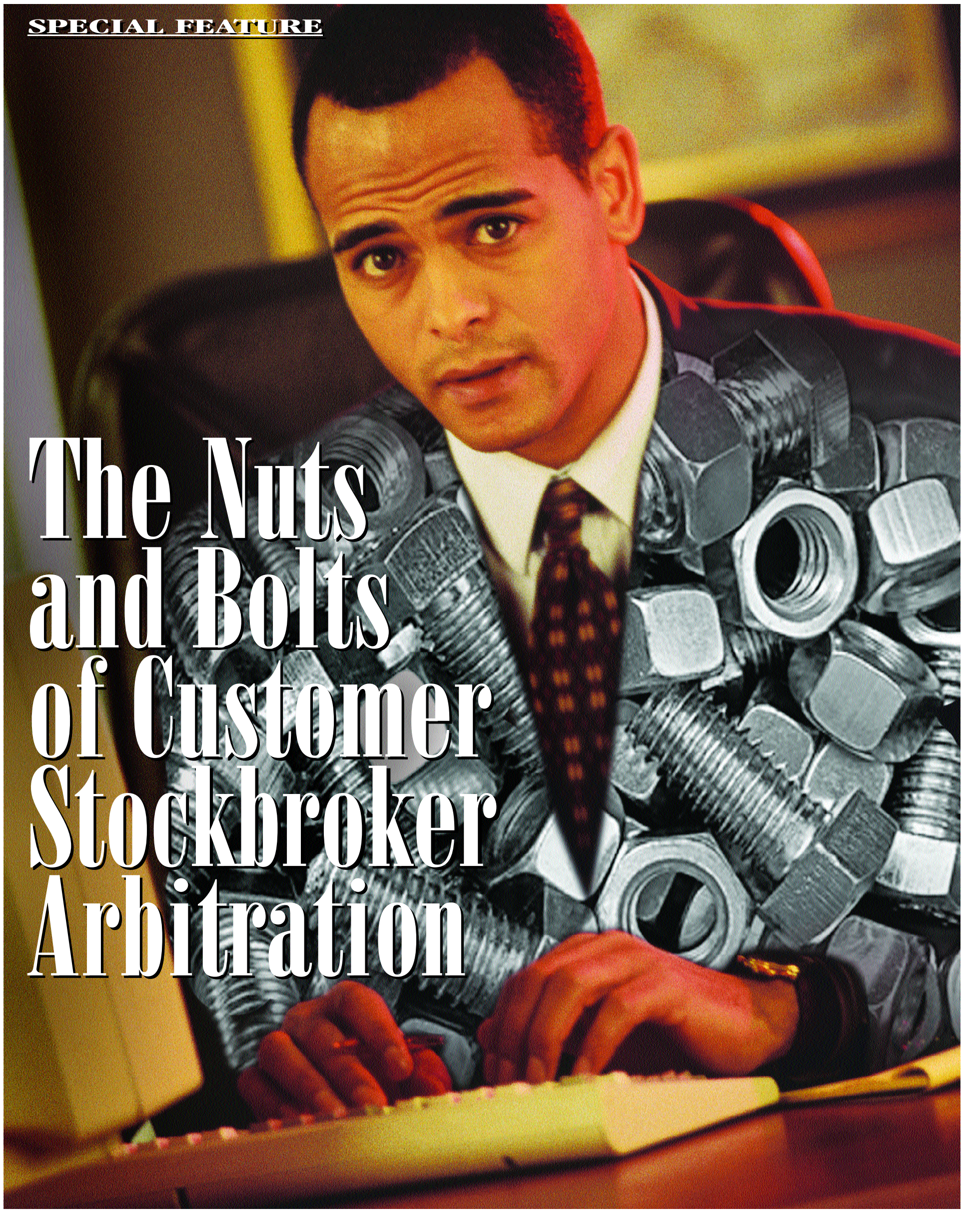
SPECIAL FEATURE



The Nuts and Bolts of Customer Stockbroker Arbitration

by Dennis A. Stubblefield

Introduction: ADR of a different ilk

If you lose money in the stock market, can you recover those losses from your stockbroker? In most cases the answer depends on whether the stockbroker made a recommendation to you which didn't match what you told him you wanted. If you represent a customer or a stockbroker involved in such a dispute, you almost certainly will be in a forum known as FINRA Arbitration. FINRA, or "Financial Industry Regulatory Authority," is the entity empowered by Congress and the SEC to regulate stockbrokers and their firms. It also operates the primary arbitration forum for customer-stockbroker disputes, which are up 65% through August 2009 over the same period last year, in the midst of the economic downturn. Virtually all such disputes are before FINRA Arbitration because of contractual provisions included within investors' account-opening documentation.

