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**FINANCIAL ADVISOR LIABILITY:
AN OVERVIEW**

**Web Seminar
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UNSUITABLE INVESTMENTS

- An issue in many, if not most, customer arbitrations and claims against financial advisors

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)

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**UNSUITABILITY
TYPICAL SCENARIO**

- Retiree (or person approaching retirement)
- Sold investment (e.g., stock, bond or mutual fund) or product (e.g., deferred annuity) that is too risky or volatile in view of the customer's objectives and needs
- Account is too heavily concentrated in one asset class (e.g., stocks/equities) or sector (e.g., financials, technology, etc.)
- Investment risks are not adequately disclosed and/or misrepresentations are made

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**UNSUITABILITY
MARGIN TRADING**

- Inappropriate use of leverage to purchase securities
- Exposes client to additional, often unnecessary risk
- Increased "cost of trading" (i.e., margin interest)
- 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)
- Margin calls can force liquidations at the worst possible time, when stocks are down

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**UNSUITABILITY
CHURNING**

- Not as prevalent as once was, but still occurs
- "Quantitative" Unsuitability
- 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
- Also can be present in option accounts, with mutual funds (switching), and with variable annuities (unsuitable exchanges)

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**UNSUITABLE PRODUCT
DEFERRED 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
- Sub-accounts can expose assets to market risk

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UNSUITABLE PRODUCT
SUB-PRIME SECURITIES

- Mortgage-backed bonds and other structured products (Collateralized Debt Obligations - "CDOs")
- Pools of sub-prime loans
- Various "tranches"
- Can find their way into retail investors' portfolios through bond funds (such as Schwab Yield Plus Fund, Regions Morgan Keegan Select Hi Income Fund)
- Value of supposedly "safe" bond funds declines significantly (e.g., Regions Morgan Keegan funds down by 85%)

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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"

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UNSUITABLE PRODUCT
AUCTION RATE SECURITIES (ARS)

- Sold as "cash alternative" to money market fund
- Supposedly as safe as money market, highly liquid
- Auctions failed, investors' funds are frozen
- Arbitration may be appropriate for institutional investors, investors with smaller firms (not part of regulatory settlement) and investors with "consequential" damages

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**VARIATION ON UNSUITABILITY
PORTFOLIO MISMANAGEMENT BY AN INVESTMENT FIDUCIARY**

- Registered Investment Adviser and its representatives have fiduciary duty to clients
- Modern Portfolio Theory (MPT) and Prudent Investor Rule define standard of care
- Inappropriate asset allocation, failure to diversify portfolio, failure to re-balance portfolio can lead to customer complaints and arbitration/litigation of customer disputes
- Financial planning "negligence" – failure to anticipate client's income needs, inflated projections based on unrealistic returns, etc.

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**MODERN PORTFOLIO THEORY
ASSET ALLOCATION AND DIVERSIFICATION**

Fundamental concepts that sometimes are disregarded by 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

Diversification:

- Means not having all of your eggs in one basket (i.e., sector)

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**UNSUITABILITY
PORTFOLIO MISMANAGEMENT**

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 financial advisor

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INVESTMENT FRAUD

- "Ponzi" schemes
 - Unregistered Advisors
 - Unregistered Securities
 - Conversion of customer assets

- Affinity Fraud
 - Targets religious or ethnic group
 - Often trusted member of "inner circle"

IF IT SOUNDS TOO GOOD TO BE TRUE, IT USUALLY IS!!

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INVESTMENT FRAUD
BERNARD MADOFF

- \$50 Billion fraud

- Trusted member of the community, high society

- Affinity fraud (many investors wealthy Jewish people from NYC and Palm Beach)

- Unrealistic steady and positive returns using stock and option trading strategy – too good to be true

- Red flags ignored by investors and regulators (including SEC)

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INVESTMENT FRAUD
"SELLING AWAY"

- Representative of broker-dealer (i.e., fully licensed, etc.)

- May handle legitimate investments for customers in brokerage account

- Pressures customers to invest in "private" (often "too good to be true") investments outside of his or her firm

- Often are promissory notes, private partnerships, unmarketable securities, and other investment schemes

- Unfortunately, frequently are Ponzi schemes, and allow unscrupulous advisors to convert customer funds for personal use

- Broker-Dealer has duty to supervise outside business activities under FINRA Conduct Rules, could potentially be liable

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ACCOUNTANTS AND ATTORNEYS CAN ADD VALUE

- Accountants and advisors can add value to client relationships by detecting and addressing suspected wrongdoing or mismanagement by stockbrokers and investment fiduciaries
- Red flags often appear at tax time (e.g., excessive and unwarranted trading activity appearing on 1099)

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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
- 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
- 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

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Thank you!

Questions?

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