UNAUTHORIZED DISCRETIONARY TRADING 2020

Douglas J. Schulz[1]

Introduction

In 1994, I wrote a comprehensive article on the securities law violation of unauthorized trading or improper discretionary trading.[2] In 2001, I wrote a second article on this subject, also covering the mismarking of order tickets.[3] Quite a lot has happened on these subjects since that second article, prompting me to examine developments.

Let's start with a summary of the prior articles. In the early years of my securities expert work, I found that a decent percentage of cases involved unauthorized trading, though the regulations at that time were a bit ambiguous. Extensive research confirmed my opinion that there were some problems and loopholes in the regulations. The regulation loopholes allowed many brokers to continue to get away with unauthorized trading. The primary purpose of my second article was to address regulatory inconsistencies and encourage regulators to fix these problems.

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1. Mr. Schulz has traded securities for over 50 years and has been in the securities business professionally for 40 years. He has held numerous securities licenses and positions as both a stockbroker and Registered Investment Advisor (RIA) and is a FINRA arbitrator. He has been hired over 1,148 times as a securities expert and has given sworn testimony almost 650 times. He is a Certified Regulatory Compliance Professional (CRCP), a title bestowed on him by FINRA and The Wharton School of Business. He co-authored with attorney Tracy Pride Stoneman a popular book: BROKERAGE FRAUD – WHAT WALL STREET DOESN'T WANT YOU TO KNOW (2002) and has been quoted in most top financial publications.

2. Douglas J. Schulz, *When Is an Order an Order? Unauthorized Trading by Securities Brokers*, PRACTICING LAW INSTITUTE (PLI) SECURITIES ARBITRATION, July 1994. The article covers the discussions that must take place between a broker and the client, the order process, discretionary trading, and the arbitration of unauthorized trading claims.

3. Douglas J. Schulz, *Unauthorized Trading, Time and Price Discretion & the Mismarking of Order Tickets*, PRACTICING LAW INSTITUTE (PLI) SECURITIES ARBITRATION, August 2001. The article addresses the regulations governing these three areas and how regulators, compliance individuals, lawyers, and arbitration panels can determine if violations have taken place. The article also suggests changes which are needed in the regulation of these infractions.

It happened. FINRA took action to fix the loopholes. I was told that it was my articles that precipitated those changes. Nonetheless, a significant percentage of my securities cases involve the issues of unauthorized trading and the mismarking of order tickets. This article focuses on the more current issues in these two areas.

FINRA Fixes the Loopholes

In the original 1994 article, I was highly critical of the regulations as they related to an exception in the discretionary trading rules referred to as "time and price discretion."[4] "Time and price discretion" means that the customer has granted the stockbroker discretion to determine when to buy or sell a certain amount of a particular security. The problem was that firms were using the "time and price discretion" exception to defend unauthorized trading claims.

For example, when claimants showed that there was no conversation between the customer and the broker just prior to a trade, the broker's attorney would claim that the conversation took place the day before or even days or weeks before the trade and that the broker was exercising "time and price discretion," so there was authority to engage in the trade. It was the broker's word against the claimant's because there was no documentation required for use of this exception. Nor were there any time parameters on how long "time and price discretion" could be used. The 2001 article was even more critical of this problem/loophole because for seven years, NASD/FINRA still had not taken any steps to rectify the problem.

Finally, in 2004, NASD/FINRA changed the regulations to solve two of the biggest problems: 1) that time and price discretion had no time limitations and 2) the lack of required documentation. FINRA Notice to Members (NTM) 04-71, released in October 2004, announced that one of the SEC's changes to FINRA Rule 2510 was the following amendment:[5]

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4. In 1994, the rules on discretionary trading consisted of NASD article III, section 15 and NYSE Rule 408. These rules were merged into FINRA Rule 2510, and the current rule on discretionary trading is FINRA Rule 3260 Discretionary Accounts (*see* Appendix A).

5. On June 17, 2004, the Securities and Exchange Commission (SEC) approved rule changes (Supervisory Control Amendments) by NASD that both create and amend certain rules and interpretive materials to address a member's supervisory and supervisory control procedures. *See* Self-Regulatory Organizations; Order Approving Rule Change and Amendments No. 1 and 2 by National Association of Securities

> Rule 2510 – Discretionary Accounts
> One-Day Limit on Time/Price Discretionary Authority
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> Rule 2510(d)(1) allows members to exercise time and price discretion on orders for the purchase or sale of a definite amount of a specified security without prior written authorization from the customer or prior written approval by the member. However, the duration of this discretionary authority is *limited to the day it is granted,* absent written authorization to the contrary. In addition, any exercise of time and price discretion must be reflected on the customer order ticket.
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> NASD believes that investors will receive greater protection by clarifying the time such an order remains pending. Customers who wish to grant more extensive discretionary authority to their registered representatives may do so pursuant to a fully executed trading authorization.

(emphasis added).