Whether on the plaintiffs' or defendants' side, the evaluation and litigation of these cases differs significantly from federal or state court cases, and even from AAA/JAMS type arbitration. This article is intended for general civil litigation practitioners who may be receiving inquiries from potential clients about this type of dispute, or who wish to develop this practice area. The article reviews the most common claims and defenses in customer-broker cases, and discusses the common damages approaches used. The article also outlines the basic procedure of how such arbitrations are brought and heard, and endeavors to impart a sense of how FINRA Arbitrators typically decide claims.

In this article, I use the term "stockbrokers" to refer to the type of investment professionals who are affiliated with the type of firm widely known as a "stock brokerage firm," or, technically, a "broker-dealer," as that term is used by the United States Securities and Exchange Commission ("SEC"). I do not address matters relating to accounts held by investors with other types of investment professionals, such as Registered Investment Advisers, disputes regarding which are often heard either in court or in AAA/JAMS type arbitration fora. This article assumes the arbitrability of customer-stockbroker disputes, which is long-established in both federal and state law. The article concentrates on the type of account which is known as "non-discretionary," in which the investor/customer has the sole legal right and obligation to make ultimate decisions regarding the purchase and sale of securities in the account.

The Basic Claims and Defenses

A fundamental obligation of stockbrokers to their customers is that of "suitability." Rule 2310 of the FINRA Manual (the "rulebook" which governs stockbrokers and the member firms of FINRA with which they are affiliated) provides that any *recommendation* of a security must be appropriate, or "suitable," based on the investor's stated investment objectives, risk tolerance and certain other key factors which must be set forth on the firm's opening account documentation (most commonly referred to as a "New Account Form") for that customer. It is this obligation which underlies the lion's share of customer-stockbroker claims in FINRA arbitration.

The key focus of any claim alleging unsuitability is a comparison of the recommendation against the investment objectives and risk tolerance of the customer. The Claimant will seek to prove that the recommendation was inappropriate, *i.e.*, that it did not match the investor's objectives; this claim often involves the allegation of the purchase of securities which were too risky and speculative given the customer's objectives. This type of claim will often contain the additional claim of *concen-*

tration – i.e., that *too much* of a given security was purchased, exposing the customer to too much risk.

Assuming a *recommendation* was made (some investors rely virtually entirely on their own analysis to support their independent, unsolicited investment decision), in defending such a case, the brokerage firm will seek to obtain information about the customer's other brokerage accounts and investment experience, in an attempt to argue that any recommendation made was in fact made consistent with the investor's true objectives and experience, notwithstanding inconsistent information which may appear on the New Account Form. In concentration claims, firms will seek to demonstrate that the investor held substantial investments in other accounts, including with other firms, in an effort to prove that the account in question, when considered in context, was not over concentrated in a particular security.

Brokerage firms will also argue that, even given an unsuitable recommendation, any losses were caused not by such recommendation, but rather by virtue of the broader movement of the stock market.

A claim predicated on an allegedly unsuitable recommendation will typically be brought under the causes of action of negligence and breach of fiduciary duty. Fraud will often be alleged in situations involving specific misrepresentations and/or non-disclosures.Unsuitability based on a violation of FINRA's suitability rule is not a recognized private right of action (*see Jablon v. Dean Witter & Co.*, 614 F.2d 677, 681 (9th Cir. 1980).); rather, proof of violation of such rule will more typically be evaluated by Arbitrators as *evidence* of an underlying tort (*e.g.*, a negligence *per se* approach).

Most practitioners assume that FINRA panels will view stockbrokers as fiduciaries to their customers. *Duffy v. Cavalier* (215 Cal. App. 3d 1517 (1st Dist. 1989)) and *Twomey v. Mitchum Jones & Templeton, Inc.* (262 Cal. App. 2d 690 (1st Dist. 1968)) so hold. However, there are Ninth Circuit cases which appear to circumscribe this duty narrowly. (*See e.g., Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb,* 769 F.2d 561 (9th Cir. 1985).) Under California state law, the analysis of the scope of the duty focuses on: (1) the relative sophistication and experience of the investor; (2) the investor's ability to evaluate recommendations and exercise independent judgment thereon; (3) whether the account was discretionary or non-discretionary; and (4) the actual financial situation and needs of the investor. (*Duffy*, 215 Cal. App. 3d at 1536 n. 10.)

