A Tradition of Self-Dealing

Recovering from Brokerage Firms for Bogus Stock Recommendations

by

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On May 21, 2002, Merrill Lynch, one of the world's biggest brokerage firms, agreed to pay $100 million to settle a case brought by the New York attorney general, Eliot Spitzer, alleging that Merrill defrauded retail brokerage customers by issuing misleading "buy" recommendations on over two dozen stocks followed by Merrill's internet analyst group.[1] According to Spitzer, Merrill issued and maintained "buy" recommendations on certain stocks in order to curry favor with the issuers of those stocks in hopes of securing lucrative investment banking business from those companies in the future.[2]

Secretly, however, Merrill analysts disparaged those stocks in internal e-mails. Merrill analysts privately described the same stocks recommended to their customers as "dogs" and "pieces of crap," among other less than flattering references.[3] Internally, it was a poorly kept secret that analyst recommendations on the retail market were little more than a tool to secure and maintain lucrative investment banking business and bore no relation to the truth about the recommended stocks.[4] In fact, Merrill makes more money in helping companies sell stocks and bonds through investment banking deals than it does in selling those same products to its customers.[5]

Retail investors had no way of knowing the truth about this inherent conflict of interest. In slick advertising campaigns, Merrill touted its "Tradition of Trust." Among the promises Merrill Lynch makes to investors are the following:

> At Merrill Lynch, the interests of our clients always come first.
>
> Your relationship with Merrill Lynch is serviced by professionals committed to the highest standards of integrity.
>
> The cornerstone of the Merrill Lynch client relationship is accountability and open communication.[6]

While the "highest standards of integrity" in the securities industry have always fallen well short of any objective measure of the term, investors are only now waking up to how low those "high standards" really are. Unfortunately, the only real value of the attorney general's settlement with Merrill is alerting the investment public to how deep the chasm is between reality and the perception of integrity generated by Wall Street advertising campaigns.

The $100 million Merrill paid to settle the New York case represents only a miniscule fraction of their $2.4 billion dollar operating profit.[7] Yet, not a single penny of that settlement will go to investors who believed Merrill's recommendations and lost their savings as a result.[8] Furthermore, Merrill denied any wrongdoing in the settlement and, to the contrary, expressed "regret" that the disparaging (but honest) remarks of their internet analysts were aired for public consumption.[9]

The only way investors injured by this conflict will recover is through private actions, which in many cases must be filed in arbitration based upon clauses contained in opening account agreements with the brokerage firm. Having refined the "highest standards of integrity," Merrill has likewise redefined "accountability" by stating that it will "vigorously defend" any such actions brought by individual customers to recover the losses they sustained by taking Merrill Lynch at its word.[10] Of course, Merrill initially responded to the New York attorney general's action in the same fashion, and even declared "outrage" at Spitzer's conflict of interest allegations.[11]

This article will examine the most likely path to success against Merrill and other firms who issue bogus stock recommendations.

Duty

Lawyers who do not practice securities law may not know that the duties owed by those who offer investment advice differ with the title of the person offering advice, with the type of account the customer has, and with the jurisdiction. Certainly, the investing public has no idea of these distinctions that can mean the difference between success and failure in an action to recover losses.

Investment Advisers. By definition, an investment adviser is "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities . . . ."[12] Investment advisers must be registered with either the SEC or the securities commissioner of the states in which they are located, depending upon the total amount of assets the adviser manages.[13] The Supreme Court has held that investment advisers are fiduciaries.[14] In doing so the Court noted that the Committee Reports on the Investment Advisers Act of 1940 "indicate a desire to preserve 'the personalized character of the services of investments advisers,' and to **eliminate conflicts of interest** between the investment adviser and the clients as safeguards both to unsophisticated investors and to bona fide investment counsel."[15]

Many brokerage firms, including Merrill Lynch, offer their customers enrollment in programs that give them access to the firm's professional "money managers" all of whom are registered as investment adviser representatives of the corporate investment adviser. Such customers will be able to take advantage of the authorities establishing fiduciary obligations and should have no trouble convincing a court or arbitration panel that the firm owed a duty to avoid conflicts of interest like those apparent from the internal Merrill Lynch documents.

Brokers. Federal and state securities statutes define "broker" as "any person engaged in the business of effecting transactions in securities for the account of others…."[16] Because brokers are expressly excluded from the definition of "investment adviser,"[17] though, the federal authorities establishing the fiduciary obligations of investment advisers do not, by their terms, create the same duty for brokers. Some states, including Georgia, hold that stockbrokers owe a fiduciary duty to their customers.[18] Federal courts have reached the same conclusion.[19] Many jurisdictions, though, look to the type of account in determining whether the broker owed a fiduciary duty.[20]

Discretionary v. Non-discretionary Accounts. Discretionary accounts allow the broker to make trades in a customer's account without obtaining prior approval for each trade. Industry rules require that the customer sign paperwork giving the broker discretionary control over the account.[21] Brokers who exercise discretion without the approved paperwork violate industry rules and are subject to discipline by the National Association of Securities Dealers, Inc. ("NASD"). All jurisdictions recognize the fiduciary obligations of a broker who has discretionary control over a client's account.[22] Because brokerage firms recognize the increased liability exposure that comes with discretionary control, many prohibit their salesman from accepting discretionary authority.

Most brokerage accounts are non-discretionary, meaning that the salesman is supposed to obtain prior approval for every transaction. In practice, many securities salesmen exercise discretion without the proper paperwork. Because the investing public does not appreciate the difference between the two accounts, many customers allow their brokers to exercise discretion, putting their trust in the broker (who, supposedly, has the expertise) to make decisions about what to buy and sell and when. Only when a dispute arises and the broker denies ever exercising discretionary control over the account does the customer realize that his trust was misplaced and that the law may not hold the broker accountable for the breach of trust.

