Protecting Yourself From Investment Fraud

Illustration by Bob Gravlee

by ROBERT C. PORT

IT SEEMS AS THOUGH EVERYONE HAS heard of the "friend of a friend" who has made a "killing" in the stock market. The last few years have been especially good to investors, with double-digit returns seemingly the norm. Financial news and magazines offering investment advice are everywhere, and Internet bulletin boards and chat rooms are filled with people claiming to have identified the next Microsoft, Yahoo or Cisco.

In this environment, investors can easily fall prey to dishonest stockbrokers, investment advisors, financial planners, insurance agents and others claiming to have the knowledge and experience to offer investment advice. Many advisors are honest professionals, who offer investment or financial advice with the best interests of their clients in mind. However, some advisors engage in dishonest, fraudulent or illegal behavior. An investor who entrusts his or her assets with such a rogue advisor can suffer devastating financial losses.

Not every investment yields a profitable result, and not every loss is the result of abusive activity by a broker. No one has a crystal ball, and even supposedly "rock-solid" blue-chip stocks have experienced significant declines from time to time. However, as more and more people come to realize that Social Security is not likely to provide a satisfactory level of retirement benefits, and participate in 401(k)s, self-directed IRAs and Roth IRAs, it is critical that investors educate themselves to avoid being the victims of investment fraud.

Your Stockbroker's & Brokerage Firm's Obligations

Stockbrokers and brokerage firms are regulated by so-called "self regulatory organizations" (SRO), which include The New York Stock Exchange (NYSE), The National Association of Securities Dealers (NASD), The American Stock Exchange (ASE) and The Chicago Board Options Exchange (CBO). In addition, laws passed by Congress and the states, as well as common law, impose various duties and obligations that may apply to those who hold themselves out as offering investment advice. These duties and obligations include:

• *The duty to know the client's financial situation:* Commonly referred to as the "know your customer" rule, this requires that a broker must make reasonable inquiries to develop an understanding of that particular client's individual tax and financial condition, investment objectives, level of sophistication, risk-tolerance, and any other information which should be used or considered in making an investment recommendation to the customer.

• *The duty to make suitable recommendations:* Closely related to the "know your customer" rule, this requires that the investment being proposed by the broker be appropriate and suitable for the client in light of that particular client's tax and financial situation, and the client's stated investment objectives and risk-tolerance.

• *Duties of good faith, fair dealing and loyalty:* Since stockbrokers earn commissions on the transactions which they execute, there is an inherent conflict between the broker's interests and the interests of the customer. The rules and regulations of the securities industry require a stockbroker to treat his or her customers fairly, in good faith, and to observe "high standards of commercial honor and just and equitable principles of trade."

• *Obligation of disclosure:* A broker has a duty to disclose all material factual information in connection with an investment recommendation, and in particular, the risks of the proposed investment, so the customer can make an informed investment decision.

• *Authorization for trading:* Unless the customer has given the broker written discretionary trading authority (allowing the broker to make trading decisions in the account without pre-approval by the client), a broker may not buy or sell securities in a customer's account unless the customer has approved and authorized the trade in advance.

• *Supervisory responsibility.* A brokerage firm has a responsibility to supervise the activities of its brokers, and to adopt and enforce procedures to ensure compliance by its brokers with federal securities laws, and with industry rules, regulations and standards.

Common Violations by Unscrupulous Stockbrokers and Brokerage Firms

Although each case presents a different set of facts and various potential violations of regulations and applicable law, there are a number of common themes and patterns that are often seen when an investor has dealt with a dishonest broker or firm. Among them are the following:

> AS MORE AND MORE PEOPLE COME TO REALIZE THAT SOCIAL SECURITY IS NOT LIKELY TO PROVIDE A SATISFACTORY LEVEL OF RETIREMENT BENEFITS ... IT IS CRITICAL THAT INVESTORS EDUCATE THEMSELVES TO AVOID BEING THE VICTIMS OF INVESTMENT FRAUD.

• *Churning.* "Churning" is when an account has an excessive volume and frequency of purchases and sales, and such excessive trading is instigated by the broker to generate commissions, without regard to the client's investment objectives. This can happen when the broker is given express discretionary authority to trade, and trades excessively to generate commissions. Churning can also occur when the broker develops a relationship of trust and confidence with the client, and as a result, the broker essentially takes control of the account, because the client follows every recommendation the broker makes.