Claimants will often allege a breach of fiduciary duty in the failure of a stockbroker to properly *monitor* an account. Although such monitoring is not required in the typical non-discretionary account (*see De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002)), *FINRA Arbitrators appear to be receptive to this claim, particularly with certain types of Claimants.* Its validity depends primarily upon the type and length of the account relationship, the extent of the stockbroker's advice and assistance, and the level of sophistication of the investor.

Defenses of ratification, waiver, laches and estoppel will typically be advanced to negate liability. In many cases the investor continues to maintain the account with the brokerage firm, holding the securities complained of as the market fluctuates up and down. Respondents often argue that the investor's losses should be cut off at the time when he/she discovers, or should have discovered, the allegedly unsuitable transaction. Claimants' counsel typically respond that, by virtue of brokerage firms' fiduciary duty, they are in a better position than their customers to evaluate the pros and cons of what to do with securities in the account. Additionally, it is argued, stockbrokers often counsel customers to "stay the course" and wait until the market rebounds. Any or all of these contentions may relieve the investor of obligations which would otherwise trigger these affirmative defenses.

A variety of other claims are also brought against stockbrokers and their firms in FINRA arbitration, including elder abuse, as well as derivative claims such as failure to supervise. It is beyond the scope of this article to cover such claims, but practitioners may get helpful information regarding them, as well as other aspects of customer-broker arbitration, in the source material at the end of the article.

Damages in FINRA Arbitration

A common damages approach is "Net Out of Pocket Losses" ("NOP"), which appears to be drawn primarily from federal Rule 10b 5 cases. (*See* Randall v. Loftsgaarden, 478 U.S. 647 (1986).) In contrast, the common law of damages applicable to certain tort claims in various states including California includes "benefit of the bargain" damages. (*See e.g.,* Twomey (which involved a breach of fiduciary duty claim).)

Brokerage firms will typically point to NOP as the appropriate measure of damages, taking account of all interest income and dividends received by the Claimant during the time the investment was held. Claimants, on the other hand, typically advance a benefit of the bargain measure of damages, commonly referred to as the "well managed portfolio" approach. This theory is premised on the notion that investors should recover the principal loss on unsuitable investments, plus whatever gain they would have enjoyed in the market had they been invested in a suitable investment, usually measured by a well-known securities market index.

For other types of claims, such as violations of California's securities laws and elder abuse, the applicable damages measure is oftentimes set forth in the statutory scheme giving rise to the cause of action; in certain claims, rescission is available.

Regardless of the approach used, Respondents will typically raise the defense of mitigation, identifying key events and communications (*e.g.*, fluctuating market values on monthly statements) to argue that it is unfair to permit a customer to have rested on what amounts to a "wait and see" approach to see if the market and the investor's holdings recover. Claimants, for their part, argue that the fiduciary duty running from the brokerage firm to the investor relieves, in total or in large part, the mitigation duty which would otherwise be present.

In addition, Respondents will argue the concept of "market-adjusted damages," by which any damages are reduced by the amount lost during the same time period by similarly situated investors (typically measured by a well-known market index).

It is very difficult to predict how Arbitrators will analyze damages in a particular case. If a Claimant is elderly or unsophisticated, or if the stockbroker undertook a broad range of functions and an active role in managing or monitoring the account, or if the stockbroker's conduct appears nefarious, the Arbitrators may be inclined to adopt the more generous well-managed portfolio measure. However, regardless of what the law may state, the reality appears to be that most FINRA panels use "NOP" as the measure of damages in cases involving unsuitability claims. And in these cases, panels more often than not define NOP as the overall loss in the account(s) at issue, not merely an individual loss on a particular security. Given the lack of statistical information and appellate guidance, it is virtually impossible to ascertain why this is the case.

FINRA Arbitration Procedure

FINRA will accept and administer the arbitration of any customer-stockbroker dispute as long as the "event" giving rise to the claim transpired less than six years prior to the filing of the Claim. (FINRA Code of Arbitration Procedure ("FINRA Rule") 12206.) This "eligibility rule" is separate and apart from any limitations defenses which may be available. FINRA maintains a comprehensive web site, www.FINRA.org, which provides various resources to understand its arbitration process. In brief, the process works as follows.

