutual fund and insurance products side, the same sin is committed by brokers persuading their customers to redeem one mutual fund or variable annuity (and often have to pay a redemption fee) and use the funds received from the redemption to buy another mutual fund or annuity. The purpose of such a switch is, typically, to earn an additional commission.

Another sure sign of investor abuse is unauthorized transactions. A broker cannot legally execute a transaction in a customer's account without express advance approval from the customer of that specific transaction unless that broker has a written discretionary authorization from the client. These authorizations are usually in the form of a power of attorney. Most customers do not understand this and tolerate their broker's trading in their account without authority, or even think that is what brokers are supposed to do. The broker

knows better. If he is violating this rule, he or she is probably violating his or her customer's interest in other ways.

Another wrong that we often see committed by brokers is simply misrepresenting the risks or the potential rewards of an investment that they are touting. This will often be accompanied by misrepresentations of fact and suggestions that the broker has "inside" information about his investment. If your client reports a conversation like this with his broker, alarm bells should be going off.

Finally, let me address the concept of unsuitability. This is not a concept that is found in the securities laws or any SEC regulation. In its most basic form, it is embodied in the NASD Conduct Rule 2310(a) which states:

"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 to his financial situation and needs."

The rule then requires the broker to make a reasonable effort to obtain information about the customer's financial status, tax status, investment objectives and other information that should be considered in making recommendations to the customer.

In summary, the suitability rule says that there is no one size fits all investment. Each investment and each investment recommendation must be tailored for the specific financial needs and objectives of the customer. All of the broker misconduct mechanisms that I have discussed above are simply specific and common examples of brokers violating this suitability rule. There are a number of other ways that this rule can be violated. Particularly for those of you who are not trained, skilled and experienced in evaluating investment portfolios, I recommend this concept of "suitability" as your touchstone. If what the investment advisor or broker has been recommending to your client does not seem to you to be suitable to your client's needs, for any reason, further inquiry is warranted.

V. What To Do If You Discover Financial Abuse.

5.1 Contact the Broker's Firm?

This is certainly a logical first thought. It is what the broker would like for you to do. It is what the NASD and the SEC urge you to do on their websites. It is, however, a communication that is fraught with peril.

Correspondence between the firm and the customer will be an exhibit at any contested arbitration or litigation. The customer almost always feels more responsibility for his demise than is justified, and that feeling is typically reflected in the letter to the brokerage firm. Brokers never pay more than a pittance in response to a letter from a customer. Brokers will use the letter writing process to deter the customer as long as possible from making a formal claim, hopefully until after the expiration of applicable statutes of limitations. This letter should be written only by an attorney who knows all of the tricks of the game, knows the buzz words to use and not to use, and knows how to craft this letter so that it will be an asset to the customer rather than a liability at the hearing.

5.2 Contact the SEC/SIRA/NASD?

I never do this. This simply creates another set of documents that the brokers can discover and use for their own benefit. They can find something in any document that they can twist against your client. The SEC and SIRA/NASD will not share any information with you, will not help you with your case and will not help your client. As much as I feel a public duty to turn in bad brokers so they can be kicked out of the industry, my primary duty is to my client. I believe I disserve my client by contacting any federal securities regulator.

5.3 Contact Your State Securities Commissioner?

This is a more complicated call than the federal agencies. State securities agencies sometimes exert significant pressure on securities miscreants to reimburse their victims as part of the settlement of the securities commissioner's enforcement case. If you have a relationship with your State Securities Commissioner or anyone in the office, they are much less rigorous than the Feds about withholding information that they learn in the course of their investigation. If you or your client has any political clout, the potential upside of getting the State Securities Commissioner involved probably outweighs the downside. If you do decide to contact your State Securities Commissioner, make sure that you control all of the communications. Otherwise, your client or some member of his or her family is very likely to create a record which is going to come back to haunt you.

5.4 Contact an Attorney Experienced in Representing Abused Investors?

This should be your first step if you have concerns that your senior client has suffered from investment abuse. We can tell you fairly quickly if you would be wasting your time and your client's money to pursue a claim further. If you are inclined to pursue a claim after the initial conference, we can guide you or take the entire responsibility from your shoulders. This is not an area of the law in which amateurs should be dabbling. Securities arbitration and litigation does not work like ordinary litigation, either substantively or procedurally.

VI. How a Claim Proceeds.

6.1 Client Intake.

The first step in developing an investment abuse case is a thorough inquiry into all information that your client and his or her family may have. Particularly important are the documents they can provide. This process often takes several weeks before an intelligent evaluation can be made about whether there is a case worth pursuing.

6.2 Case Investigation and Evaluation.

In today's world of the Internet and instantaneous communications, a treasure trove of valuable information is publicly available. This information should be gathered and evaluated before anything public is done with the claim.