• *Unsuitable Recommendations.* A broker must determine the customer's financial condition, level of sophistication, investment objectives, and risk-tolerance, and only recommend investments that are appropriate for the customer's circumstances.

• *Unauthorized Trading.* A broker is prohibited from executing a trade in the account unless the client has approved and authorized the trade, before the trade has been made.

• *Fraud and Misrepresentation.* A broker may induce a customer to buy or sell a stock by making statements or representations of facts that are known by the broker to be untrue, and that are relied upon by the customer in deciding to purchase the investment. A broker is also prohibited from making reckless misrepresentations —statements concerning important facts which the broker may not specifically know are false, but which he did not verify and which the broker knew would be relied upon by the customer. Also, a broker can commit fraud by an "omission"—failing to reveal important facts that would have been important to the customer in making the investment decision.

• *Overconcentration.* It is generally accepted that investment risk can be reduced by diversifying investments among a number of different types of stocks or by diversifying in different types of investments (such as stocks, bonds and mutual funds). A broker who recommends that a client place all or substantially all of their investments in one or just a few securities may not only be ignoring sound investment theory, but may also be violating a number of legal and regulatory obligations owed to his or her customer.

• *Unauthorized Margin Borrowing.* "Margin" is money borrowed from the brokerage firm to buy more securities, using securities already owned as collateral for the loan. An investor cannot engage in margin trading unless the customer agrees to do so in writing, and has been provided with certain disclosures concerning the terms of the margin loan, such as the interest rate and the brokerage firm's right to liquidate other assets in the account stock to pay for the margin loan.

• *Excessive Margin.* Even if a customer is authorized to trade on margin, the broker may improperly induce the customer to carry an unreasonably large margin debt. This can place a customer at substantial risk of a ruinous "margin call." This occurs when the account value falls below levels permitted for the margin debt, and the customer is required to put more money in the account. If the customer fails to do so, the brokerage firm might liquidate some or all of the assets in the account to satisfy the margin debt.

• *Failure or Refusal to Execute an Order.* The broker has an obligation to the customer to execute "sell orders," if given. An unscrupulous broker or firm sometimes refuses to do so, because a quantity of sales might push down the price of a security they are promoting.

• *Switching of Mutual Funds.* Although mutual funds are often viewed as an appropriate investment option, a broker looking to improperly increase his or her commission may recommend that the customer sell the mutual funds they own, and purchase funds offered by a different mutual fund company.

• *Selling Away.* All investments recommended by your broker must be executed through his or her brokerage firm. In other words, if your account is with "ABC Securities," your broker should not be recommending an investment—particularly a partnership, initial public offering or private placement—that is to be purchased through "XYZ Brokers" or directly from another source, such as a marketer of limited partnerships.

• *Failure to Supervise and Manage.* Brokerage firms are required to put into place supervision procedures over their brokers for the purpose of preventing violations of the rules and regulations of the securities industry.

Tips for Investors

While unscrupulous brokers will always be developing new and innovative ways of parting investors from their hard earned money, there are a number of recurring patterns and themes that suggest improper activity. An investor sensitive to these types of activities, and who additionally takes the time to learn about and understand the facts, and the potential risks and rewards of the investments being recommended by their broker, can do much to protect themselves from fraud and dishonest and illegal behavior.

• *Understand and Monitor Your Investments.* An investor's best defense is to be cautious, cynical, and learn and understand the reasons the broker is suggesting a certain investment or investment program. Ask questions. If the answers are not satisfactory, don't simply conclude that this is something too complicated for you.

• *Do Independent Research.* Companies traded on the public markets file numerous disclosures with the Securities and Exchange Commission, and these can be accessed for free at a number of sites, including www.freedgar.com. Internet sites such as www.morningstar. com and www.valueline.com provide independent analysis and rating of stocks and mutual funds. Mutual fund companies will be happy to send you a prospectus on the fund, which contains important information on fees and sales charges, as well as a description of the fund's investment approach.

• *Carefully Select a Broker.* Get recommendations on a broker from friends or business professionals, such as CPAs, whose advice you respect. However, remember that a referral does not insulate you from a dishonest broker.

