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# THE St. Louis Broker-Dealer™

To the St. Louis small broker-dealer community, compliance officers, legal officers and small banks with securities-related activities. We forward to you with pleasure the eighth issue of our newsletter.

Clients - as both brokers and attorneys know, we cannot live without them. But it is also difficult sometimes to live *with* them. Regardless of the amount of professionalism and diligence put into advising them, clients on occasion tend to later disagree with our advice, and bring claims against us.

In the securities business, those claims are almost always now brought not in court but before arbitration panels of the National Association of Securities Dealers ("NASD") or the New York Stock Exchange ("NYSE). The NASD has just completed a virtual total rewrite of its arbitration rules concerning customer disputes. The first article of this issue discusses the changes from the prior rules, and attempts to predict the effect of those changes on brokers and their registered representatives.

The "Business Memo" of this newsletter also discusses claims by clients, and in particular, the defenses which brokers may have to claims of "unsuitability" of investment recommendations. The claim most often made by complaining clients is that of "unsuitability".

## New NASD Code of Arbitration for Customer Disputes is Effective

by: Joe Soraghan (jsoraghan@dmfirm.com)

The long-awaited new NASD codes of arbitration became effective April 17, 2007. They are reorganized into three different codes: member-customer disputes, industry disputes and mediation. We will discuss here the code likely to be the most used, i.e. the code for member-customer disputes.

Although the provisions for customer-member disputes were almost totally rewritten in the new rules, there are surprisingly few substantive changes in them. I have, somewhat arbitrarily, broken the more important substantive changes into categories.

**Control of the Process**. Two of the more important new rules give more control of the arbitration process to the attorneys and parties, and one takes some away, giving it to the Director of Arbitration and the arbitrators.

New Rule 12207 allows the parties by agreement to extend or modify important deadlines, including the deadlines for serving answers, responding to arbitrator selection requirements and motions by opposing parties, and exchanging documents and witness lists in the course of discovery. Under the prior rule, only the Director of Arbitration and/or the arbitrator panel had the authority to extend such deadlines. And new Rule 12601 allows the parties by agreement to require that the hearing be postponed. (If such postponement occurs just prior to the hearing, the parties may be required to pay a significant postponement fee.)

This writer believes that these amendments will benefit claimants (customers) and respondents (broker-dealers and registered representatives) equally, and the process generally, because the parties and their counsel know better what their needs are than do the arbitrators and the Director.

To paraphrase a famous quote, "the SEC and the NASD giveth and the SEC and NASD taketh away." New Rule 12512 *reduces* the control given the parties and their counsel, allowing only arbitrators to issue subpoenas for the production of documents and the appearance of witnesses. Prior to this rule, attorneys for the parties also had the power to issue subpoenas. Undoubtedly this rule change resulted from perceived abuses by attorneys for both sides, though probably most of such abuse was by claimants' counsel. (An example of such abuse would be subpoenaing executives from the broker-dealer, requiring their attendance, when there is no clear need for their testimony.)

This writer believes that this rule change will hurt customers more than brokers, because claimants have a more frequent need to subpoena otherwise unwilling witnesses. This new rule will also significantly hinder the processing of the cases of both counsel validly needing a subpoena. More often than not, counsel (for both parties) know which persons to subpoena only relatively shortly prior to the hearing. Under the new rule, subpoenas must be issued sufficiently prior to the hearing

*Inside this issue…*

- *Defending Against Allegations of Unsuitability.*

(i) for the subpoena to be forwarded to the NASD and other parties; (ii) for the NASD to process it; and forward it to the arbitrators; (iii) for the arbitrators to set a time to meet about whether to issue the subpoena, and then (iv) to actually meet and decide it and to inform the NASD of heir decision; and (v) for the NASD to then notify the parties of the decision. This could require as much as, say, three or four weeks time, causing a serious hindrance to the party validly seeking the subpoena.

**Quality and Effectiveness of the Arbitration Process**. A number of the recent amendments are intended to raise the quality and effectiveness of the arbitration system. But they will simultaneously increase the complication and cost of that process.

Perhaps the major such change concerns selection and qualification of the chairpersons of arbitration panels. The chairperson has enormous impact on the hearing. New rule 12400(c) now requires that all chairpersons be *attorneys* who have served as arbitrators in at least two hearings leading to awards or, if not attorneys, have served as arbitrators through awards in at least three arbitrations.

Theoretically, this new rule allows non-attorneys to become chairpersons after they complete three arbitrations as non-chairpersons. However, because attorneys undoubtedly constitute the most frequent occupation of non-chairperson arbitrators presently, and because to qualify as chair, attorneys need only two, rather than three, completed arbitration hearings, it is clearly most likely that within a short period of time all but a minor proportion of chair-qualified arbitrators will be attorneys.