A FINRA arbitration is initiated by the filing of a Statement of Claim ("Claim"), which sets forth the nature of the case and relief sought, followed by answers filed by all Respondents. All parties to the arbitration must execute a "Uniform Submission Agreement," which is the agreement to arbitrate before FINRA under its applicable rules. (*See* FINRA Rules 12300-12306.) The Claim is typically a narrative, often in the form of a letter. Answers are nearly always also in narrative form; answers which do not specifically address the claims (like typical general denials in state court cases) and assert defenses may bar Respondents from submitting evidence at the hearing. (FINRA Rule 12308.)

For three-Arbitrator claims (over $100,000 in claimed damages), two Arbitrators are classified as "Public" (basically no ties to the stockbrokerage industry), one of which is classified (with specific training) as a "Chairperson;" the third Arbitrator is classified as "Non-Public," and is drawn from a pool of persons who have experience in the industry and/or related fields. The arbitration selection process is set forth in FINRA Rules 12400 *et seq*. Each separately represented party has the opportunity to strike up to four names in each category and rank the remaining Arbitrators. (FINRA Rule 12404.) The panel is chosen from those rankings. (FINRA Rules 12405–12406.) Unlike other arbitration fora, FINRA provides fairly extensive disclosure not only about both potential Arbitrators' backgrounds, but also the past awards they have rendered in FINRA cases, which include the names of counsel of record.

Unlike the compensation structure typically in place at providers such as AAA and JAMS, FINRA Arbitrators are given a stipend of $200 per hearing session (defined as a session of 4 hours or less), or, in a typical arbitration hearing on the merits, $400 per day (an additional stipend of $75/day is provided to the Chairperson). (FINRA Rule 12214(a).)

Discovery in FINRA arbitration is streamlined. Documents which are deemed to be "presumptively discoverable" are to be exchanged quickly and on a voluntary self-executing basis between parties. (FINRA Rule 12506.) Additional discovery of documents and information may be requested from parties, but are designed to be limited; "[s]tandard interrogatories are generally not permitted in arbitration." (FINRA Rule 12507(a)(1).) **Except under extraordinary circumstances, no depositions are permitted.** (FINRA Rule 12510.) Similarly, subpoena power is very limited, is not self-executing (the Arbitration Panel must issue subpoenas only after proper application), and may present challenges of enforcement against third parties who are not FINRA members. (FINRA Rule 12512.)

Matters typically proceed to evidentiary hearing within a year. Twenty days prior to the hearing, parties exchange documents they intend to introduce and witnesses they intend to call. (FINRA Rule 12514.) Arbitrators are specifically not required to follow state or federal evidence rules. (FINRA Rule 12604.) The style and tone of a typical FINRA arbitration is more relaxed and informal, and is in a conference room, private and more enclosed than state or federal court. Partly because of this difference in context, the "likeability" of parties and counsel appears to be more important in FINRA arbitration than in state or federal court.

The vast majority of decisions, or awards, rendered by Arbitrators are simple, two to three pages in length, which do little more than list the claims, defenses, amount of alleged damages, counsel of record, hearing dates, and a statement along the lines of "All Claims of Claimant are Denied," or "Respondent is to pay Claimant $X." (FINRA Rule 12904.)

It appears that oftentimes Arbitrators will evaluate cases before them in terms of comparative negligence. Whether the Arbitrators go further and evaluate cases in terms of comparative fault in the context of a fiduciary relationship is a more difficult question. In any event, "Split-Baby" awards are very common. Many practitioners believe that, in general, FINRA Arbitrators do not focus on the law, much less actually read the statutes, regulations, cases and other materials cited (this seems likely, if only because of the structural constraints of how FINRA Arbitrators are compensated). Therefore, the particular facts and circumstances of both underlying disputes as well as the way they are presented to panels, including intangible factors such as "likeability," tend to be more important in case evaluation than specific legal precedents.

Conclusion

The arbitration of customer-stockbroker claims is materially different than most other types of arbitration or litigation. The key features of this type of dispute resolution – the significance of the underlying regulatory obligations, the resulting unique nature of the core claims arising therefrom, the damages approaches employed, the unusual and discovery-truncated procedure, the composition of panels and the compensation of the Arbitrators who comprise them, and the opaque nature of the awards given – are such that practitioners new to this area – even those with extensive jury trial experience – are well served to tread cautiously, and not simply rely upon on conventional litigation wisdom drawn from state and federal court.

Helpful resources regarding customer-broker arbitration include Robbins, *Securities Arbitration Procedure Manual* (Matthew Bender); Ryder, *Securities Arbitration Commentator;* PIABA.org [professional organization comprised of attorneys who bring claims by investors against securities brokerage firms]; SIFMACL.org [professional organization comprised of attorneys and compliance professionals who represent securities brokerage firms].

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