How to Handle Securities Cases

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Commercial litigation is on the rise. Within that area, an increasing number of investor torts are being filed. According to information published by the ALI-ABA and presented at a January 1999 seminar, new case filings average around 7,000 to 8,000 a year. This is a substantial increase from ten years ago when annual filings averaged 2,800. Because of this increase, it is imperative that we as trial lawyers are able to identify and handle competently a securities case.

Almost without exception, all of these filings proceed in arbitration. The boilerplate language which every brokerage customer signs contains an arbitration agreement. Typically, a customer has his choice between a NASD or NYSE panel in which three arbitrators will serve. Of the three arbitrators that will decide his case, one will most likely be actively employed in the securities industry. Heavy securities regulations ensure that a paper trail has your client's case carefully documented. For this reason, securities cases do not bring the typical dread held by consumer plaintiffs and their counsel when faced with arbitration as a means to settle their dispute. Securities regulators require brokerage firms to supervise the activities of their brokers in an effort to protect the interest of customers.

There are three main bodies that promulgate these regulations: the Securities and Exchange Commission ("SEC"), the National Association of Securities Dealers ("NASD"), and the New York Stock Exchange ("NYSE"). Other self-regulatory organizations and state securities commissions also have a hand in making and enforcing regulations.

Trial lawyers already possess most of the needed knowledge to successfully arbitrate a securities case: breach of contract, fraud, negligent misrepresentation, breach of fiduciary duty, and breach of a legal duty. Aside from this knowledge, the key to success in a securities case is two-fold. First, a lawyer must be able to recognize a good case. Tracking the paper trail and locating necessary documents is the second key to handling a securities case properly.

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I. How to Identify a Good Securities Case

Recognizing a good securities case differs a bit from ordinary torts. As stated above, the securities industry is heavily regulated. The SEC, NASD, and the NYSE as well as other regulatory bodies all require detailed paperwork to make it easy for regulators to detect conduct by brokers and others that compromise the integrity of the markets and put customers at greater risk than they bargained for. Severe sanctions are the consequence for failure to abide by these regulations so brokers tend to follow the regulations and fill out paperwork that become important if a dispute arises. Section 17(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires brokers, dealers, and others to "make and keep for prescribed periods such records…as the Commission (the Securities and Exchange Commission), by rule, prescribes as necessary or appropriate in the public interest…" Exchange Act Rule 17a-3 (17 C.F.R. §240.17a-3) sets forth the records that brokers and dealers have to make, and Rule 17a-4 sets forth the requirements for preservation of those records.

The Alabama Securities Act is found in the Code of Alabama (1975) in Title 8, Section 6. Subsection 8-6-2 provides definitions ascribed to terms within the act. Some of the definitions included are the definitions for agent, dealer, issuer, broker, investment advisor, as well as others. In section 8-6-3 are the general provisions dealing with the registration and bonds of dealers and salesmen. This section gives specific instructions as to who may transact business in the state of Alabama as a dealer or agent for securities. It also states that the prescribed period for dealers and brokers to keep records on hand is five years unless the commission prescribes otherwise for particular types of records. Section 8-6-18 provides the criminal penalties for violations. The civil liabilities of sellers and agents and the remedies available to purchases can be found in Section 8-6-19.

Some of the most common investor torts are:

Churning: The excessive trading of securities. This is usually done with stocks by a broker to create large broker commissions. Brokers get paid to trade. For that reason, the temptation to churn stocks is inherent in the industry. For example, if a client

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chooses good stock and doesn't make a single trade during the year, the client may receive 100% return on his investment while the broker gets nothing. On the other hand, if the broker sells every time the stock rises a couple of points and buys the stock back, the stock value will have increased the same amount, the broker will have made substantial commissions, and the client will have received substantially less than 100% return than he would have under the more prudent "buy and hold" strategy.

