The Financial Consultant's Guide to Arbitration and Mediation And How to Avoid Getting Sued

PART 1: THE U-4

The process for a Registered Representative begins when he or she signs a "U-4" (Uniform Application for Securities Industry Registration or Transfer), with a member firm of the Financial Industry Regulatory Authority (FINRA), i.e. your Broker/Dealer (B/D). This form and agreement is 39 pages long as per the 5/09 revision, including 4 pages of disclosure questions and 21 pages to explain any positive responses to those disclosure questions.

You must be fingerprinted by a local police authority and provide special fingerprints cards to your B/D. Your Sales Assistants and any other employees that come in contact with customer files must also be fingerprinted. You must disclose residential history for the past five years, all identifying information (name changes), employment history for the past ten years and any current outside business activities.

Following is the exact font and verbiage used in the U-4's Item 15A. INDIVIDUAL/APPLICANT'S ACKNOWLEDGEMENT AND CONSENT:

> I apply for registration with the *jurisdictions* and *SROs* indicated in Section 4 (SRO REGISTRATION) and Section 5 (JURISDICTION REGISTRATION) as may be amended from time to time and, in consideration of the *jurisdictions* and *SROs* receiving and considering my application, I submit to the authority of the *jurisdictions* and *SROs* and agree to comply with all provisions, conditions and covenants of the statutes, constitutions, certificates of incorporation, by-laws and rules and regulations of the *jurisdictions* and *SROs* as they are or may be adopted, or amended from time to time. I further agree to be subject to and comply with all requirements, rulings, orders, directives and decisions of, and penalties, prohibitions and limitations imposed by the *jurisdictions* and *SROs*, subject to right of appeal or review as provided by law.

United States District Court confirmed this fact for the District of Columbia Misc. Action No. 06-355 (JDB). You also agree to take service legal or otherwise at your address on the form.

Furthermore:

> I agree that neither the *jurisdictions* or *SROs* nor any person acting on their behalf shall be liable to me for action taken or omitted to be taken in official capacity or in the scope of employment, except as otherwise provided in the statutes, constitutions, certificates of incorporation, by-laws or the rules and regulations of the *jurisdictions* and *SROs*.
>
> I authorize the *jurisdictions*, *SROs*, and the *designated entity* to give any information they may have concerning me to any employer or prospective employer, any federal, state or municipal agency, or any other *SRO* and I release the *jurisdictions*, *SROs*, and the *designated entity*, and any person acting on their behalf from any and all liability of whatever nature by reason of furnishing such information

The form further states that you must arbitrate any dispute between you, your BD and any client. The Regulators state that you probably should not invoke your Fifth Amendment Right., if the Regulators want to question you. If you do invoke the Right, the Regulators can suspend you.
Here is the arbitrability of disputes clause:

I agree to arbitrate any dispute, claim or controversy that may arise between me and my *firm*, or a customer, or any other person, that is required to be arbitrated under the rules, constitutions, or by-laws of the *SROs* indicated in Section 4 (SRO REGISTRATION) as may be amended from time to time and that any arbitration award rendered against me may be entered as a judgment in any court of competent *jurisdiction*.

6. For the purpose of complying with the laws relating to the offer or sale of securities or commodities or investment advisory activities, I irrevocably appoint the administrator of each *jurisdiction* indicated in Section 5 (JURISDICTION REGISTRATION) as may be amended from time to time, or such other person designated by law, and the successors in such office, my attorney upon whom may be served any notice, process, pleading, subpoena or other document in any action or *proceeding* against me arising out of or in connection with the offer or sale of securities or commodities, or investment advisory activities or out of the violation or alleged violation of the laws of such *jurisdictions*. I consent that any such action or *proceeding* against me may be commenced in any court of competent *jurisdiction* and proper venue by service of process upon the appointee as if I were a resident of, and had been lawfully served with process in the *jurisdiction*. I request that a copy of any notice, process, pleading, subpoena or other document served hereunder be mailed to my current residential address as reflected in this form or any amendment thereto.

