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Taking Aim at the Brokers

By ROBIN GOLDWYN BLUMENTHAL

Investors burned by brokers are getting a better shot at winning redress.

INVESTORS ANGRY WITH their brokers are starting to get even. Or at least trying to.

In the wake of last year's market meltdown, investors filed some 4,991 securities-arbitration claims in the first eight months of this year. That's up 65% from the total in the corresponding 2009 span, and more than the tally for all of 2008, according to the Financial Industry Regulatory Authority, Wall Street's self-regulation arm.



Mark Wallheiser for Barron's
Ken and Sharon Welch, a retired couple in Pensacola, Fl., say that their broker put them in "unsuitable" investments, causing half of their life savings to vanish.

Linda Fienberg, Finra's president of dispute resolution, expects to end the year with nearly 7,500 cases filed, the highest level since 2004, when investors were still reeling from the tech wreck.

"Lots of people are very upset with their brokers, and not just because of a bad market," says Brian Smiley, of law firm Smiley Bishop and Porter in Atlanta, and president of the Public Investors Arbitration Bar Association. "A huge number of people were put into investments that they thought were relatively risk-free that were actually very speculative."

BROKERAGE ARBITRATION, A SYSTEM RUN BY Finra and previously by the National Association of Securities Dealers, is virtually the only way for investors to seek redress. While the system has long been criticized as being stacked against investors, the picture is starting to brighten.

Investors won some 45% of the cases decided this year through August, up from 37% in 2007, according to Finra. For claims under \$1 million -- the bulk of the total -- winning investors are typically getting about half the amount they seek, says Richard Ryder, editor of the [Securities Arbitration Commentator](#).

Investors also may benefit from structural changes in the wind. Congress is considering eliminating mandatory arbitration, which would allow investors to take their complaints straight to court. In the age of Madoff-market mayhem, the climate is "very ripe" for Congress to take up the issue, says Denise Voigt Crawford, the Texas securities commissioner and president of the North American Securities Administrators Association.

"There are so many people that are never going to invest in the markets again," Crawford says. "We have to make sure from a policy perspective that we don't allow capitalism to destroy itself."

Finra, for its part, is expanding a pilot program to allow investors to choose panels of arbitrators made up entirely of members of the general public, rather than the traditional setup of two public members and one industry-related member.

The pressure is on to do something, given the surging level of investor ire. Consider the case of Ken and Sharon Welch, a retired couple from Cantonment, Fla., who lost nearly 50% of their life savings in an account with Citigroup Global Markets' local office in 2008. The broker told them he was managing their portfolio "with protection of capital as a prime consideration," according to the Welch's arbitration filing.

"He assured us it was diversified," Sharon Welch said in an interview. In all, the couple expected to earn \$60,000 a year, says attorney, Peter Mougey, of Levin, Papantonio, Thomas, Mitchell, Echsner & Proctor.

But the Welches later learned that by July 2008, nearly 80% of their portfolio was invested in the financial sector, including preferred stocks, closed-end mutual funds and equities, with names like [Fannie Mae](#) (ticker: FNM), [Goldman Sachs](#) (GS) and [Morgan Stanley](#) (MS). The couple told their broker and branch manager several times that they wanted to pull out, only to be told, "Everything's going to be fine. Stay the course," Sharon Welch says.

Of course, financial stocks cratered. The Welches finally decided to freeze their account in September of '08, after seeing it fall to \$387,000 -- from a high of \$950,000 -- in a matter of 14 months. Says Sharon Welch: "If we'd have waited two more weeks, we wouldn't have had a dime."

In legal terms, the couple argues that Citi put them in "unsuitable" investments. Citigroup declined to comment on the case.

SUITABILITY CLAIMS LIKE the Welches' have predominated in this year's filings, says Ryder. Suitability has to do with "acknowledging the broker as a professional has a higher duty to the customer to do due diligence -- not only in learning a client's objectives but in pairing those objectives with the types of trades he recommends," Ryder says.

Many cases in the last two years have centered around auction-rate securities -- short-term-debt instruments whose prices reset in periodic auctions, Finra's Fienberg says. A lot of investors were unaware of the risk of these securities, believing them to be as safe as cash or a money-market fund. But the \$330 billion market collapsed early in 2008 during the credit crunch, and investors couldn't recover funds they'd thought were as liquid as cash.

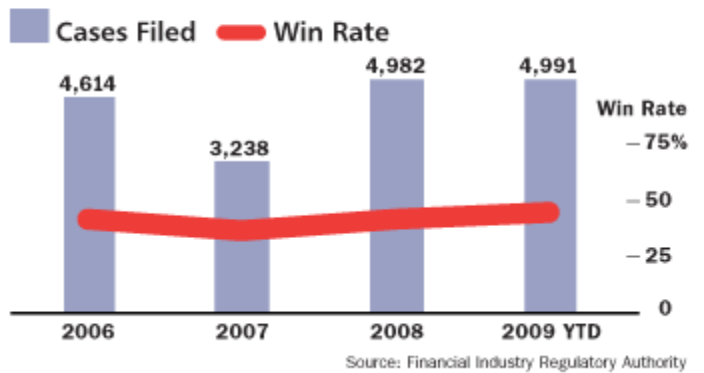
"There are people who are left holding what they thought was a seven-day bond that doesn't mature until 2038," says Smiley, the head of the public investors' lawyers group.

INDEED, TD AMERITRADE in July agreed to buy back \$456 million of auction-rate securities from about 4,000 clients, as part of a settlement with the New York Attorney General, and Pennsylvania and federal regulators.

Citigroup (C) agreed to buy back more than \$7 billion of such securities and pay \$100 million in civil penalties, in a settlement with the Securities and Exchange Commission and the New York attorney general in August. In a high-profile arbitration award in February, a panel ordered Credit Suisse to pay a \$400 million award to **STM**Microelectronics (STM), after the Swiss semiconductor company accused the bank of mishandling its investment in auction-rate securities.

Rising Animosity

Investors filed more arbitration claims through August of this year than in all of 2008. And they are starting to win a little more often.



That award helped push the average recovery rate -- the percentage of a winning investors' claims that is actually awarded -- to a whopping 99% in the first quarter, according to Ryder. The median, 43%, still represents a solid advance for investors.

Many cases also have involved mutual funds, says Fienberg. Investors are alleging that brokers sold funds of their own firms that were heavily invested in subprime debt -- and didn't disclose the risk.

The explosion of cases clearly has increased the stress on the arbitration system, says Jill Gross, a law professor at Pace University who also directs its investor-rights clinic. While she applauds Finra for expanding its pilot program of public arbitrators, she says that the regulator "really needs to face reality that the industry arbitrator is a vestige of old times."

Many on Wall Street disagree. "We believe the current arbitration system is vast, efficient and fair for investors," says a spokesman for the Securities Industry and Financial Markets Association. If investors were forced to go to court, he said, "it's likely that average investors wouldn't have a forum available to them," because lawyers wouldn't want to take on some of the smaller cases.

In the end, it will almost surely take Congress to arbitrate this dispute.