FINRA gave additional clarification on the issue of "time and price discretion" in a May 2008 Release entitled "Improving Examination Results." FINRA wrote: "FINRA issues this publication to assist member firms in their compliance efforts. As in past years, this edition highlights examination priorities and frequently found deficiencies relating to FINRA's examination program." In a subsequent paragraph it stated the following:

> Time and Price Discretion (Rule 2510(d)(1))3
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> *Deficiency*: NASD Rule 2510 prohibits the exercise of any discretionary power in a customer's account unless such customer has given prior written authorization (a Power of Attorney/Trading Authorization) to a stated individual or individuals and the account has been accepted by the member firm, as evidenced in writing by the firm or the partner, officer

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Dealers, Inc. Relating to Internal Controls and Supervisory Control Amendments and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3, Exchange Act Release No. 34, 49883; File No. SR-NASD-2002-162 (June 17, 2004), 69 F.R. 35092 (June 23, 2004). On September 30, 2004, the SEC granted accelerated approval to proposed rule changes to the Supervisory Control Amendments to conform certain parts of the new rule requirements to the New York Stock Exchange's (NYSE's) recently approved internal control amendments. *See* Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to Proposed Rule Change and Amendment No. 1 by National Association of Securities Dealers. Inc. Relating to Supervisory Control and Inspection Procedures, Exchange Act Release No. 34, 50477; File No. SR-NASD-2004-116 (September 30, 2004), 69 F.R. 35092/35108 (October 6, 2004). The rule changes became effective January 31, 2005.

> or manager, duly designated by the firm, in accordance with NASD Rule 3010.
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> *Exception:* There is an exception to this requirement, under subsection (d)(1), that applies to the exercise of time and price discretion- which is discretion orally granted by the customer to purchase a specific amount of a particular security (e.g., "Buy 100 shares of ABCD and get the best price you can").
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> *Temporary*: A verbal grant of time and price discretion is limited to the end of the business day on which the customer grants it. An extension of such time and price discretion requires explicit signed and dated customer instructions. Any exercise of time and price discretion must be reflected on the order ticket (as is the case with "regular" discretion).
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> *Beyond the Day:* FINRA examiners have found instances where the extension of time and price discretion beyond the business day on which the customer grants it is not being authorized by signed and dated customer instructions.
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> *Why This is Important?* The concept of time and price discretion has been subject to abuse and/or misunderstanding. At one time, there was no time limit placed on a grant of verbal time and price discretion by a customer. This became problematic in instances where a registered representative was granted such discretion but did not exercise it for an extended period of time, sometimes several weeks. This led to claims of unauthorized trading by customers who may have forgotten that they granted the discretion, or who assumed it was not valid for such an extended period of time. The "written extension" requirement under current Rule 2510(d)(1) is intended to prevent such misunderstandings. Accordingly, firms should educate their registered representatives to be cognizant of this requirement so as to avoid situations that could result in otherwise avoidable customer complaints.
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> *The Solution:* Ensure that registered representatives are made aware, via written firm policy and training, of Rule 2510(d)(1) regulatory requirements pertaining to time and price discretion.

The next significant Release on the issue of discretionary accounts occurred in June 2015 when FINRA issued Regulatory Notice 15-22 - Discretionary Accounts and Transactions. This lengthy Release finalized and consolidated the discretionary rules into FINRA Rule 3260 and asked for member comments. Because of the lengthy discussion, it is an important Release as it relates to discretionary accounts. It states:

> *The Initial Proposal* - transferred the existing exceptions in NASD Rule 2510(d)(1) into proposed FINRA Rule 3260(c)(1)(A). Specifically, the initial proposal provided an exception to the requirements of proposed FINRA Rule 3260(a) for a customer's limited authorization for time or price discretion for the purchase or sale of a definite dollar amount or quantity of a specified security. In response to inquiries from firms regarding the duration and scope of such authorization, the initial proposal clarified that a firm may exercise:
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> > (1) time or price discretion given by a customer during a normal trading session, provided that such discretion is only valid during that session; or
> >
> > (2) time or price discretion given by a customer after the close of a normal trading session, provided that such discretion is only valid during the next normal trading session.

Item (2) is helpful because there was a slight impracticality when trying to apply the rule to the real trading world. It is very common for brokers to discuss trading ideas and make recommendations to their clients after the markets have closed for the day. Those discussions could result in orders for the next day. Ignoring the rare trading in "after-hour markets" by retail clients, it is only natural that those orders would be placed and executed when the markets open the following day. And, if one of these "after-hour" orders is one where the client gave the broker "time and price discretion," if properly documented, it would be appropriate that the duration under the rules would consist of the entire next trading day. Unfortunately, this clarification did not end up in the rule itself but is only discussed in the regulatory notice.