• *Check Public Records on the Broker's Background.* A broker's employment history, records of customer complaints, state registrations and other background information are public records. Be sure the broker is licensed to do business in your state. A broker's CRD (central registration depository) record can be obtained from the NASD at (800) 289-9999 or your state's securities division. This information is also available on the Internet at www.nasdr.com.

• *Interview the Broker.* Talk to a number of brokers, preferably in person. Although large, well-known firms have their share of rogue brokers, the larger firms tend to have better supervisory controls in place to catch improper activity. Explain to the broker your current income range, net worth, investment experience and risk-tolerance, and financial objectives. Consider whether their suggested investments and attitude about investing are consistent with what you have explained.

• *Be Candid with Your Broker.* Be honest in telling the broker your complete financial condition. Discuss with the broker your short- and long-term goals and investment objectives. Keep your broker informed of changes in your financial situation or investment goals.

• *Determine Your Investment Objectives.* When opening an account, many brokerage firms have a form which lists investment objectives such as "preservation of capital," "capital appreciation," "current income," "long-term growth" and "speculation." Understand how your broker interprets each of those objectives, and what types of investments he or she would be recommending for each category.

• *Review Carefully All Documents You Are Asked to Sign when Opening an Account, and Get a Copy.* These documents should accurately reflect what the broker was told about your financial circumstances and your investment goals. If the broker has listed your income higher than you said, or listed your investment objectives as "speculation" when you discussed the need for current income or preserving your capital, find another broker. Read and understand all of the fine print. The account-opening agreements contain very important provisions about how the account will be handled, your rights in the event of a dispute and other matters. You will be held to whatever terms are in the agreements, whether you read them or not.

• *Understand How the Broker Gets Paid.* Brokers earn their living from commissions on the transactions they generate. Unfortunately, this creates an incentive for an unscrupulous broker to generate lots of transactions. A stockbroker who tells you that he or she is not making money on a trade, or only makes money if you make money, is not telling the truth.

• *Be Wary of "Cold Calls."* A "cold call" is a telephone call from a broker whom you have never met, soliciting your business. Often, such brokers tell you they have "inside" information, claim they have made lots of money for other people, or claim that they are out to help the small investor, unlike the "big boys" on Wall Street. If you get a call like that, hang up.

• *Be Sensitive to the "Bait and Switch."* The initial recommendations of a dishonest broker may be for the purchase of well-known, widely traded blue chip stocks, or other securities consistent with your investment objectives. After you have invested, they will then suggest that such companies have little growth potential, and pressure you to sell the blue chip stocks and invest in small, unknown companies, which they claim will bring you spectacular profits.

• *Don't Be Pressured into Buying.* Buying stock is not a game in which you must act immediately or the opportunity is lost. A good investment today is likely to be a good investment tomorrow, or a month from tomorrow. If your instincts tell you that you are being pressured into something you are uncomfortable doing, don't do it!

• *Carefully and Promptly Review the Statements and Other Papers the Brokerage Firm Sends You.* Review each monthly statement and be sure it accurately reflects all of the transactions you authorized in your account. Sometimes a brokerage firm will send a "comfort letter," asking you whether you are satisfied with the way your account has been handled. If you have a complaint, respond immediately.

• *Carefully and Promptly Review Each Confirmation.* When a stock is bought or sold in your account, the brokerage firm sends you a "confirmation." Review it for accuracy. Confirmations are required to be marked either "solicited," meaning that the broker recommended the investment, or "unsolicited," meaning that the purchase was the customer's idea. A confirmation you receive may inaccurately state that purchases recommended by the broker were "unsolicited." Errors sometimes occur, and a call to the broker may be all that is necessary to correct the inaccuracy. However, if this occurs repeatedly, this is a red flag that improper activity may be occurring in your account.

• *Promptly Object, and Seek Reversal of Unauthorized Transactions.* If you receive a confirmation for a purchase or sale you did not authorize, call the branch manager immediately and state that you did not authorize the transaction and want it reversed. Follow up immediately with a letter. If you wait too long, you may be deemed to have "ratified" the transaction, even if you did not authorize it.

• *Do Not Allow Your Investments to Be Concentrated in Relatively Few Investments.* A broker who insists that you invest in one or a few companies is exposing you to substantial risk, particularly if the investments are in smaller, relatively unknown companies.

