

Protecting Yourself In Bull And Bear Markets

What Investors, Their Accountants and Advisors Should Know
About Investment Product Suitability and Investment Abuse



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Ronald M. Amato, Esq.

- SNSFE associate attorney
- Securities arbitration & litigation
- Extensive experience representing individual investors and trust beneficiaries
- Represents financial advisors in employment-related disputes and regulatory matters

OVERVIEW

- Stockbroker/Advisor abuse can occur even in flat or rising markets
- Investment fraud, as well as advisor incompetence through improper asset allocation, imprudent advice, and/or the sale of unsuitable products, can wreak havoc on investor portfolios
- Retirees, those on a fixed-income, may never fully recover investment losses

OVERVIEW (CONTINUED)

- Investors should be aware of red flags when reviewing their portfolios
- Accountants and advisors often are in a position to detect wrongdoing or negligence
- Accountants and advisors can add value to their client relationships by alerting clients to possible incompetence or abuse in investment portfolios

INVESTMENT FRAUD – CHURNING

Churning occurs when:

- Accounts are excessively traded -- that is, the equity/account value unnecessarily is “turned over”
- Commissions, and sometimes margin interest, are unnecessarily high
- Stockbroker/Advisor has “control” of the account

INVESTMENT FRAUD – CHURNING (CONTINUED)

- Often involves short-term trading of similar securities (or even the same security)
- Churning (quantitative unsuitability) also can be present in option accounts, with mutual funds (switching), and with variable annuities (unsuitable exchanges)
- Red flags include numerous trade confirmations, 1099 (at tax time) showing excessive transactions, “activity letters” from advisor’s branch manager or compliance department

INVESTMENT FRAUD – UNAUTHORIZED TRADE

- Fairly rare, but occasionally happens
- In the absence of written discretionary trading authority, stockbroker/advisor must always call first
- Best course of action – **COMPLAIN IMMEDIATELY!**

INVESTMENT FRAUD – SPECULATIVE STOCKS

- Micro-cap stocks – inherently speculative, often illiquid individual stocks
- Traditionally sold by smaller firms – many of whom make a market in these securities (and hold an inventory)
- Companies with weak or non-existent fundamentals
- Advice to investors – **AVOID LIKE THE PLAGUE!**

INVESTMENT FRAUD – SELLING AWAY

- Occurs when stockbroker/advisor sells investment “away” from, or not sanctioned by, his employing broker-dealer
- Often are promissory notes, private partnerships, unmarketable securities, and other “too good to be true” investment schemes
- Unfortunately, frequently are Ponzi schemes, and allow unscrupulous advisors to convert customer funds for personal use

INVESTMENT FRAUD – MARGIN

- Borrowing against volatile stocks to purchase more stocks can have devastating effects on portfolio
- Gives broker/advisor more money to play with, while investors pay the tab (in the form of margin interest)
- Risks of margin trading often are not adequately disclosed
- Margin calls can force liquidations at the worst possible time, when stocks are down

UNSUITABILITY

- Still a major concern – an issue in many, if not most, customer arbitrations
- **NASD Conduct Rule 2310:**
Requires broker/advisor to have reasonable grounds for believing that recommendation is suitable based on the facts, if any, disclosed by the customer as to his or her other security holdings, financial situation, and financial needs
- Advisor must determine if the recommendation is suitable for *any* investor, regardless of the investor's wealth, willingness to bear risk, age or other individual characteristics (so-called "reasonable basis" suitability)

UNSUITABLE PRODUCT – VARIABLE ANNUITIES

- Frequently cited as abusive, unsuitable investments
- High commission, high expense products
- Surrender fees can make these products illiquid
- Potential for sales practice abuses through unnecessary exchanges
- Subaccounts can expose assets to market risk

UNSUITABLE PRODUCT – HEDGE FUNDS

- Lack of transparency, risk make them unsuitable for most retail investors
- Potentially illiquid
- Potential for fraud/conversion
- High fees, particularly with “funds of funds”

UNSUITABLE PRODUCT – OPTIONS

- Risky instruments, often abused by stockbrokers/advisors
- Risk of strategies such as put selling/writing typically is inadequately disclosed
- Full-service brokerage commissions make fairly low-risk strategies, such as covered calls, not worthwhile

UNSUITABLE PRODUCT – BONDS???

The potential for abuse is there:

- Risks often are inadequately disclosed
- Bonds can be volatile due to changing interest rates
- Stockbrokers/advisors sometimes push low quality bonds with long maturities, from their firms' inventories
- In the typical principal transaction, bonds are subject to “mark ups” and “mark downs”

MODERN PORTFOLIO THEORY – ASSET ALLOCATION AND DIVERSIFICATION

Fundamental concepts that sometimes are disregarded by stockbrokers/advisors

Asset Allocation:

- Practice of combining non-correlated asset classes (e.g., stocks, bonds, cash, REITs, hedge funds)
- Significantly reduces risk (i.e., volatility) in portfolio
- Does not significantly reduce investment returns

MODERN PORTFOLIO THEORY – ASSET ALLOCATION AND DIVERSIFICATION (CONTINUED)

Diversification = Not having all of your eggs in one basket

- In equity portfolios, this means **SECTOR DIVERSIFICATION!**
- Equity portfolios further are diversified through exposure to foreign markets (both developed and emerging markets)

A prudently managed portfolio is both appropriately asset allocated, and invested across different sectors (e.g., consumer cyclicals, technology, transportation, utilities, etc.)

MODERN PORTFOLIO THEORY – ASSET ALLOCATION AND DIVERSIFICATION (CONTINUED)

For retirees, investors on a fixed-income, and investors with a short time horizon:

IMPRUDENT ASSET ALLOCATION INEVITABLY LEADS TO A PORTFOLIO'S FAILURE TO MEET INVESTMENT AND RETIREMENT INCOME GOALS!

MODERN PORTFOLIO THEORY – ASSET ALLOCATION AND DIVERSIFICATION (CONTINUED)

- The appropriate standard of care requires that stockbrokers/advisors recommending investments and structuring portfolios consider modern portfolio theory concepts
- Retirees (and those approaching retirement) who have been placed in portfolios 100% comprised of growth stocks may have a viable cause of action against their brokers/advisors

CONCLUSION

- Regardless of market conditions, investors can fall victim to investment fraud, sales practice abuses, and negligence/mismanagement at the hands of trusted investment professionals
- There are numerous pitfalls – investors should diligently monitor their portfolios
- Accountants and advisors can add value to client relationships by detecting and addressing suspected wrongdoing or mismanagement

Questions?

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Thank you!