Discretionary Accounts

Today, the abuses the securities industry experienced with true discretionary accounts are limited. The regulations and firms have long required that these legal, discretionary accounts be documented. Because the industry knows that it is easier for a broker to abuse an account where he has discretion, the rules require brokerage firms to give documented discretionary accounts additional, special supervision. What has really restrained the abuse is the fact that since everything now is totally electronic - and most brokerage firms have sophisticated screening systems - compliance and supervisory staff often quickly catch excessive and questionable trades.[6]

The dishonest broker who is planning to abuse a customer's account, now being aware of this extra level of supervision, does not open the account as a discretionary account. Instead, he or she opens a regular nondiscretionary account designed to receive standard supervision and then trades on a discretionary basis. These problems continue to this day, primarily because a large percentage of investors in this country are unaware that their broker is required to speak to them just prior to each trade.

Unauthorized Trading is Fraud

Unauthorized trading and improper discretionary trading is a fraudulent act. SEC Rule 10b-5, codified at 17 C.F.R. § 240.10b-5 states as follows:

> § 240.10b-5 Employment of manipulative and deceptive devices.
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> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

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6. FINRA's 2018 Report on FINRA Examination Findings December 7, 2018, under the "Abuse of Authority" section states, "Registered representatives may engage in discretionary trading when they execute a securities transaction in a customer's account after receiving prior written authorization from the customer. NASD Rule 2510 (Discretionary Accounts) also establishes other obligations that reduce the risks associated with discretionary trading by requiring firms to accept discretionary accounts only in writing, prohibiting firms from effecting transactions that are excessive in size or frequency relative to the financial resources and character of the account, and requiring firms to approve discretionary orders in writing and *review discretionary accounts at frequent intervals*." FINRA, *Report on FINRA Examination Findings*, December 2018 available at https://www.finra.org/sites/default/files_/2018_exam_findings.pdf (emphasis added) (hereinafter referred to as FINRA's 2018 Report on FINRA Examinations Findings).

> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Although a violation of this securities law is satisfied by either a), b) or c), unauthorized trading arguably violates *each* of these subsections: The "scheme to defraud", the "practice" or "course of business" are often shown by the recurrent nature of the wrongdoing if, as is often the case, there are multiple unauthorized trades over a significant period of time. When this is coupled with the broker's reluctant admission on cross-examination that he or she understands the unauthorized trading rules, the logical inference is that the broker's actions were purposeful, intentional or (FINRA's favorite word) willful.

Unauthorized trading necessarily involves an omission—the omission of advising the customer of the trade. As one court stated, "A broker's failure to inform an investor of transactions made on his or her account is itself a material omission, and, in fact, no omission could be more material than that."[7] The SEC's definition of fraud found in its own rules further supports a finding that the failure of a stockbroker to discuss with a customer an impending trade is a material omission.[8] Finally, the "in connection with the purchase or sale of a security" is easily satisfied because trades were necessarily made in an unauthorized trading case.

The SEC has long determined that unauthorized trading is a fraudulent act. See, for example:

1. *In the Matter of Donald A. Roche*, Exchange Act Release No. 34-38742 (June 17, 1997) (Roche violated the antifraud provisions by making unauthorized trades. "In general, unauthorized trading violates the antifraud provisions when accompanied by deceptive conduct. This requirement is satisfied by the respondent's omission to inform the customer of the materially significant fact of the trade before it is made. We therefore affirm the law judge's findings that Roche violated

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7. Rivera v. Clark Melvin Securities Corp., 59 F. Supp. 2d 280, 293 (D.P.R. 1999). *See also William C. Piontek*, 57 S.E.C. 79 (2003) ("A broker who trades in a customer's account without authorization commits fraud if there is accompanying deceptive conduct. The deceptive element is established when the broker omits 'to inform the customer of the materially significant fact of the trade before it is made.'").

8. 17 C.F.R. § 230.405 (2020) (whether there "is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security . . .").

the antifraud provisions by making unauthorized trades in these two accounts.");