Not surprisingly, perhaps because I am an attorney, I believe that this amendment will increase the quality of the hearing process, as concerns rulings on the admission of evidence, the order of the hearings, and other process issues. It may also, however, cause technicalities of the court-trial process (e.g., the rules of evidence) to creep back into the arbitration process, notwithstanding it was originally intended that arbitration preclude such technical rules. Clearly this amendment also increases the need for each side to be represented by counsel, and will probably benefit broker-dealers and RRs more than claimants, at least to the extent that it is more frequent for claimants to be unrepresented than brokers and RRs.

Another improvement in the arbitration process is intended, and is likely, from new Rule 12214(c) This new rule provides payment of $200.00 to arbitrators for deciding discovery-related motions without hearing sessions. Prior thereto there was no such payment, which for some arbitrators was likely a significant disincentive to spending sufficient effort on such motions. (Indeed, even the $200.00 honorarium is much less than the average hourly pay for most attorneys, who typically are the deciders of such motions). Again, of course, this will at least slightly increase the cost of the process.

It is arguable that claimants are the more frequent violators of the discovery process, refusing to produce documents, and filing claims which lack sufficient detail, requiring broker-dealer and RR respondents to file more discovery motions. If that is true, it is the brokerage community which will benefit most from this new rule.

**Stronger Enforcement of Discovery**. And in two other new rules, the NASD seeks to put more "teeth" into the discovery process in arbitration. Prior to these new rules, in its "Discovery Guide" set forth in Notice to Members 99-90, the NASD set forth specific documents, specific types of documents and specific types of information which were expected to be produced to the opposing parties by customers, broker-dealers and RRs, as they prepared their cases for hearing. However, NTM 99-90, was a *guide* only, and was frequently ignored.

In its new rules 12505-12511, the NASD makes *mandatory* the discovery procedures set forth in the Discovery Guide. And Rule 12509, specifies that parties may make motions to require other parties to produce documents or information if the non-moving party has failed to comply with the requirements therefor. Further, new Rule 12511 provides serious sanctions when parties fail to respond or frivolously object to producing required documents or information.

It is difficult to speculate whether these changes in discovery rules will benefit customers or broker-dealers more. It can be argued that, because typically broker-dealers **have** more documents and information, and customers *need* more documents and information, these tougher requirements of discovery will impact broker-dealers more negatively.

**Sanctions for Failure to Comply**. New Rule 12212 provides that arbitrators may sanction a party for failure to comply with any provision of the arbitration code or with any order of the Panel. The sanctions allowed are serious: monetary penalties, precluding a party from presenting evidence (probably causing that party to lose), making an adverse inference against the violator, and assessing postponement, forum or attorneys fees against the violator.

The sanctions provided can be very damaging to a violator. It is doubtful to this writer, however, that they will be fully utilized by arbitrators, except for particularly egregious, repetitive violations. It will also be interesting to see whether they will be applied to parties who are not represented by attorneys.

Although it is pure speculation, this writer believes this new rule will, on balance, benefit broker-dealers more than customers.

**Authority of Arbitrators to Dismiss Without Hearings**. Another new rule clarifies and strengthens the authority of the arbitrators to dismiss a claim or a defense prior to, and without, a hearing on the evidence. New Rule 12700 makes it clear that the arbitrators have the authority to dismiss cases and defenses for egregious refusals to comply with discovery requirements or other orders of the Panel, or for failure of a claimant to file his claim within the six year period of eligibility (which acts as a "statute of limitations").

This writer believes this rule will benefit broker-dealers significantly more than complaining customers.

Interestingly, the new rules do not address whether the arbitrators may dismiss a customer claim if it fails to state facts sufficient to give the customer a right to some relief ("failure to state a cause of action," in legalese.). This non-addressing the right will undoubtedly cause claimants to argue that arbitrators may not dismiss such complaints.

CONCLULSION

The new customer dispute arbitration rules **will** generally improve the logic and organization of the arbitration process, while increasing its cost. This will also benefit those parties whose cases are thoroughly prepared. Because the defenses by broker-dealers are usually more thoroughly prepared–if only because their attorneys are paid by the hour, and customers' attorneys are more often paid only contingent fees - it is likely the new rules will be of greater benefit to broker-dealers.

## Business Memo: Defending Against Allegations of Unsuitability - Part I

by: Joe Soraghan (jsoraghan@dmfirm.com)

As pointed out in our July, 2003 issue, far and away the most frequent allegation brought against broker-dealers and RRs is alleged "unsuitability" of recommendations by RRs. As also pointed out in that issue, a claimant alleging unsuitability must show that the securities or investment program recommended were (1) unsuitable to the investor's circumstances; and (2) that the broker-dealer and RR held sufficient "control" over the investor.

In that issue, we discussed what aspects of the RR's recommendations could be unsuitable. In the next two issues, i.e., February, 2004 and September, 2004, we discussed what constituted "control" and what constituted a "recommendation." In this issue we will discuss briefly the defenses available to a broker-dealer to a claim of unsuitability.

The most obvious and best defense, of course, is "***suit***ability," i.e., a showing by the broker-dealer that the offense alleged simply did not happen, and that all aspects of the RR's recommendations were suitable. Other defenses which the broker should consider are lack of control, the statute of limitations (i.e., that the claimant's eligibility to file a claim has expired), ratification, estoppel, waiver, and laches.