• *Be Cautious on Recommendations to Switch Mutual Funds.* If a broker suggests that mutual funds you own be switched to different funds, carefully study the prospectus for the fund(s) he or she is recommending. The prospectus will contain information on sales charges and commissions. The mutual fund might also have a website which will give information about the fund. You should also consider and compare the fund's rating, investment objectives and long-term track record to the fund(s) currently held. Services such as Morningstar (www.morningstar.com) offer useful information on the investment objectives of funds, performance over time, commissions and sales charges, and provide ratings for funds.

• *Insist that Your Broker Follow Your Instructions.* A dishonest broker will refuse to sell a stock when you have directed him or her to do so, or will buy more shares than you directed.

• *Avoid Brokers Claiming to Have "Inside Information."* An unscrupulous broker will often claim that he or she has information not known to the public, which when released will make the stock price rise or fall. If the broker has such inside information, it is illegal to use that information to make a trade. If the broker does not have inside information, he or she is being dishonest. In either case, you should have nothing to do with such a broker.

• *Avoid a Manager Who Promises to "Make it Right."* Often, a customer who has lost substantial money as a result of a rogue broker gets a call from the "manager" of the firm, offering to make things right. Often, the customer will be asked to send more money, "so we can have something to work with." The "manager" might claim that the other broker was young and inexperienced, or claim that the other broker has been fired. This "manager" is often not the manager of the office, but someone working in tandem with the first dishonest broker.

• *Be Wary of "Chat Room" Comments.* You have no idea of the qualifications or motives of the people in a chat room making investment comments. Some are terribly unsophisticated; others may have personal reasons for making comments (such as just being fired). Still others may be using the Internet to increase interest in a stock so they can bail out when the price is high.

• *Limited Partnerships and Private Placements.* These types of investments are often not registered securities, and are restricted to high net-worth individuals. Be wary of any broker who encourages you to exaggerate your income, net worth, or investment knowledge in the paperwork that must be filled out for such investments.

• *Be Wary of Brokers Who Recommend Low-Priced Stock.* The price of a stock, by itself, is not the sole reason to make an investment decision. However, many dishonest brokers vigorously promote "penny stocks," which are generally stocks selling for under $5 per share. These stocks are often unknown, relatively new companies, with no history of earnings or any reasonable prospect for future earnings or profits.

• *Be Wary of Brokers Who Recommend Options, Futures, or Other Aggressive Strategies.* Generally, options, commodities and other similar types of investments are for sophisticated investors who understand such strategies and can withstand the financial risks of such investments. These types of investments are often unsuitable for the average investor, and a broker who insists that you buy or sell options or futures may be exposing you to significant risk.

• *Payments Should Be Made by Check, Payable to the Brokerage Firm.* All deposits made to the account should be by check, made payable to the firm or its clearinghouse. Never send or give cash directly to the broker.

• *Understand the Risks of Margin.* In a period of high-market volatility, if the securities used as collateral for the margin-borrowing fall in value, the investor may be faced with a "margin call," a demand by the brokerage firm that sufficient cash or other securities be placed in the account to maintain the required ratio of margin debt to stock value. If the margin call is not met, the brokerage firm might liquidate the investor's securities to raise sufficient cash.

• *Put Complaints in Writing.* If you have a problem, determine who the branch manager or supervisor is for the office in which your broker works, as well as the compliance officer for that office, and send them a letter clearly explaining the problem. Keep a copy for yourself.

• *When in Doubt, Stop All Trading in the Account, Consult a Professional, and Consider Closing the Account.* You are under no obligation to continue transacting business with a broker when you have serious questions about how your account is being handled. If necessary, give written instructions to the broker, with copies to his or her manager or supervisor, and the compliance officer, that all activity in the account should stop immediately. Consult with an attorney, CPA or other professional advisor with the knowledge to determine whether your account has been handled properly.

• *Consider Whether Investing Is Appropriate for You.* Not all investments go up; many lose money, and sometimes lots of money. If you are going to lie awake at night worrying about losing money, reconsider whether you should be investing at all.

• *The Broker Is Not Responsible Just Because You Lost Money.* The fact that you lost money in your account, or the value of your account has declined, does not, by itself, give you the right to make a claim against a broker or a brokerage firm. Investing has risks and rewards, and one of the risks is that even the best investments sometimes lose value. ■

 Mr. Port is an attorney with Hassett Cohen Goldstein Port & Gottlieb, LLP, Atlanta Georgia. (rcport@mindspring.com)
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