2. *In the Matter of Martin Herer Engelman, Peter Paul Kim, and Lawrence David Isen*, SEC Initial Decision, Administrative Proceeding File No. 3-7719, 1993 ("the sending of confirmations of trades to customers who had not agreed to those trades is violative of the antifraud provisions of the securities acts." And broker "willfully violated Section l0(b) of the Exchange Act and Rule l0b-5 thereunder by…effecting unauthorized trades in the accounts of customers.");
3. *Edgar B. Alacan*, 57 S.E.C. 715, 729 (2004) ("Unauthorized trading violates the antifraud provisions when it is accompanied by deceptive conduct. The deceptive conduct element is met when the broker omits to inform the customer of the materially significant fact of the trade before it is made.*");*
4. *In re J. Stephen Stout*, Exchange Act Release No. 34-43410 (Oct. 4, 2000) (*"*Purchasing securities on margin in customer accounts without customer approval violates the anti-fraud provisions of the securities laws.");
5. *In re Joseph J. Barbato*, Exchange Act Release No. 34-41034, p.11 (February 10, 1999) ("Where a registered representative omits to disclose material information necessary to make his statements not misleading to customers about an investment he is recommending, including known risk factors and negative information about the stock, the representative violates the antifraud provisions");
6. *In re Pryor, McClendon, Counts & Co., Inc.*, Exchange Act Release No. 34-45402, p.7 (February 6, 2002) ("The Commission has held that a broker-dealer has a duty to disclose to its customer information indicating that the customer's agent is engaged in fraud with respect to the customer's investments. In failing to make that disclosure, the broker-dealer shares in the agent's liability to the customer with respect to any transactions involving the broker-dealer"); and,
7. *In re Leslie E. Rossello*, Exchange Act Release No. 33-7922, pp. 4,5 (Dec. 1, 2000) ("Reasonable investors consider the cost of the transactions an important fact in their deliberations…To the extent there are sales charges associated with such a purchase or sale of mutual funds, such as contingent deferred sales charges on either the fund to be liquidated or the fund to be purchased, members should discuss with the customer the effect of those charges on the anticipated return on investment*,"* quoting NASD Notice To Members 94-16 (March 1994), broker "had an affirmative duty to disclose the

unsuitable nature of the frequency of these particular mutual fund switches to her customers").

Many courts also have held that unauthorized trading is a violation of l0b-5 of the 1934 Act.[9]

When defense firms argue—and support their arguments with case law showing - that the customer failed to prove his or her reliance on the broker's representations, the strongest rebuttal for customer attorneys can be found in the *Affiliated Ute Citizens of Utah v. United States*,[10] where the United States Supreme Court held that when a fraud consists of omissions rather than misstatements, reliance may be presumed.

The very nature of unauthorized trading involves only omissions and not misstatements. The Supreme Court's ruling makes sense, because how does one prove reliance on something that was not said?

In addition, unauthorized trading almost always violates specific state securities statutes relating to fraud. Most states have adopted the Uniform Securities Act or have enacted their own provisions similar to the Uniform Act, which provides:

> Part I Fraudulent and Other Prohibited Practices
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> Sec. 101. [SALES AND PURCHASES.] It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud,
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> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

State securities laws mirror the federal securities law regarding fraud. Showing the arbitration panel that unauthorized trading violates not only a host of FINRA rules (2010, 2020, 3110, 3260, 4510, 4512, and 7440), Federal SEC regulations 10b-5 and Exchange Act Rule 17a-3(a) and state laws, can be quite compelling. Establishing for the arbitration panel that unauthorized trading is

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9. Corbey v. Grace, 605 F. Supp. 247, 252 (D. Minn. 1985); U.S. v. Pray, 452 F. Supp. 788 (M.D. Pa. 1978); Nye v. Blyth Eastman Dillon, 588 F.2d 1189 (8th Cir. 1978); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Cruse v. Equitable Securities of N.Y., 678 F. Supp. 1023 (S.D.N.Y. 1987).

10. 406 U.S. 128 (1972).

an illegal, fraudulent act under the federal securities laws, state law, and the securities regulations reinforce the seriousness of the wrongdoing.

Unauthorized Trading is Serious and Egregious

FINRA has proclaimed, "There is no dispute that, generally, executing trades for a customer without authorization constitutes 'a serious breach of the duty to observe high standards of commercial honor and just and equitable principles of trade,' going to 'the heart of the trustworthiness of a securities professional.'"[11] In some states, an unauthorized trade is an automatically rescindable trade.

In the suitability section of FINRA Regulatory Notice 11-02 SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations - Effective Date July 9, 2012, footnote #8 states:

> #8 FINRA Rule 2111(a). Former NASD Rule 2310 contained interpretative material (IMs) discussing a variety of types of misconduct. Although FINRA eliminated those IMs, most of the types of misconduct that the IMs discussed were either explicitly covered by other rules or incorporated in some form into the new suitability rule. The exception was unauthorized trading, which had been discussed in IM-2310-2. However, it is well-settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010 (previously NASD Rule 2110)[12]. ***Unauthorized trading continues to be serious misconduct that violates FINRA Rule 2010***. (emphasis added).

FINRA's Interpretive Memo (IM) "discussing a variety of types of misconduct" cites the following:

IM-2310-2. Fair Dealing with Customers NASD

(4) Fraudulent Activity

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11. *Dep't of Enforcement v. Audra Lynn Lalley*, FINRA Hearing Panel Decision No. 2011030072301 (OHO 2015) (hereinafter referred to as *Lalley*).

12. *See, e.g.,* Robert L. Gardner, 52 S.E.C. 343, 344 n.1 (1995), *aff'd*, 89 F.3d 845 (9th Cir. 1996); Keith L. DeSanto, 52 S.E.C. 316, 317 n.1 (1995), *aff'd*, 101 F.3d 108 (2d Cir. 1996); Jonathan G. Ornstein, 51 S.E.C. 135, 137 (1992); Dep't of Enforcement v. Griffith, No. C01040025, 2006 NASD Discip. LEXIS 30, at *11–12 (NAC Dec. 29, 2006); Dep't of Enforcement v. Puma, No. C10000122, 2003 NASD Discip. LEXIS 22, at *12 n.6 (NAC Aug. 11, 2003). The new suitability rule does not alter that conclusion.

