

Wealth Management & Investment Management

Week 2

Invest Legal Issues of a Representative of a Client

Fraud and Suitability

Learning Issues

- All registered representatives licensed by FINRA are required to be licensed
- Series 6
- Series 7
- Series 65-66
- Other persons who run independent RIA Registered Investment Advisor Companies are regulated by SEC rules too.

What you should know

- Blue Chip
 - Income and Fixed
 - Growth
 - Dividends
-
- Advisors know about products that fit the needs of clients.

Suitability

- **Suitability**
- When your broker recommends that you buy or sell a particular security, your broker must have a reasonable basis for believing that the recommendation is suitable for you. In making this assessment, your broker must consider your risk tolerance, other security holdings, financial situation (income and net worth), financial needs, and investment objectives.
- This implies age, needs, time horizon, etc.

Know Your Customer - SKILL

- On November 17, 2010, the Securities and Exchange Commission (SEC) approved two new FINRA rules: Rule 2090 (Know Your Customer) and Rule 2111 (Suitability) to replace NYSE Rule 405 and NASD Rule 2310. These rule changes are significant because they: 1) extend the suitability obligations from solely transaction-based recommendations to include **investment strategy**; 2) create a suitability obligation where a member/associated person makes “an explicit recommendation to hold a security or securities”; and 3) recognize three distinct suitability obligations: (a) a reasonable-basis suitability, (b) customer-specific suitability and (c) quantitative suitability. FINRA now must issue a Regulatory Notice announcing SEC approval. The implementation date of the new rules most likely will be the Fall of 2011.

2111

- The Securities and Exchange Commission has approved new FINRA Rule 2111, an updated version of the old NASD Rule 2310 (Suitability) requires brokers and their firms to "have a reasonable basis to believe that a recommended transaction **or investment strategy** involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."

Strategy

- FINRA's new Rule 2111 expands a broker's responsibility toward the customer. While not reaching the level of requiring brokers to act in their customers' best interests, the new standard is an improvement in the protection of investors because it will explicitly cover situations that industry members have historically opposed. Specifically, the new suitability standard will no longer apply only to recommendations concerning the purchase or sale of a security. Rather, it now applies also to the recommendation of investment strategies. "TAX ISSUES" Opens Door.

Learning Video

- <http://www.finra.org/Industry/Education/OnlineLearning/Podcasts/Suitability/P123368>
- Note: It may take a moment for the podcast to start after clicking "Play" depending on the size of the podcast and the speed of your connection. Please be patient while it loads. If you prefer, you may [download](#) the podcast.

Commissions and Fees

To get paid, advisors need to get a person to invest in something or have their account managed.

- Stocks
- Funds
- Annuities
- Managed Portfolios
- Insurance
- Or Alternative or Packaged Products

WHEN YOU SELL

When you sell something, things happen.

- Taxes – State and Fed
- Loss of benefits (insurance cancelled)
- Penalties? 401K, Tax, other.
- Product Penalties contractual

Raymond James Case

- <http://investmentfraudpro.blogspot.com/2011/05/raymond-james-rocked-with-massive-finra.html>
- This week FINRA released a large arbitration award in favor of an investor against Raymond James. The panel found that Raymond James failed to properly supervise broker Paul Davis as he sold an elderly couple life insurance and variable annuity products. The case also involved switching of variable annuity products to generate fees and commissions for the broker. Specifically, Davis sold the claimant investor's \$3.8 million portfolio, which had been heavily invested in conservative municipal bonds, and bought annuities and life insurance products instead.

FINRA

- FINRA Enforcement has warned brokerage firms about the suitability of variable annuities as well as fraud related issues for switching of one variable annuity into another. By 2006, the broker allegedly started doing exactly that, exchanging one annuity for another.

