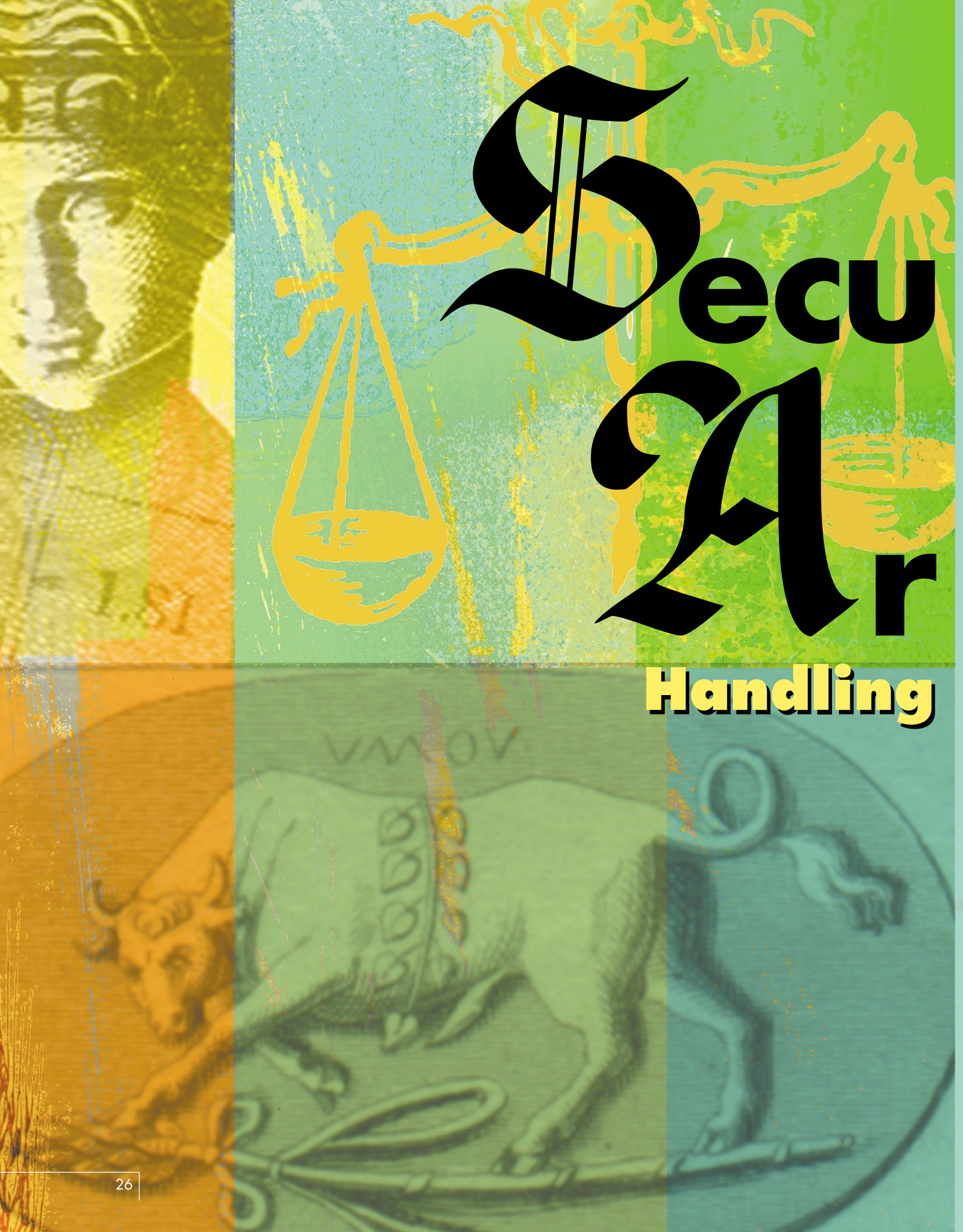
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Fast Facts:

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a Case under the NASD Rules

By Joseph P. Yaney

The terrorist attack on New York City and Washington, D.C., caused a considerable drop in asset values on all exchanges. Even without the attacks, the public was filing more complaints with NASDR (National Association of Securities Dealers, Dispute Resolution, Inc.). There were 6,584 new customer complaints filed in the year 2000, which was up by 27 percent from 1997. The case load is administered by the Dispute Resolution offices across the nation, which accept the complaints, appoint arbitrators, and follow the case to the end.