In section 7 you consent to service of any process, pleading, subpoena or other document in *any* investigation or administrative proceeding conducted by the SEC, CFTC, or a jurisdiction or in any civil action in which the SEC, CFTC or jurisdiction are plaintiffs or the notice of any investigation or proceeding by any SRO against the applicant may be made by personal service or by regular, registered or certified mail or confirmed telegram at your most recent business or home address as reflected on the U-4 or any amendment of same.

Part 15A; Section 8 gives just about anyone access to the information on this form and you agree to this when you sign the U-4. Of note: nowhere in iny part of the U-4 does it explain what an SRO is, what the CFTC (Commodity Futures Trading Commission)is or what the SEC is, although I'm fairly certain most people have heard of the SEC.

A CRD report on your past employment and any complaints for the past six years or any statement your B/D desires to make about you is readily available on the FINRA web site.
In addition to signing the U-4, your BD may request you sign a contract. Please read it carefully. If you leave your BD and they don't like the fact you are leaving, The BD can request and be granted a temporary restraining order (TRO) against you; this is also known as injunctive relief. A court usually grants a TRO if there is a contract and evidence that you violated the terms of that contract. An Arbitration panel can only remove the TRO after the court order has expired. Presently there is a new tactic B/Ds are using to block a representative from leaving a firm. Representatives who leave their B/D may be in violation of SEC regulation S-P, which deals with privacy of consumer financial information.

Furthermore, neither you nor any member of your immediate family nor any member of your household can purchase shares during an IPO. Some firms require Registered Investment Advisors (RIAs) and Investment Adviser Representatives (IARs) to register as both in every state that they do business. It goes without saying you must do the same as a Registered Representative. Becoming licensed in certain states may result in forfeiture of your rights of extradition, which means you must appear in the state that issues the subpoena.

Have you ever read the U-4 that you signed? Did you read your employment contract?
Have you ever checked your CRD? I have heard attorneys suggest you do so at your earliest convenience at: http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm to make sure that all of the information provided on same is accurate.

PART 2: E&O INSURANCE

E&O insurance is unique to Independent brokers; financial advisors and insurance agencies must carry E&O insurance (errors and omission insurance policy). Usually it costs around $2300 per $1,000,000 worth of coverage and a total of $1,000,000 for all aggregate claims per year. You also pay for your B/D's insurance to $20.000.000 per claim and aggregate. Most polices have a deductible of $10,000.00 that you have to pay upfront if you are sued, however the deductible could be higher or lower depending on the amount of the claim. Here are two examples: If the B/D and the Broker (a non- New York State rep.) are both named in the suit then the deductible is $25,000, with the B/D paying $12,500 and the Broker paying $12,500. Brokers in New York State that have coverage through CAN are covered up to $20,000,000, but if that amount is claimed and awarded then none of the other Brokers of that B/D are eligible coverage in that year. The B/D must have 100% of its Reps covered in order for the B/D to be covered. A claim must be reported within 30 days to the insurance company or the claim is timed barred. Your U-4 must be amended within 10 days. The E&O carrier reserves the right to hire their attorney as well as many other rights and exclusions. Options may not be covered. Yes, you can hire your own attorney but at your cost. READ YOUR POLICY.

Big New York Stock Exchange firms usually have their brokers bonded; you should read that policy also. Errors and Omissions insurance is a broad-reaching type of coverage, which protects professionals from liability resulting from negligence, unintentional omissions and errors. Even the most meticulous and honest professional can end up as a Defendant in a lawsuit. Without comprehensive Errors and Omissions insurance, you could have to pay thousands of dollars to defend yourself, even from a frivolous liability suit.