> (A) Numerous instances of fraudulent conduct have been acted upon by the Association and have resulted in penalties against members. Among some of these activities are:
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> (ii) Discretionary Accounts
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> Transactions in discretionary accounts in excess of or without actual authority from customers.
>
> (iii) Unauthorized Transactions
>
> Causing the execution of transactions which are unauthorized by customers or the sending of confirmations in order to cause customers to accept transactions not actually agreed upon.

FINRA and the SEC agree that unauthorized trading is a serious issue. One reason the vast majority of my unauthorized trading cases have settled is that not only do the regulators consider unauthorized trading serious, so do arbitration panels. But equally important is the fact that the regulators and the Enforcement Division of FINRA often find that unauthorized trading is egregious activity.

Being a FINRA arbitrator myself, I am aware that when egregious activity is proven, it is more likely that the Award will be exponentially higher and may include punitive damages. One only needs to look as far as the FINRA Sanction Guidelines:

FINRA SANCTION GUIDELINES

X. Sales Practices [Version up to May. 1, 2018]

Unauthorized Transactions and Failures to Execute Buy and/or Sell Orders

> Footnote #2 The NAC has identified in its decisions the following categories of egregious unauthorized trading: 1) quantitatively egregious unauthorized trading, i.e., unauthorized trading that is egregious because of the sheer number of unauthorized trades executed; 2) unauthorized trading accompanied by aggravating factors, such as, efforts to conceal the unauthorized trading, attempts to evade regulatory investigative efforts, customer loss, or a history of similar misconduct (this list is illustrative, not exhaustive); and 3) qualitatively egregious unauthorized trading…

The Wrongdoing Continues

FINRA’s website, under the section Arbitration and Mediation - Dispute Resolution Statistics, November 2019, has a subsection entitled “Top 15 Controversy Types in Customer Arbitrations.” Unauthorized trading is #12.

But if you remove the "Types" that are either basically legal claims or omission claims (which are repetitive), unauthorized trading is # 6. Reviewing the last four years of statistics, the claims of unauthorized trading and mismarking order tickets have not lessened. The following are a few examples.

1. Unauthorized Trading

In October 2019, a FINRA arbitration panel issued a $3.15 million Award in an unauthorized trading case.[13] The customer-claimants' out-of-pocket damages were $1.5 million. As is common in unauthorized trading cases, the brokerage firm - Raymond James - argued a laundry list of unauthorized trading defenses that did not sway the Panel (see below).

In July 2018, FINRA fined and suspended a broker for executing 10 unauthorized trades totaling $40,004 in the accounts of two customers.[14]

FINRA has concluded that there was evidence of unauthorized trading despite frequent communication between the broker and the customer. In *In the Matter of Kim Dee Isaacson*,[15] FINRA found that the broker executed 360 purchases and sales of various securities that were unauthorized, despite the fact that the broker and the customer spoke on a daily basis. This broker also failed to follow the customer's instructions. FINRA wrote:

> Shortly thereafter, HM told Isaacson that he did not want to be invested in Petrobras and directed Isaacson to sell the shares. Isaacson told HM that he executed the sales even though he did not.

The broker then continued to purchase the stock the customer did not want. This, in my opinion, is perhaps the most egregious example of unauthorized trading - when a broker disregards a customer's directive on trading. It may explain why FINRA permanently barred the broker from associating with any FINRA registered firm in any and all capacities.[16]

Similarly, FINRA has suspended and fined brokers who make trades in the accounts of deceased clients, which is a quintessential example of unauthorized trading:

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13. Cage, et al vs. Raymond James, FINRA Case No. 17-02973. 28 claimants and 40 accounts. Panel also awarded $140,000 of my expert witness fees. Full disclosure—I was the customers' expert witness.

14. In the Matter of Eric Korhut*,* FINRA AWC No. 2016051348101 (July 30, 2018).

15. In the Matter of Kim Dee Isaacson, FINRA Case No. 2014040199101 (July 25, 2017).

16. *Id*.

1. *In the Matter of Michael David Garris,* FINRA AWC No. 2018059146801 (July 22, 2019) (customer died and broker failed to notify the firm, as required, and six months later broker executed over $300,000 of trades in the accounts; one-year suspension and $5,000 fine).
2. *In the Matter of Steve Baptist,* FINRA AWC No. 2018058666001 (Aug. 8, 2019) (broker traded in deceased customer's account. FINRA stated: "These trades were all unauthorized." It suspended the broker for 30 days and fined him $5,000).