Negotiations and Litigation

The first step is to allow the securities representative and his brokerage executive to undo the transaction. For example, if the securities were too risky for a customer's profile, the branch manager might offer to replace those securities with a more conservative selection. No wrongdoing is admitted by such a compromise.

The second step is to fit the facts of the case into a common misconduct category: churning the accounts, misrepresenting the financial and marketing aspects of some securities, not following the customer's instructions, suggesting purchases that are unsuitable, or failing to follow the brokerage house's own compliance rules on supervision and auditing. For example, an older customer may allege that the broker purchased 200 shares when the customer wanted only 100 shares. Evidence is the problem. Some brokerage firms now tape record all

client calls. The client's attorney may request that the brokerage turn over copies of the tapes.

Procedural Rules and Civil Procedures

The case starts with pleadings alleging a wrong committed by the broker. The Code of Arbitration Procedure outlines the routine procedural rules, such as issuing a complaint, offering documents to support the claim, and depositing money for forum fees. There has been a clear shift in policy giving the arbitration panel power to apply sanctions against the parties for ignoring the procedural rules. For example, not providing documents in discovery may bring a sanction of not being able to dispute those documents in the full hearing. The arbitration panel has the responsibility to evaluate requests for delays. If the panel decides that the delays have been without merit, the panel can assess the forum fees against the defendant.

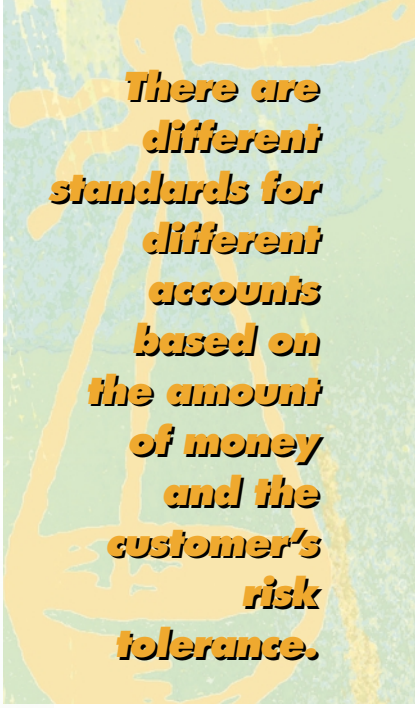
There are three important procedural choices about how to proceed in the arbitration process. First, the parties can agree to simplified arbitration when the claimant alleges a dollar amount not exceeding $25,000. The parties will argue by brief before a single public arbitrator. The public arbitrator has the authority to request additional documents (Rule 10302). The customer has a second choice regarding the single arbitrator pilot program for claims between $50,000 and $200,000. The parties must select a single public arbitrator to hear the case instead of a panel of three arbitrators. The single arbitrator can communicate directly with the parties instead of going through the regional NASDR office. This decentralization policy started February 15, 2000, and is still under evaluation.

The parties must use a three-person panel on cases alleged to be over $200,000 in damages.

Arguments and Defenses During the Hearing

The claimant has the responsibility for presenting a case convincing enough that the arbitrators will award some monetary damages. The legal test is the preponderance of the evidence. The claimant will argue that the securities representative acted in a way that directly caused the client to lose money. A key document is the predispute arbitration agreement that lists background information about the buyer and asks the buyer to show how much risk he is willing to assume. The claimant might have changed his mind and completed a new form, but that rarely happens. The original form might have said that the buyer would make risky trades and wanted to be an aggressive investor.