In our increasingly litigious society, a subject that will be covered in greater depth in a later chapter, more and more consumers are seeking to place blame on all parties involved in a transaction. While many consumer complaints are legitimate, a number of complaints are entirely without merit and driven by the legal system. That said, judges, juries and arbitrators looking to provide monetary compensation for victims often call upon professional organizations (your Broker Dealer) to hand over that remuneration. This may not be fair, but it is reality. The arbitration process has a dynamic of its own that I will cover in Part 6.

One might think that the bottom line is that the "professional services" as covered by an E&O policy in Massachusetts, for example, embrace those activities that distinguish a particular occupation from other occupations. This may be evidenced by the need for specialized learning or training, as well as the ordinary activities of life and business. Be extremely careful about the outside business activities you choose. Please refer to FINRA Rule 3030 and 3040. It's important that you read both, and keeps your broker dealer apprised of any outside activity **(if in doubt disclose the activity).**

Common exclusions in E & O policies, regardless of the type of business insured, include those for claims related to acts occurring prior to the effective date of the policy of which the insured (the RR) was already aware: claims for bodily injury or death, claims arising out of an assault and battery, claims between insured parties, claims for wrongful employment related practices and claims for willfully dishonest, fraudulent, malicious or criminal acts. Therefore before you comply with the new FINRA ethics guide (IM-2310.2), think of how much it is going to cost you to sue and consider the odds of winning.

In additions to these common exclusions, most policies are specific to the business activity being covered. For example, an E & O policy issued to an insurance broker might contain an exclusion for claims related to the collection of premiums; an E & O policy issued to a securities broker-dealer might exclude claims against or fines or penalties levied against the broker-dealer by a state or any federal regulatory agency including the SEC. Chapter 4 will cover how and when the E&O coverage kicks in.

PART 3: THE CLAIMANTS

Who is going to file a claim against you? Just about anyone however my experience has been as follows:

1.**Family members** especially during probate of an estate.
2.**IRA accounts and retirement accounts** (MAKE CERTAIN ALL PAPERWORK IS IN ORDER including RMD's).
3.Sometimes **foreigners** may not understand your explanation of the investment discussed (GET IT IN WRITING).
4.**Unsuitable investments** for clients (SALE OF GOOD STOCKS TO BUY ANNUITIES) "one size fits all".
5. People who use the securities markets to gamble are not investing.
6**. Elderly** (**Older) people** or for that matter anyone who may be taking medication, may not be thinking properly. They may also be forgetful. Perhaps there is an emotional problem or recent death of a loved one, which has lessened their ability to concentrate.
7. **Doctors and Educators**

These are just a few examples, however the rule of thumb is; **"if it doesn't' feel right, then don't do it."** Some people (clients) cannot admit to themselves that they made a mistake. They have to blame someone else. Let's try to avoid being the one blamed.

There have been many arbitration cases filed against brokers by clients who have actually made money. These clients claim that just one of the stocks, mutual funds or policies lost money even though the overall investment portfolio made money. In mediation this is referred to as "cherry picking", but the legal term is *selective rescission*. Case in point; a doctor whose portfolio made $440,000 still sued his broker because **one** of the investments did not work out. Please make sure the client understands the expectations of an investment and/or is made aware of what can happen to that investment in the future.

When a client is thinking about suing his broker, he/she will contact an attorney. There is a group of attorneys who specialize in suing brokers. The Public Investors Arbitration Bar Association (PIABA) is an organization that represents customers of securities brokerage firms in arbitration before FINRA arbitration panels and in other arbitration forums. Check PIABA's web site at www.piaba.org. I have found most PIABA attorneys are reasonable but as in any industry, there are always a few that can make life miserable. **A study preformed by a well known B/D found that the average arbitration case costs $27,500.**

PART 4: THE FINRA UNIFORM SUBMISSION AGREEMENT CLAIM and ANSWER

The uniform submission agreement is a form used to file a claim against you for just about any reason while you serve in the capacity of Registered Representative. Once the action is filed with the Regulators then the Regulators contact your B/D. The B/D, in turn, notifies you and your E&O carrier. Your BD then must file an amendment to your U-4 stating the nature of the claim. The Regulators place this information on your CRD for the whole world to see. Please be aware that it is extremely difficult and expensive to get this information expunged from your record. Your B/D must also send in a $500 fine to the Regulators.

