

Stockbroker Malpractice

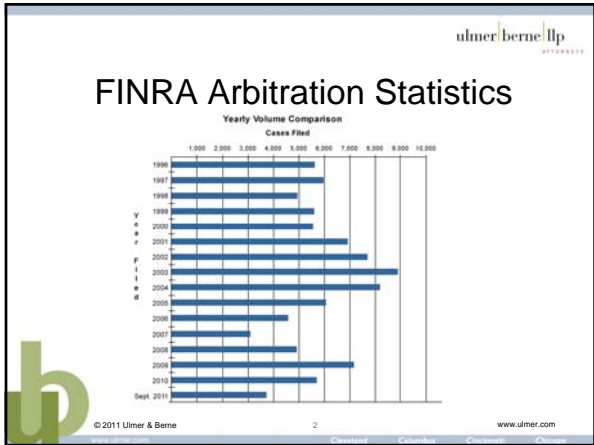
Michael Ungar, Esq., Cleveland, OH

Stockbroker "Malpractice"

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ATTORNEYS

Michael N. Ungar, Esq.
216.583.7002

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FINRA Arbitration Results


- Cases Resolved by Arbitrators After Hearing
 - 2007: 19%
 - 2008: 19%
 - 2009: 18%
 - 2010: 19%
- Cases Where Customer is Awarded Damages
 - 2007: 37%
 - 2008: 42%
 - 2009: 45%
 - 2010: 47%

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FINRA Arbitration Results

- Cases Resolved by Direct Party Settlement
 - 2007: 57%
 - 2008: 47%
 - 2009: 47%
 - 2010: 51%
- Cases Resolved by Mediation
 - 2007: 9%
 - 2008: 10%
 - 2009: 7%
 - 2010: 10%




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The “Know Your Customer” Rule

- Know Your Customer
 - FINRA Rule 2090
 - “Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.”
 - “Essential Facts. For purposes of this Rule, facts ‘essential’ to ‘knowing the customer’ are those required to (a) effectively service the customer’s account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.”




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Suitability: What Does it Actually Mean?

- Suitability
 - FINRA Rule 2111
 - “A member or an associated person must have a *reasonable basis* to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile. A customer’s investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.” (emphasis added)




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Potential Causes of Action

- Suitability
- Breach of Fiduciary Duty
- Breach of Contract
- Common Law Fraud
- Federal and State Securities Fraud
- Negligent Misrepresentation
- Negligence
- Churning
- Unauthorized Trading
- Failure to Supervise




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Potential Defenses

- Eligibility
 - 6 years (FINRA Rule 12206)
- Statute of Limitations
 - Ohio Securities Act: 2 years after discovery but no later than 5 years. O.R.C. 1707.43
- No private cause of action for industry rule violations. *Byrley v. Nationwide Life Ins. Co.*, 94 Ohio App. 3d 1, 17 (Erie Cty, 1994).
- Cannot circumvent previous rule with breach of contract action. *Salzman v. Prudential Securities, Inc.*, 1994 WL 191855 (S.D.N.Y. May 16, 1994).
- No fiduciary duty. *Bissel v. Merrill Lynch & Co.*, 937 F. Supp. 237, 246 (S.D.N.Y. 1996), *aff'd*, 157 F.3d 138 (2nd Cir. 1998).
- Suitability not applicable if trade is unsolicited
- Ratification




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FINRA Arbitration Procedure

- File Statement of Claim
- File Statement of Answer
- Rank Arbitrators
- Participate in Initial Pre-Hearing Conference
- Discovery
- 20 Day Disclosure
- Arbitration Hearing



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Statement of Claim

- Forum: Generally Financial Industry Regulatory Authority (FINRA)
 - Arbitration Provision
- FINRA specifies due date for Respondent's Statement of Answer



Statement of Answer

- Format is Unlike Court
 - It is More Like a Trial Brief
- Motions to Dismiss are Limited and Discouraged (FINRA Rule 12504)
 - Eligibility
 - Non-moving party previously released claim in settlement agreement or other form
 - Moving party was not associated with account, conduct, or securities at issue



Arbitrators

- Number of Arbitrators (FINRA Rule 12401)
 - \$25,000 or Less
 - One Arbitrator Decided On Papers Unless Customer Requests Hearing
 - \$25,000 - \$100,000
 - One Arbitrator Unless Both Parties Agree in Writing to Panel of Three Arbitrators
 - Over \$100,000 or Unspecified
 - Panel of Three Arbitrators



Arbitrators

- Composition of Panel (FINRA Rule 12403)
 - Majority Public Panel
 - Always 2 public; 1 non-public
 - Limited strikes
 - All Public Panel
 - Customer must request in writing
 - Either 3 public or 2 public; 1 non-public
 - Limited public strikes; unlimited non-public strikes
 - If party strikes all non-public arbitrators, the next highest ranked public arbitrator is the third arbitrator



Arbitrators

- Information provided by FINRA
 - Education
 - Employment history
 - Previous arbitration awards
 - Disclosures



Discovery Process

- FINRA Discovery Guide
 - Notice to Members 11-17 (previously Notice to Member 99-90)
 - Customer generally must produce all account opening documents, confirmations, statements, correspondence with brokerage firm, any notes, tax returns, documents from other brokerage firms
 - Brokerage firm generally must produce all account opening documents, confirmations, statements, correspondence with customer, broker notes, branch file, audits regarding customer, complaints against broker of similar conduct, materials on the security
- Additional Requests for Documents and Information (FINRA Rule 12507)
- Depositions
 - Almost never allowed (FINRA Rule 12510)
- Motions to Compel (FINRA Rule 12509)



Damages: Generally

- Net Out of Pocket Losses (NOP)
 - Difference between all that the investor contributed to the investment and all that the investor received from the investment.
- Market Adjusted Losses
 - Takes into consideration market performance
 - Need appropriate benchmark
- Well Managed Portfolio
 - Hypothetical suitable portfolio



Damages: Specific Cases

- Rescission
 - Fraud under State Securities Act
- Commissions
 - Churning
- Punitive Damages
 - Willful Misconduct



Contact Information

- Michael N. Ungar, Esq.
- mungar@ulmer.com
- 216.583.7002