The respondent wants to convince the panel that this buyer was treated in a reasonable manner during all their telephone conversations and office visits. The respondent needs to show that the securities prospectus and other research reports were given to the claimant. Next, respondent will show that the buyer may have delayed any objections, hoping that the securities would regain their lost value. If the claimant waits an unreasonable amount of time before complaining, there is a question that the buyer ratified a questionable transaction. The respondent's office staff will show that the buyer received monthly statements. Each statement requests that the customer contact the office manager if there are any errors. The office manager wants to know if the clients believe that they have been treated unfairly. The respondent might argue that the buyer was tardy and that tardiness contributed to the loss.



A second common argument by claimant is that the securities representative made unauthorized trades in this account. Many buyers say they want expert advice before buying or selling securities. The respondent wants to show that there were frequent discussions over coffee or at lunch about the customer's financial goals. The respondent wants to show that the buyer gave his permission to buy and sell in order to reach the financial goals. The respondent may argue that the claimant had other accounting or paid legal advice beyond what the representative offered. The argument is that a reasonable man would have more confidence in what his own attorney or accountant told him.

"Churning" is a word that suggests its own behavior. A typical claimant might argue that too many trades were made in his accounts. Was there too much trading in this account given the customer's instructions, the size of the account, and the firm's routine operating procedures? The securities business has been very diligent about being a self-regulating organization. There are different standards for different accounts based on the amount of money and the customer's risk tolerance. For instance, a $30,000 account may have few transactions since the commissions might eat up any small gains.

Putting the Pieces Together

The securities industry has spent millions of dollars on computer equipment to document the transactions and record any withdrawals made by the customer. Both sides have copies of these documents. For example if there were five or more trades per month in a modest account owned by a widow, there is some question that these actions do not fit the requirements for being a reasonable broker. On the other hand a wealthy contractor may want his representative to aggressively trade stocks and bonds. The compliance director of the brokerage firm has an obligation to review what their representatives do. This supervision requirement is built into the National Securities Dealers Association's rules and customs. Each brokerage house has a compliance manual and a compliance officer to review what their employees are doing.

Both parties hold most of the original transaction documents or computer generated copies. There may be some additional documents held by the respondent, such as the internal audit reports or copies of complaints made against this representative by other customers. The claimant has a right to see such complaints. NASDR issued its notice 99-90 (November 1999) about new discovery guidelines for arbitration. The document repeats what the parties

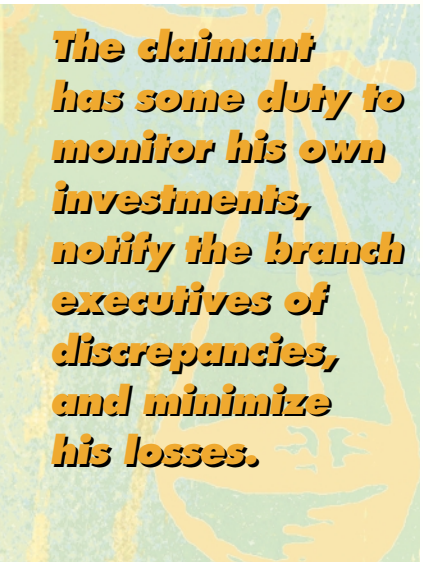
already knew: "discovery disputes have become more numerous and time consuming" (p. 689). The rules now outline which documents are automatically required in customer cases. The rule states that the parties should exchange these documents without asking the arbitrators. For example, list 6 of 14 is about the issues of "failure to supervise." The brokerage office must share its files, showing all commissions paid relating to the customer's account, any questions raised about this account, and a copy of the latest internal audit report. The parties may agree to exchange other documents voluntarily as allowed by NASD Rule 10321(b). For instance, the parties may stipulate that both have copies of the transactions for the past two years. The parties can offer the arbitrators their own views of what was said and what a reasonable person might think of such conversations.

Arbitration Awards and Settlements

Each party has the opportunity to summarize its position in a closing argument. Closing arguments are important to tie the actions under question to possible results. Did the securities representative act in a way that harmed the claimant? The securities industry has created special categories that immediately raise questions, such as making too many transactions in the customer's accounts or signing documents without the customer's approval.