At this point you may obtain your own attorney; it may be wise to hire your own attorney because the B/D's and/or the E&O carrier's interests may differ from your interests. If you do not retain your own counsel, your B/D and/or E&O carrier will obtain counsel for you. More likely than not, this will be the same attorney representing your B/D and/or E&O carrier because your B/D will probably be named in the suit along with you. Whether to hire your own counsel or not? The decision is entirely yours; however please note that most E&O carriers use good law firms with good attorneys.

Once you have selected or accepted counsel, your attorney will answer the claim. The Regulators will provide a list of arbitrators to your attorney and the Claimant's attorney. The attorneys may choose the arbitrators they want, however but you may not actually get the Arbitrator(s) that you desire. The Regulators can replace any arbitrator at any time. For the most part you are stuck with the panel you get and the possibility exists that you may not get a(n) Arbitrator(s) that is a fellow broker with a better understanding of your side of the story. You may get an Arbitrator who is classified, as an Industry Arbitrator but this person may be retired from the industry, no longer working in the industry or someone who does not have to take branch exams, firm element exams or CME courses. Many participants of past arbitrations believe that the Regulators, allegedly, control the consistency of arbitration panels and removes Arbitrators from their rosters who have sided with retail brokers in previous cases.

There is an initial discovery conference is only with the discovery arbitrator or the panel chairperson with the parties and the industry panel member is not present. If the arbitration is an employment case then there should be an all industry panel. The initial pre-hearing conference call is attended by all parties, as represented by counsel, and the full panel. This call sets dates for discovery/evidence submission, the actual arbitration hearing dates and advises the parties of FINRA's voluntary mediation process. **GO TO MEDIATION, ESPECIALLY IF YOU DID NOT DO ANYTHING WRONG**. My experience is that you cannot lose in mediation, particularly if the Mediator has a strong grasp of the securities industry and is a good mediator.

There may be other conference calls prior to the hearing that include all parties, as represented by counsel, but the Regulators may request that only the Chairperson of the panel participate in these calls. Please be advised that the Chairperson is not usually an Industry Arbitrator. There may be expert witnesses brought in to testify against you during the hearing; however their testimony may actually help you if you did nothing wrong. Your counsel may also choose to hire an expert witness to testify in your behalf.

PART 5: MEDIATION

Many people believe that mediation is the only good part of the Regulators required alternate dispute resolution process. Once the parties have agreed to mediate, a mediator is chosen by the Claimant and Respondent from the Regulators mediator roster. There are many good mediators, but my advice is to choose one who is familiar with securities rules and regulations. Mediation is a private matter. The mediator's job is to attempt to get everyone to settle the matter before arbitration. The mediator should be honest and not pressure anyone. A good mediator will ask questions and may, if asked, offer suggestions on how to resolve the matter provide information regarding how similar matters have been settled in the past. You may never see the Claimant or their attorney during this process. Some seasoned mediators say that if all parties are somewhat unhappy after a successful mediation, that process worked and it was a "good" mediation. A good mediator should be pleasant, honest, ethical and should make the parties feel that the process worked and satisfies that the matter is resolved.

PART 6: Arbitration

If mediation has failed or if the parties do not desire to mediate, then the arbitration process begins. The hearing date arrives and you walk into a conference room. The Claimant and their attorney(s) sit on one side of the table and you and a member of your B/D and your attorney, the Respondents, sit on the other side. In front of you are 3 arbitration panel members.

Usually, the Claimant will give an opening statement and then your attorney will give an opening statement. Then the witnesses, as they are called to testify and all evidence is offered to the Arbitrators in exhibit form by Claimant and Respondent. The panel members may ask questions after Claimants and Respondents attorneys have finished questioning each witness. Brokers make the worst witnesses I have ever seen, unless of course they are guilty as sin and can lie with ease. The arbitration may take many days and will be costly (forum fees).