**Ratification, Waiver, Estoppel and Laches**

In this issue, we will discuss the defenses of *ratification*, *estoppel*, *waiver* and *laches*. The small broker-dealer should be aware of these defenses and should prepare its compliance systems to make such defenses in future claims.

**Ratification**

The theory of *ratification* is that the claimant-customer has ratified the actions of the broker-dealer and the RR, and thus is bound to accept them. In order to make this defense the broker-dealer must show (1) that the claimant knew all the material facts concerning the existence of his claim (i.e., knew that he **had** a valid claim); (2) that he had the intent to approve the actions of the broker-dealer now alleged to be unsuitable; and (3) that the customer has accepted the benefits of the broker-dealer's actions.

**Waiver**

The theory of the defense of waiver is that the customer has waived the unsuitability of the broker-dealer's conduct, or has waived his right or claim. In order to make this defense, the broker-dealer must produce evidence to show that (1) the claimant had actual or constructive knowledge that he had a valid claim; and (2) that the customer had an intention to waive his right or claim.

As can be seen, this claim is virtually identical to that of ratification.

**Estoppel**

The defenses of ratification and waiver essentially are based on a theory that the claimant has made a choice, and having done so must live by it. The defenses of estoppel and laches are based more on the theory that the claimant by his conduct has lured the broker-dealer into taking action which would be unfair and to the detriment of the broker-dealer if the claim was granted.

To make the defense of *estoppel*, the broker-dealer must show that (1) the claimant knew all the material facts giving rise to his claim; (2) that the claimant intended, or took actions leading the broker-dealer to believe he intended, that the broker-dealer act to his detriment based upon the customer's inaction; (3) that the broker-dealer in fact did act to his detriment; (4) in reliance on claimants' action or inaction.

**Laches**

The theory of the defense of *laches* is that the claimant has unreasonably delayed in asserting in his claim, to the prejudice of he broker-dealer. Making the defense of laches requires that the broker-dealer show (1) knowledge by the claimant-customer that he has a claim against the broker-dealer; (2) unreasonable delay by the claimant in bringing his claim; and (3) prejudice or injury to the broker-dealer caused by such delay.

**Analysis**

The claims of ratification and waiver are virtually identical to one another, and the defenses of estoppel and laches are very similar to one another. All four of these defenses require a difficult showing that the claimant knew, or should have known, that he had a claim. Because it is virtually impossible to show actual knowledge, the hotly contested issue on which the parties produce evidence, and which the arbitrators must decide, is whether the claimant had sufficient information, and sufficient sophistication, to know that the actions of the broker-dealer or his RR were so unsuitable as to give the claimant a right to recover.

Some courts and arbitrators have ruled that once the customer has received account statements and confirmations, etc., even though he does not understand from them the unsuitability of the RR's recommendations, the customer has a duty to be sufficiently suspicious to either know, or seek expert assistance about, whether the broker-dealer's and RR's actions were improper. Other courts and arbitration panels have ruled that account statements and confirmations, although they inform the customer that transactions have taken place, do not inform the customer that such recommendations and transactions were unsuitable, and therefore the customer does not have sufficient knowledge of his claim to have ratified or waived or for estoppel or laches to apply, simply because he received account documents.

Last, three of these defenses require a showing of *intent* on the part of the claimant. That is, for ratification or waiver, an intent to waive the unsuitability of the broker-dealers' actions, and in estoppel, an intent to lure the broker into taking some action to the broker's injury. Obviously, proving such an intent would be very difficult for the broker. And, to make a defense of estoppel and laches, the broker-dealer must show that he has been lured into prejudicial action or inaction by the claimants' action or inaction. This is also a very difficult showing for a broker to make.

Also, these are "affirmative" defenses. That is, the burden of proof of showing that the defense exists is on the broker and the RR. Theoretically at least, the burden is not placed upon the claimant of showing that these defenses do not exist.

**These Defenses are Rarely Successful in Themselves**

Courts, and probably arbitration panels, are generally reluctant to apply these defenses, particularly when the claimant is an unsophisticated investor. This is perhaps not surprising when it is remembered that in order for these defenses to even come into the play, the arbitrators must have decided that the actions of the broker and his RR were unsuitable.

Therefore, in establishing its supervisory and record keeping systems, the broker-dealer should realize that the actual best "defense", in the event of a claim being made for unsuitability, is to be able to defeat the claimants' allegations of unsuitability and lack of supervision in the first place. This will be discussed in a later issue of The St. Louis Broker-Dealer.

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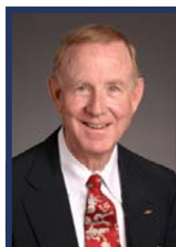

*Joe Soraghan represents broker-dealers and registered representatives in court, in arbitrations and mediations, and before the SEC and state securities commissions. He is a frequent arbitrator and mediator for the NASD. Published in several law reviews and a frequent speaker on securities, Joe also teaches Securities Law Litigation and Arbitration as an adjunct professor at Washington University School of Law.*

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