6.3 Demand Letter to Broker.

There are good attorneys in my area of practice who never write such a letter. I almost always do. The principal exception would be if the running of a crucial statute of limitations were imminent. In that case, I very well might contact general counsel for the broker and ask for a tolling agreement.

I find a demand letter sometimes results in the receipt of information that is valuable to me in the future. The responsive letter from the broker, or the broker's failure to respond, are always good evidence of the broker's bad faith when you get to the hearing and are asking for attorneys' fees. The letter to your client's broker must be written extremely carefully, though, or your demand letter will wind up being much more valuable to them than their response is to you.

I typically give the broker thirty days to respond. Almost without exception, someone in the broker's compliance department or legal department or outside counsel will contact me on day 29 and ask for an additional thirty days. Almost without further exception, nothing happens in the next 30 days, and we must follow up with the broker and demand a response. Sometimes this gets a response. Sometimes it doesn't.

The response, if and when it arrives, is inevitably a denial of liability and an explanation of the broker's position as to why it has no liability. Knowing what the broker's position is in advance can be very helpful in drafting a claim to initiate a formal legal proceeding.

6.4 Selection of Forum.

The first bad news in this area is that your client has in all likelihood signed an agreement to arbitrate any claim against the broker. Almost without exception, the courts will and regularly do enforce these agreements.

Even if there is no agreement, court is often a bad place to be with a customer claim against a broker. The brokers' attorneys are experts at motion practice and discovery. They can turn a court case over a \$100,000 claim into a \$200,000 attorneys' fee endeavor for the claimant's counsel very quickly. If you get through all of their motions and wind up in court, the decision may be made by a jury of twelve people who have never had two nickels to rub together and view both your client and the broker in the same category of "rich people." So much complexity has developed in the securities laws through seventy-five years of litigation that the instructions the court must give to the jury would be incomprehensible to most law school professors. Except in the rarest of cases, or when there is no way to get the case into arbitration, I usually opt for arbitration.

The number of available arbitration forums was reduced to one by the recent merger of NASD and NYSE. The only available arbitration venue is now the forum sponsored by SIRA. They have a brand new set of rules and are now without competition. There are a lot of things not to like about the SIRA arbitration forum and process. But as the gambler responded when asked why he kept losing at the local roulette wheel that he knew was rigged, "It's the only game in town."

6.5 Expectable Outcomes.

The good news is that historically, seventy to eighty percent of all filed arbitrations settle. This does not mean, by any stretch of the imagination, that your client gets his or her investment losses back. The broker's first offer will almost always be less than the cost of defense. The broker's negotiating range will be a percentage of your client's net out-of-pocket loss. Out-of-pocket loss is almost never the damages computation that the claimant will want. Cases get settled in this area for the same reason they get settled everywhere. The parties are willing to take a resolution that is less favorable than they think they would get if they went to trial in order to avoid the risk, expense and unpredictability of a trial.

Of the cases that go to decision (called an "award") in NASD arbitration, the historical figures are that 60% of the claimants win something and on the average, they win 60% of what they request. Recently, those statistics have gone badly downhill for claimants. In the past several years, according to an analysis recently done by one of the nation's premiere arbitration attorneys and his expert economist, the statistics are more like 40% of claimants win something and, on the average, they win 20% of what they are asking for.

My analysis of the reason for this change in fortunes is:

(1) The historical 60-60 figures included a lot of very large successful claims against really schlock brokerage houses that promptly went out of business without paying the arbitration award. In terms of realistically collectable awards, the historical figures are probably more like 50-40.

(2) The second reason for the change is the market crash of 2000 to 2002. This had two effects on the arbitration system. First, it brought in a flood of cases, many of which were bad cases where the culprit was the market, not the broker. The second factor is that this market crash brought in a flood of new attorneys, largely personal injury and mass tort attorneys, who did not understand or have any experience in securities arbitrations. They thought they were going to rush in and make a quick buck in this area. They learned otherwise, much to their dismay and to the distress of their clients.

6.6 Prospects for the Future.

My predictions for the future are:

(1) Good and relatively small cases (under \$500,000) will continue to settle once the brokerage firm is convinced that the claimant and the claimant's attorney are prepared to try the case;

(2) Big cases (over \$1M) will continue to have to be tried and there will continue to be a lot of disappointing "wins" in which the investor receives an award of only a fraction of his or her actual losses;

(3) Averages will trend back toward 60-60; and

(4) Good attorneys with good cases will continue to get consistently good results.

CONCLUSION

As I trust you understand, it was beyond the aspirations of this brief article to make life care planning law attorneys into securities arbitration lawyers. The goal of this presentation is much more modest. I hope that with this information, you will be able to recognize when your client has been financially abused by the financial services industry and will be in a better position to work with your client and his or her family to decide whether and how to proceed to recover some or all of the damages that have been inflicted.

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