Once all the witnesses have testified and the evidence has been accepted by the arbitrators, the Claimant and Respondent's attorneys offer closing statements. Once the closing statements have been heard, all parties are dismissed from the room and the panel meets privately to make a decision. If you win, great! If you lose, you have already paid your E&O deductible and the award made against you becomes a permanent record on your CRD. Also, be aware that the B/D that you are associated with can terminate you at any time and publish any statement ("absolute privilege") they choose on your U-5. .

PART 7: Your best defense and How to Avoid a Claim

The **New Account Form** and updated new account forms signed by the client (s) serve as your first line of defense and can be your best defense exhibits. Make sure these forms are filled in correctly and completely. If the client changes his/her objectives **GET AN UPDATED NEW ACCOUNT FORM**. **IF YOU FEEL SOMETHING HAS CHANGED, GET AN UPDATED NEW ACCOUNT FORM or at least send a letter to the client disclosing your concerns via receipted mail or receipted overnight delivery**. The Regulators desire an updated new account form every three years, but FINRA employees only work 5 days a week with weekends off, sick time and paid vacations. Do you remember what a paid vacation is?

When you open a new account make sure you understand what the client's objectives and expectations are now and in the future. Make sure you explain the investment. Remember you are held to a higher standard of fiduciary responsibility, which means that **"you are not to participate in any action that puts your interests above that of the client"**. A misstatement of fact is **fraud**.

Suitability compliance is a must. Make sure you have the client sign mutual fund A, B, C share disclosure forms or wrap-fee disclosure forms. Make sure you sell exactly as the prospectus states. Do not ignore break points. Make sure you are registered in your client's state of residence.

Have the client sign mutual fund "switch" letters when you move the clients' investments from one fund to another, and make sure the reason for the switch is memorialized in writing. Make sure you send letters (with a receipt) to clients that are draining their accounts. If IRA accounts are being drained, make sure you get signatures on distribution forms. You may even want to make a note the distribution form with the reason why the client is taking the money prior to their signing.

Please be extremely careful when dealing with **elderly people**. Be especially careful of placing annuities with elderly clients Should you "market time" the underlying assets of a Variable Annuity? Should you put an annuity in an IRA?

Do not use inside information under any circumstance. If you use it and get caught you are out of the securities industry (10b-5 violation). Tread carefully when selling "A" or "B" shares and back-end loaded annuities. Do not place unnecessary insurance policies. Remember certain states have laws about fair dealing with the elderly and fair dealing in 529 plans.

Please be extra careful with e-mail, telephone surveys, newspaper interviews, outside activities, outside investments. Please be careful when speaking to any group or anyone about investments. **DO NOT allow an account to "blow up"**, especially an IRA, an ERISA account or a custodial account.

Get rid of problem clients, but make sure they leave happy.

"Ethics" is a hot topic. If you are affiliated with a good firm you will not have to worry about whistle blowing. If not, **be careful**. Peter Scannell, the Putnam Funds whistle blower, is presently out of the securities industry according to an associated press article published 9/1/07.

Use titles approved by your Compliance Department such as: Registered Representative, RIA, CFP etc. **DO NOT USE TITLES THAT HAVE NOT BEEN APPROVED BY COMPLIANCE**. The Commonwealth of Massachusetts recently filed a case against an insurance salesman/ registered

representative, who allegedly represented that he was a published author, when he was not. Be careful of ghost writings.

You may feel that your Compliance Department is overbearing. Please remember they are attempting to follow the regulators guidelines and rulemaking. If you believe that your compliance department has unrealistic expectations then SEC Bulletin #17 regarding remote office supervision is required reading.

Thank you for taking the time to read this syllabus. I hope the information is helpful and that it keeps you out of arbitration.

Ted Turner, Mediator