Unauthorized trades in the accounts of elderly customers have likewise garnered harsh criticism from FINRA. In a March 2017 News Release, Susan Schroeder, FINRA Acting Head of Enforcement, said, "There is no place in this industry for brokers who take advantage of elderly customers. Protecting senior investors from predatory behavior such as unsuitable and unauthorized trading is part of our core mission and will always be a priority for FINRA."

This statement was in relation to a case where the broker's customer was a 72-year-old retired woman who had worked at Colgate and who specifically told her broker that she did not want to sell any of her Colgate stock, which she considered a valuable, long term investment and a reliable source of dividends. Not only did the broker sell the Colgate stock on 41 occasions without his client's consent or authority, but he told his client that the sales were a "computer glitch" at the clearing firm and were made without his knowledge. FINRA ruled that the broker violated FINRA Rules 2010 and 2020 by making unauthorized trades and then attempting to conceal them through misrepresentations and omissions. FINRA barred the broker from the industry.[17]

2. Mismarking Order Tickets

In November 2018, FINRA fined and suspended a broker for mismarking six order tickets, reiterating that such conduct was violative of multiple rules. FINRA Rule 4511 provides that "Members shall make and preserve books and records as required under the FINRA rules, the Exchange Act and the applicable Exchange Act rules." Further, Exchange Act Rule 17a-3(a) requires that firms make and keep current books and records relating to their business, including memoranda of each brokerage order.

17. In the Matter of Craig David Dima, FINRA AWC No. 2015046440701 (Feb. 28, 2017).

FINRA found the broker violated each of these rules, as well as the catchall FINRA Rule 2010, which requires that members and associated persons observe high standards of commercial honor and just and equitable principles of trade.[18]

In March 2019, FINRA fined a brokerage firm for mismarking multiple order tickets, violating SEC Rule 17a-3(a)(6)(i) and FINRA Rules 4511 and 2010:

> During the relevant period, Stonecrest also failed to accurately record the terms and conditions of customer orders on its books and records. Specifically, the firm failed to mark order tickets for 2,808 securities transactions as either "solicited" or "unsolicited." Instead, the section of the order ticket where that information was supposed to be noted was marked "N/A." The inaccurate order tickets represented 45% of Stonecrest's securities transactions during the relevant period.[19]

The above finding highlights the importance of correctly marking the order ticket either unsolicited or solicited; any other marking is not compliant.

In April 2019, FINRA fined and suspended for eight months a broker employed by LPL Financial. The broker, among other things, mismarked customers' order tickets to make it appear as though the customer solicited mutual fund transactions that the customer had not solicited.[20]

FINRA considers the accurate marking of an order ticket solicited or unsolicited to be a critical component of the firm's ability to supervise.[21]

In December 2017, FINRA highlighted evidence of mismarking of order tickets that should be discernable to supervisors. It stated: "… Johnson [the broker] told Wynne [the Branch Manager] that his customers' sales were

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18. In the Matter of Tony Tolene, FINRA AWC No. 2016051834101 (Nov.15, 2018). *See also* Dep't of Enforcement v. Newport Coast Securities, et. al*,* No. 2012030564701 at p. 3 (NAC May 23, 2018) ("[The broker] mischaracterized as unsolicited 22 trades in the account of one customer and thereby caused Newport's books and records to be inaccurate, in violation of NASD Rules 3110 and 2110 and FINRA Rule 2010.").

19. In the Matter of Stonecrest Capital Markets, Inc., FINRA AWC No. 2016048194301 (March 1, 2019).

20. Dep't of Enforcement v. Brian Lawrence Stephan, FINRA Disciplinary Proceeding No. 2014042022401 (Apr. 11, 2019).

21. Dep't of Enforcement v. David JC Bolton*,* FINRA Default Decision No. 2016049775701 (Aug. 24, 2018) ("This designation is important to a firm's supervision of an associated person to monitor whether he is exercising undue influence over customers.").

unsolicited, when in fact, it is clear that Johnson actually solicited several customers to sell their IWEB shares at the same time Johnson was soliciting other customers to purchase IWEB." *FINRA sanctioned the branch manager for deficient supervision* in that he "did not adequately review Johnson's trading in IWEB stock."[22]

As the above cases show, unauthorized trading and mismarking of order tickets are two distinct violations.

What is Required on an Order Ticket?

One can easily see the parallel between the content of discussion a broker must have with his client about an order[23] and what the broker is required to record on the order ticket. There is a wealth of information required to be recorded for every buy and sell transaction, as shown below. Much of that information cannot be inputted without a detailed discussion beforehand with the client.

Again, unless the broker has opened a documented, signed and preapproved discretionary trading account, this information not only *must* be discussed in detail, but, at the conclusion of the discussion, the client must give his or her approval for the trade.

The following is the language from a broker-dealer's Compliance Manual as to what the firm dictates the broker must record for each and every trade. An examination of order tickets produced by brokerage firms in securities arbitrations should reflect the same or similar information.

