

# WASHINGTON BUSINESS JOURNAL

## IN DEPTH: INVESTMENT & FINANCE QUARTERLY

### Common broker complaints and how to avoid them

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Special To the Washington Business Journal

More than 5,100 customer complaints against stockbrokers and their firms were received by NASD-Regulation in 1998, the last full year for which data are available, and almost 5,000 arbitration cases were filed, representing about 90 percent of all securities industry arbitration cases filed that year.

Even though the number of customer disputes is high, traditional full-service stockbrokers may still take some comfort in reports recently released by the Securities Industry Association, a trade association, and the Securities and Exchange Commission.

A recent SIA survey suggests relatively high customer satisfaction with brokers, and the SEC reported it received fewer sales practice complaints against broker-dealers in 1998 than in prior years. But there was a 330 percent increase in operational complaints against online trading firms, which led directly to an overall increase in customer complaints for the first time in five years.

While traditional full-service brokers appear to be doing well to maintain customer satisfaction, customer disputes are as inevitable as fluctuations in the stock market. Here are some common customer claims and some steps to avoid liability if a claim is made:

**Conflict of interest.** Every broker knows that the rules and regulations of the securities industry impose a responsibility to deal fairly, honestly and openly with a customer.

Because brokers receive commissions on the trades they execute, there is an inherent potential conflict between a broker's interest and the customer's. It is the broker's obligation to be loyal to the customer and the customer's interest must dominate. In some instances, for example, when a broker handles a discretionary account and is therefore in a position of trust and confidence, the broker is held to an even higher duty, that of a fiduciary, who owes the utmost loyalty and fidelity to the customer. Customer disputes flow from these obligations.

**Unsuitability** is a frequent customer claim in which the customer complains, with hindsight, that the broker recommended an investment that was not appropriate for the customer's investment goals, financial status, level of understanding or risk tolerance.

An unsuitability claim is more likely to fail if the broker is familiar with the investment and makes reasonable efforts to obtain relevant information from the customer when the account is opened and throughout its existence. Customers' lives and finances change -- they marry, divorce, have children, change jobs, move and retire, and their net worth increases and decreases over time -- and the broker must stay informed.

Churning is another common customer complaint. It is trading in an account that is excessive in light of the customer's goals and financial situation, usually for the purpose of generating commissions. Churning is the antithesis of a "buy and hold" strategy. An often-used rule of thumb is that trading becomes excessive when the portfolio turnover ratio is six or greater on an annualized basis.

When an account is going to be traded actively, or heavily margined, the broker should document the strategy at its inception and during the life of the account. Some brokerage firms automatically send customers letters when active trading is detected, and customers are asked to sign and return the letters to evidence their continuing consent to the trading strategy. A signed activity letter (or refusing trades until the letter is signed) is powerful evidence against a churning allegation.

Material misrepresentations and omissions are often alleged by customers. A broker is, of course, obligated to disclose all information that may be reasonably be relevant to an investment decision, and the disclosure should be clear and comprehensive, including information about the investment and its risks.

Documenting the disclosure will support the broker when a "swearing contest" ensues over what the broker told or did not tell the customer. A broker would also be well-advised to disclose compensation and whether the brokerage firm is acting as a principal in the transaction, before the customer consents, because it should not make a difference if the investment is a sound one.

Unauthorized trading is another common customer complaint. If a broker informs the customer of a trade after execution, the trade is still an unauthorized one, but a customer complaint is likely to fail if the customer does not promptly reject the trade. Trading without a customer's consent transforms the account into a discretionary account, and a broker must have discretionary authority in writing under NYSE and NASD rules.

A broker seeking protection from a successful customer claim should document her actions in customer files, and should consider buying an errors and omissions policy for coverage of a meritorious complaint.

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