Damages

- The panel awarded the following damages to the suckered investors, Hurshel Tyler and the Estate of Mildred Tyler:
 - \$1,129,796.00 in **compensatory** damages;
 - **interest** on the sum of 5% per annum from and including December 1, 2006 through and including the date the Award is served;
 - \$34,988.00 in costs for **expenses**;
 - \$82,281.00 in costs for **IRS penalties on taxes past due**;
 - \$250,000.00 in **attorneys' fees** pursuant to Texas statute on breach of contract

Claims

- Claims against stockbrokers and other financial advisors are on the rise. The Financial Industry Regulatory Authority (FINRA), which oversees nearly 4,800 brokerage firms, 172,000 branch offices and approximately 646,000 registered securities representatives, reports that 2009 experienced a 65 percent increase in the number of cases filed as compared to 2008. The increase in the number of cases filed does not mean that claimants are winning more often, however.

45 Percent

- In 2009, only 45 percent of cases resulted in an award of damages to the investor. [1] And, on average, investors who win get back less than half of their claimed loss, according to a study by Attorney Dan Solin and the Securities Litigation & Consulting Group. This statistic reveals that achieving a good result on securities cases is no easy charge. Moreover, it is almost impossible to put a securities claim in front of a sympathetic jury. Almost all new account agreements contain a binding arbitration clause, and those clauses are strictly enforced. [2]

Suitability and Risk

- Suitability cases can most easily be described as events when an investor's funds are placed in investments that are unreasonable based on the particular circumstances of that particular investor. In other words, while **high-risk** stocks might be acceptable for one investor, they will not be for another. When a broker buys securities for a customer that fall outside the bounds of reasonableness in light of the customer's overall financial position, the investment may be unsuitable. **The Rules Governing Unsuitable Investments Under FINRA Rule 2730(19) on Suitability,**

Funds too Risky?

- Mutual Fund
- ETFs
- S&P? What is the technology weighting?
- Energy
- Telecom
- Internet?

Fees 1,2 3 % Totality?

- Mutual funds are offered in four main share classes: A, B, C and another letter, which will vary by fund company but typically denoted as X, Y, Z, L, R or the like. A shares have their fees levied up front while B shares take the fees at fund redemption. C shares charge an ongoing fee, and the fourth type of share charges no fee so advisers typically charge their own 1 percent annual fee. Long-term investors are typically best suited to A shares, but sometimes a no-fee fund with a 1 percent adviser fee could be a good fit for the right kind of adviser service.

Read more: [Mutual Fund Suitability Guidelines | eHow.com](http://www.ehow.com/way_5379718_mutual-fund-suitability-guidelines.html#ixzz1Q0X9SWCL)

[http://www.ehow.com/way_5379718_mutual-fund-](http://www.ehow.com/way_5379718_mutual-fund-suitability-guidelines.html#ixzz1Q0X9SWCL)

You Picked It - Suitability

- According to the FINRA Arbitration Decision, the Claimants cited NASD Notice to Members 96-90 [sic] in support of their position that the transaction at issue was unsuitable. However, the Arbitrator noted that pursuant to NASD Rule 2310, a Member's suitability obligation applies only to securities **that have been recommended by a member** and would not apply where the member acted merely as an order taker for persons who, on their own initiative, effect transactions without a recommendation from the member. The Arbitrator found that because the Claimants had picked the FRE Pfd. stock, their allegation of Unsuitability was meritless.

Signed and Selected

- The Schuesslers went to a WAMU bank branch, where they were referred to WAMU Investments and met with a WAMU broker, who filled out an order form which the Schuesslers read and signed.
- Suitability, Risk, Monitoring, Supervise, Fraud were Rejected
- In the Matter of the Arbitration Between Joseph Schuessler (Claimant) and Diane Schuessler (Claimant) vs. WAMU Investments, Inc. (Respondent)

Supervise

- 15 U.S.C. 78t(a) .

In order to establish liability under Section 20(a), a plaintiff need only allege that the controlling person had knowledge, or at least a duty to know, of the alleged wrongful activity, and the power or ability to control or influence the affairs of the controlled persons.