Clients can be well served by negotiating a settlement. The documents remain private, and the case is then listed as closed. NASDR reports that about 70 percent of the cases are settled peacefully and confidentially. Of the rest of the cases about 55 percent grant some relief to the claimant (NASDR public records). The arbitration panel is not required to write an explanation for its decision. It takes a majority of the arbitrators to make a procedural ruling or a final decision (Rule 10325). The staff will provide the panel with administrative forms showing the names of the parties, counsel, a summary of the issues including securities purchased, the damages granted, the names of the panel members, the dates of the hearings, and the signatures of the panel members. The parties know that "all awards rendered pursuant to this Code shall be deemed final and not subject to review or appeal" (Rule 10330). Most arbitrators will retain their personal notes that outline the issues and evidence presented. The arbitrators have common-law immunity from being compelled to testify in any state court concerning this case.

There are hearing fees that are usually split evenly between the parties. At present, the prehearing conference is $300. For each four hours or less of a full hearing, the parties split the $400 fee. For example, a typical two-day hearing with three arbitrators will cost $300 for the prehearing and $1,600 for two hearing days or a total of $1,900. This is an obligation owed to NASDR and is to be paid within 30 days.



A deposit is required when a party asks for an adjournment (Rule 10319). The adjournment is at the discretion of the panel, but requires the moving party to deposit another $1,600 for the rescheduled two-day hearing. If the panel decides that the delay was avoidable, the moving party will pay that fee to NASDR. The new discovery guide, issued September 2, 1999, has clarified the ordinary production obligations in customer dispute cases (NASD notice to members, 99-90). The notice lists all the ordinary documents that are to be exchanged without complaint. Each party pays its own expenses. If one party feels abused, it can petition the panel to be reimbursed for excessive production costs (Rule 10322).

Compensatory damages take the claimant back to the day he made the transaction with the broker. In an uncomplicated case, the claimant is asking for the fair market value of his securities if there had been no negligence or wrongful conduct. Sometimes the claimant did not know about the wrongful conduct until later, and so the securities will be valued at that later date. The claimant has some duty to monitor his own investments, notify the branch executives of discrepancies, and minimize his losses. The arbitration panel can grant interest from the date the disputed transaction occurred or the date the claimant should have known of the loss. Interest continues to run until the respondent pays the damage award. The rate is usually what the state courts allow from treasury bills or Internal Revenue rules.

Special damages require special circumstances. While there is talk of punitive damages, there are at least two hurdles. First, state law may require that the parties had contemplated punitive damages in their brokerage agreement or through a supplemental contract. Secondly, the arbitration panel may not have the authority to grant punitive damages. State law may require the claimant to petition a court for such relief. Punitive damages are for outrageous behavior, and a claimant needs to offer a clear paper trail, such as discovering fax copies or memoranda of wrong doing. If such evidence exists, the arbitration panel has a duty to refer this matter to the NASD investigation division for further proceedings against the securities representative.

Appeals are very limited under the NASDR rules. The petitioner has to claim fraud, bias, or some intentional withholding of information by the arbitrators. Even a procedural error by the arbitration panel may not be sufficient for a reversal. ✦

Joseph P. Yaney is a public arbitrator for the NASDR. He lives and works in Chicago. He is also listed with the American Arbitration Association and Federal Mediation and Conciliation Service for labor arbitrations. He graduated from the University of Michigan, JD and PhD.

References

NASD Dispute Resolution, Inc., 10 S. LaSalle Street, #1110, Chicago, Illinois 60603; tel. 312, 899-4440. (This article does not necessarily reflect the views of NASDR.)

Code of Arbitration Procedure, NASD Regulation, Inc., Office of Dispute Resolution, 1735 K Street, NW, Washington, DC 20006. Code changes are often announced in a special mailing or website update.

Website www.nasdr.com (excellent reference source).