1) Identification of the account
2) Buy or sell
3) If sell, long or short
4) If a short sale, an indication the security can be borrowed
5) If sell long, an indication that the seller can deliver the security on a timely basis
6) If an option, put or call and open or close
7) Solicited or Unsolicited
8) Name of security
9) Quantity
10) Price (if a limit, stop or stop-limit order)

22. Dep't of Enforcement v. Meyers Associates, L.P., Complaint No. 2013035533701 (NAC Dec. 22, 2017) (emphasis added).

23. *See* Schulz, *supra* note 2.

11) Day or GTC (if not a market order)
12) Other terms of the order (fill or kill, stop limit, etc.)
13) Identity of Financial Advisor responsible for the account, if any
14) Identity of any other people who entered or accepted the order
15) Date and time order is received from the client
16) Date and time order is entered
17) Discretion, non-discretion, or "time and price discretion"

Other information to be recorded for the order includes:

18) If the client's order is granted a stop (i.e., price protection on order as negotiated by the firm and the client), the stop is to be noted on the order
19) Any modification to/cancellation of order or instructions
20) Execution price
21) Date and time of execution or cancellation

For the vast majority of orders, this list is sufficient. FINRA Rule 7440, entitled "Recording of Order Information,"[24] sets forth circumstances which call for additional documentation of orders.

When Is an Order an Order?

Often at the heart of unauthorized trading is the issue of whether the discussion between the broker and the client met the requirements such that the order was proper?

This section discusses the requirements of the conversation that the broker must have with the client prior to writing and entering an order. If phone records and other evidence show that the broker did not have a timely conversation with the client, the issue of how detailed the conversation was is moot.

24. FINRA Rules 7420–7460 deal with orders. SEC regulations covering order tickets are contained in 17 C.F.R. § 240.17a-3 (6)(i) . . . An order entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated . . . . (7) . . . An order with a customer other than a member, broker or dealer entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated. (B)(3)(D)(ii) If an account is a discretionary account, a record containing the dated signature of each customer or owner granting the authority and the dated signature of each natural person to whom discretionary authority was granted.

Each of the following must be discussed prior to entering the trade:
1. *The Name of the Security*. Many securities, such as Citigroup, KKR and Ford Motor have issued common stock and different preferreds. If the investment is a bond, particularly state or city municipal bonds, there can be a long list of different, separate debt issues. Because of this, the discussion must be very clear on exactly which security is being contemplated.[25]
2. *The Type of Order*. Though the vast majority of orders are either market or limit orders, there are other types: fill or kill, immediate or cancel, all or nothing, stop limit, sell stop, buy stop, good till canceled (GTC), on the close.
3. *The Price.* If it is a market order, the broker is required to discuss what the current or last price was and what the market order price is likely to be. If it is a limit order, the limit price must be discussed and specified.
4. *The Size of the Order*. It is not uncommon, when brokers are making recommendations, to talk in terms of dollars to be invested, which is appropriate under the regulations as long as the broker clarifies with the client ultimately the number of securities that will equate to.
5. *Commissions*. The regulations do not require that a broker disclose on each and every trade the commission that is going to be charged. But, under the regulations of proper communications and full disclosure, there are regulatory guidelines that the cost/commissions/fees must be disclosed. Brokers can not imply that there is no commission, even if that commission or fee is a part of the overall share price such as initial public offerings (IPOs).[26]
6. *Material Facts, Conflicts of Interest, Risk.* Numerous securities regulations, notices, interpretations, rulings, policies and procedures make clear that a broker must give all material information and full disclosure as it relates to any particular trade when the broker is soliciting the trade. For a customer to be capable of accepting or rejecting an order recommendation, the broker must provide the client with all material information. The broker should give the client enough detailed information and understanding to either accept or reject the recommendation/trade with full knowledge and understanding.

25. Stock options and index options have an extensive list of different options and different types of options for each security, making the detailed conversation between the broker and the client an even higher requirement.

26. There are securities regulations on commission fees and costs as it relates to annuities, front end loaded mutual funds and unit trusts.

Falsely Marking Tickets Unsolicited

Remarkably, this illegal practice continues today. Worse yet is that I often find that brokers who make unauthorized trades compound their violation by falsely marking those trades as being unsolicited (i.e., that the trade was the client's idea, not the broker's).[27]

It is one of the more serious securities violations for a broker to make unauthorized trades, but to exacerbate this wrongful act by attempting to hide the illegality by falsely marking the trade unsolicited is reprehensible.

Compliance manuals and policies and procedures manuals at most of the major broker-dealers acknowledge that mismarking order tickets "unsolicited" is often an attempt by an unethical broker to hide questionable trades, unsuitable trades or problematic trading patterns such as excessive trading.