Jurisdictions that do not recognize the practical realities of the typical broker-customer relationship require a detailed factual analysis of the relationship before deciding whether the broker owed a fiduciary duty. Among the factors that these jurisdictions examine are whether the broker exercised *de facto* discretion over the account, and whether the broker touted his experience as an adviser in making recommendations to the customer.[23]

Lawyers facing firms in analyst cases should argue that even the most basic of legal duties, the duty of due care, requires that a firm refrain from lying to its customers. Internal documents will establish that the firms did lie to customers by issuing false analyst recommendations.

Breach

A lie establishes the breach of a duty to tell the truth. Merrill's e-mails and other internal documents establish that the firm lied to its customers by issuing false "buy" recommendations. In other investigations the New York Attorney General's office has subpoenaed "self evaluation" memos prepared by research analysts from several firms. News reports indicate that analysts anxious for a big bonus drew a direct connection between the recommendations they issued and the amount of investment banking business their firms earned.

Causation

Causation will be the battleground for customers with non-discretionary accounts. For investment advisory clients and customers who had conveyed formal discretionary control to the firm, causation is less an issue as the firm decided what to buy and when. For customers with non-discretionary accounts establishing causation means establishing reliance, and lawyers representing aggrieved customers should begin now gathering the facts to prove it.

Firms may have sent customers a hard copy of the analyst's recommendation. Counsel should have potential clients gather every scrap of paper they received from their brokerage firm and forward all of it to counsel.

Many brokerage firms, including Merrill, annotate monthly account statements with the analyst ratings on stocks in the customer's account. While ratings on stocks already in the account obviously could not have led to the initial purchase, they may have been the basis for subsequent purchases and may have led the customer to hold onto the stocks after they began to decline in price.

Part of the paperwork associated with every stock trade, order tickets include important information for counsel representing investors. Each order ticket will be marked either "solicited" or "unsolicited." Solicited trades are those the broker recommended to the client. Although it is by no means uncommon for brokers deliberately to mismark order tickets to cover up inappropriate recommendations, a "solicited" order will defeat the firm's defense that the customer ordered the purchase without any input from the firm.

The customer's trading history will help in establishing reliance. If the customer has a solid history of following analyst recommendations, the firm will have a tougher time convincing an arbitration panel that the customer did not rely upon the analyst recommendation in this instance.

Damages

Most state securities acts provide for rescissionary damages in the event of a sale involving fraud, deceit, and/or a material misrepresentation or omission of material fact.[24] For example, the Georgia Securities Act provides that "[d]amages are the amount which equals the difference between the fair value of the consideration the buyer gave for the security and the fair value of the security at the time the buyer disposed of it, plus interest thereon from the date of payment down to the date of repayment . . . ."[25] The Georgia statute also provides for recovery of "taxable court costs and reasonable attorneys fees."[26]

W.C. Fields coined the phrase "Never give a sucker an even break." Investors are learning the hard way that the brokerage industry has been following his advice. Knowledgeable counsel can help investors hold brokerage firms accountable for that decision.

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1 Merrill Lynch Press Release, "Merrill Lynch Announces Agreement with New York State Attorney General," May 21, 2002.
2 Affidavit of Eric R. Dinallo, Assistant Attorney General of the State of New York, on behalf of Eliot Spitzer, Attorney General of the State of New York, April 8, 2002, filed in the Supreme Court of the State of New York, New York County.
3 *See supra* Note 2 at 10-11.
4 *See supra* Note 2 at 3-5, 10-22.
5 Noelle Knox, *Merrill agrees to pay $100 million to settle charges*, USA Today, May 21, 2002.
6 *See* Merrill Lynch website at *www.ml.com.*
7 Pradnya Joshi, *Merrill Lynch Set to Pay $100 million*, Newsday, May 22, 2002. Under the terms of the settlement, $48 million will go to New York State and $52 million will go to other states. Investors are not addressed in the settlement.
8 *See supra* note 7.
9 *See supra* note 1.
10 *See supra* note 7. Comments of Merrill Lynch President and COO, Stan O'Neal.
11 Merrill Lynch Press Release, "Merrill Lynch Statement On Action By New York State Attorney General," April 8, 2002.
12 15 U.S.C. § 80b-2(a).
13 15 U.S.C. § 80b-3.
14 *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963).
15 *See supra* note 14 (emphasis added).
16 15 U.S.C. 78c(a)(4).
17 15 U.S.C. § 80b-2(a).
18 *Glisson v. Freeman*, 532 S.E.2d 442 (Ga. App. 2000); *Minor v. E.F. Hutton & Co., Inc.*, 409 S.E.2d 262, 264 (Ga. App. 1991).
19 *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977).
20 *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750 (3d Cir. 1990)(New Jersey law); *Caravan Mobile Home Sales, Inc. v. Lehman Bros, Kuhn Loeb, Inc.*, 769 F.2d 561 (9th Cir. 1985)(California law).
21 NASD Conduct Rule 2510(b).
22 *E.g. Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817, 820 (6th Cir. 1981); *Rupert v. Clayton Brokerage Co. of St. Louis*, 737 P.2d 1106 (Colo. 1987); *Merrill Lynch, Pierce, Fenner & Smith v. Boeck*, 127 Wis.2d 127, 377 N.W.2d 605 1985).
23
24 O.C.G.A. § 10-5-12.

[25] O.C.G.A. § 10-5-12

[26] O.C.G.A. § 10-5-14(a).