- <http://www.securitiesarbitrations.com/Claims-Against-Brokers/Failure-To-Supervise>

Supervise

- In addition to vicarious liability under the common law, Section 20(a) of the Exchange Act of 1934, 15 U.S.C. 78t(a) provides that:

every person who directly or indirectly controls a person liable under any provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in **good faith** and did not directly or indirectly induce the acts or acts constituting the violation or cause of action.

Fiduciary Duty

- A broker must:
- (1) manage the account in a manner directly comporting with the **needs and objectives** of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history [citation omitted].
- (2) keep informed regarding the changes in the market which **affect** the customer's interest and act responsively to protect those interests [citation omitted];
- (3) keep his customer informed as to each completed **transaction**;
- (4) explain the practical impact and **potential risks** of the course of dealing in which the broker is engaged.

Duty More

- Brokers also owe the following fiduciary duties to their customers:
- (1) The duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis.
- (2) The duty to inform the customer of the risks involved in purchasing and selling particular securities.
- (3) the duty not to misrepresent or omit any fact material to the transaction.

Awards and Damages

- **Finra panel awards pilot \$2.7 million in flap over suitability**
- Bulk of retiree's savings invested in two non-public mortgage funds; 'didn't have any access to his money'
- The panel decided that American Investors Co. and adviser Sewell Frey Sr., should pay \$1.32 million in damages, interest and fees. Fund manager Dunham & Associates Investment Counsel, Inc. was told to pay \$1.37 million in damages to Mr. Michalak, who was ordered to transfer ownership of his shares with the Dunham & Associates Daily Mortgage Fund back to Dunham.
- <http://www.investmentnews.com/article/20110325/FREE/110329959>

Things to Remember

- Know Customer
- What is the Risk Tolerance
- What is the Time Horizon
- How do you preserve and protect
- Blue Chips, Growth, Income, Defensive, Guaranteed?
- Duties
- Supervise & Monitor
- Communicate and Inform
- Tax Schemes?
- Strategy may now include tax, retirement, and estate planning.

Broker-Dealers: Why They Ask for Personal Information

- Brokers generally request personal information, including financial and tax identification information, from their customers to comply with various laws and rules — including suitability rules imposed by self-regulatory organizations (SROs), record-keeping and other requirements under the federal securities laws, and anti-money laundering, anti-terrorist financing, and tax laws. Brokers not only request this information from new customers, but also from customers who have had long-standing relationships with their firms.
- <http://www.sec.gov/answers/bd-persinfo.htm>

Tax Strategy? And 2111?

- Scams & schemes involving Internal Revenue Code Section 412(i) pension plan fraud have taken many business owners by surprise. Told by insurance companies that contributions to their employee retirement plans could be up to ten times more than a traditional plan, and that withdrawing up to 80% of funds could be done on a pre-tax basis, business owners say that they were taken – all for big insurance company commissions.
- http://employment-law.freeadvice.com/pensions_benefits/412-i-pension-plan-fraud.htm

Pension Fraud

- Typically, these transactions will include an Insurance company, accountant, tax attorney, and a promoter (someone with an insurance background, perhaps an actuary, who knows how to structure the policy itself). These groups will use insurance brokerages and sub-agents (licensed in the various states) to sell the policies themselves.
- The IRS does not recognize the tax benefit of such a plan and has repeatedly issued announcements indicating that such plans are contrary to federal tax laws and regulations. These plans were targeted to high net worth individuals, including doctors, dentists, corporate executives, and professional athletes

Awards?

- Tax Liability
- Principal
- Expenses
- Legal
- Time
- Interest

End of Class

- Thanks for being here.

Kindest Regards, George

References

- The major securities industry self-regulatory organizations have suitability rules. You'll find FINRA's suitability rule – currently [NASD Rule 2310](#) – and links to other FINRA materials concerning suitability in the [FINRA Manual](#) on FINRA's website. Similarly, you can find the New York Stock Exchange's suitability rule – [Rule 405](#) – among the NYSE incorporated rules on the FINRA website.
- <http://www.axley.com/printable.jsp?nid=771>