Unsuitable Trading: "Know your Customer" is a requirement brokers/dealers must follow under NYSE Rule 405 and Article III, §2 of the NASD Rules of Fair Practice which mandates that a broker determine and make recommendations consistent with his customer's risk tolerance, investment objective and needs. For example, a customer with a low risk tolerance and the primary objective of "preservation of capital" should not be making highly volatile investments. The broker who fails to act consistent with the customer's profile can be held liable.

Misrepresentations and Omissions: Again, the danger inherent in the manner by which brokers are paid is incentive to be less than honest with the customer. To convince a customer to sell held stock and buy certain other stock, a broker may sometimes embellish the attractiveness of that certain stock or omits disclosure of its downsides. When a customer would not have bought the stock otherwise, the broker becomes liable for the results to the customer's account.

Unauthorized Trading: In pursuit of high commissions, brokers may sometimes trade stocks without authorization while hoping for a return profitable enough to keep the investor from complaining. Whether the investor authorized the trades will often become a swearing contest. But certain regulations require that such authorization be formally written down, which can become the infamous smoking gun.

II. The Smoking Gun

The second key to successfully handling a securities case is knowing how and where to find the smoking gun. Exchange Act Rule 17a-3(a)(6) requires that brokers and dealers keep order tickets for every securities trade. Those tickets bear a time stamp

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showing the date and the time that the customer ordered the trade. Knowing the existence of these types of documents can make a difficult case into a smoking gun case.

Arbitration was mentioned in the introduction as probably being the customer's only recourse. Because of the severe limitations arbitration places on discovery, finding the smoking gun can be the major source of difficulty in successfully handling a securities case. The brokerage firm is given an overwhelming advantage because it holds the evidence that the customer needs to prove his case. More than likely, the arbitrators will be slow to order production of the documents needed by the customer as well as hesitant to sanction the firm for flagrant discovery abuses. This does not mean that the arbitrators are out to deny justice. It only re-emphasizes the point that attorneys handling these types of cases must be familiar with the regulations and lingo to guide the arbitrators through all the 'smoke' the defendants will blow. Effective counsel must also be able to convince the arbitrators that the document is discoverable. The defendant of course, will try to raise suspicions in the arbitrators' minds about any discovery requests. One ploy is to feign confusion about the document, making the arbitrator conclude that if the defendants do not know what you are talking about, it must not exist. If they do acknowledge the document, they may complain that it is too burdensome to retrieve the document in mountains of paperwork as well as claim that it is not relevant.

In the mind of an arbitrator, as well as with a judge or jury, it is imperative to present yourself as a reliable source of information. And the easiest way to do this is being able to cite SEC, NASD, and NYSE regulations as well as other rules that require brokers to make and keep documents. Point out to the arbitrators that the Exchange Act was intended to be construed "not technically and restrictively, but flexibly to effectuate its remedial purpose." Affiliated Ute Citizens of Utah, 408 U.S. 931 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)). Therefore, the rules requiring records to be kept and maintained for prescribed periods of time were designed to "avoid frauds." This goal cannot be accomplished if the documents created pursuant to the rules are withheld in a case alleging fraud.

Also helpful are document requests narrowly tailored to the facts of the case. Any objections defendants raise will reveal their bad faith regarding discovery over the smoking gun document. An initial discovery request should included the brokerage's

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compliance and supervisory manuals which set forth internal procedures for handling orders and proper conduct in various areas where complaints are frequent. A second request may include specific documents in those manuals.

III. Conclusion

Though arbitration is often the “death nail” to the ordinary, consumer plaintiff, an investor plaintiff still has an opportunity to succeed if his case is competently handled. The abundant pitfalls inherent in arbitration face the investor plaintiff as well. But the heavy regulations applicable to those who work within the industry provide the means to succeed. An attorney who takes the time and effort to familiarize himself with the nature of the industry and its regulations can be a valuable asset to his client’s case. Whether the attorney is willing to do this may determine the success in getting the smoking gun to the table and using it to win his client’s case.

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