Wells Fargo states in its compliance manuals that a pattern of trades marked unsolicited for a particular security for one client, or more importantly a group of clients of the same broker, is a "red flag" [28] and should be investigated.[29] Numerous state securities regulations address the issue of mismarking order tickets, the following being two examples:

27. A recent FINRA release concurs with my opinions and experience on this point. FINRA's 2018 Report on FINRA Examination Findings December 7, 2018, Selected Examination Findings Mismarking Order Tickets states "[s]ome registered representatives mismarked order tickets to obscure unauthorized discretionary trading by indicating that trades were executed in an unsolicited capacity, when, in fact, customers did not initiate the transactions and were unaware of the trading occurring in their accounts. In other instances, registered representatives mismarked order tickets and placed trades in customer accounts that did not comply with the securities' threshold limitations or trading restrictions." *See* FINRA's 2018 Report on FINRA Examinations Findings*, supra* note 6.

28. The term "red flag" is a term of art in the securities industry. "Supervisors must also respond vigorously to indications of possible wrongdoing. Supervisors must inquire into red flags and indications of irregularities and conduct adequate follow-up and review to detect and prevent future violations of the federal securities laws." In the Matter of Western Asset Management Co., and Legg Mason Fund Adviser, Inc., Exchange Act Release No. 1980, 2001 WL 1152569 (Sept. 28, 2001).

29. Schulz, *supra* note 3. One major brokerage firm states in a compliance memo, "A series of orders marked unsolicited will be closely questioned on the theory that multiple unsolicited orders were, in fact, solicited." Another major brokerage firm once put it this way in its Branch Manager's Supervisory Manual: "When reviewing the order tickets, a Branch Manager must consider the following: . . . A series of orders marked "unsolicited" for the same stock from a client or clients of the same Financial Consultant. The marking of order tickets as "unsolicited" will not protect

1. Arizona Administrative Code Corporation Commission – Securities Authority: A.R.S. §§ 44-1821 and 44-1845 R14-4-130. Dishonest and Unethical Conduct 19. Engaging in a pattern of marking order tickets as unsolicited when the dealer or salesman directly or indirectly recommended the transaction or introduced the customer to the security.
2. Nevada Administrative Code 90.237 identifies numerous actions as "unethical or dishonest practice" as defined by Nev. Rev. Stat. § 90.420(1)(h). This specifically includes "[m]arking any order ticket or confirmation as unsolicited if the transaction is solicited." *Id.* at NAC 90.327(1)(c).

Definition of a Solicited Order

Regulators, as well as brokerage firms, have addressed what constitutes a solicited order.[30]

One firm's brokerage compliance manual states:

> When a transaction is recommended to a client, or the Financial Advisor (FA) discusses the appropriateness of an investment, offers advice or provides a limited list of investments and the client enters an order as a result, the resulting transaction is considered to be solicited.
>
> Only those transactions in which the client has specifically requested that security by name or CUSIP (i.e. buy ABC Stock or sell XYZ Mutual Fund) should be indicated as "unsolicited."

Another firm's compliance manual makes it clear that trades should still be marked solicited even if there has been a reasonable period of time between

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the Branch Manager if the circumstances are suspicious, in which case the Branch Manager must determine if the orders are, in fact, solicited. . . ."

30. *See also* FINRA, NOTICE TO MEMBERS 96-60 (1996) discussing the definition of solicited: "However, a broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as "solicited" or "unsolicited." In particular, a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages."

the client discussion and the trade actually being entered and executed. That manual also provides that if the broker's discussion with the client positively influences the client to make the trade, even if the initial trade idea was that of the client, that trade should be marked solicited.

Still another firm's supervisory manual requires management to confirm the accuracy of a series of transactions with different clients all marked unsolicited, as this could raise questionable practices regarding authorization and suitability of the transaction. And, acknowledging federal law, that firm's manual declares that it is a violation of Section 17 of the 1934 Act to mismark a trade unsolicited when it was solicited.

Some of the better brokerage firms' compliance manuals and supervisory manuals provide examples of what is and is not a solicited trade. One of my favorites is the manual that states that if a broker is in doubt as to how to mark the ticket, mark it solicited.

Supervision and Detection of Unauthorized Trading

In one arbitration hearing where I was the expert witness for the investor/claimant, the branch manager stated that it is the client/investor who is on the front line and on whom he relies to discover unauthorized trading. Really?

It is no wonder that in this case the broker - who that branch manager was supervising- was found to have violated the unauthorized trading regulations in unparalleled amounts over numerous years. It would be a nice trick if Wall Street could shift the burden and responsibility for monitoring, detecting and supervising unauthorized trading to their clients. But it just so happens there is a list of securities regulations that require the opposite.[31]

And lucky for investors, in addition to the regulations themselves, most Wall Street firms, have compliance and supervisory policies and procedures addressing not only unauthorized trading, but its proper supervision and

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31. When it comes to detecting and preventing unauthorized trading, this article like my previous articles is not only for Wall Street management and compliance, it is also to aid the securities regulators, as my January 2004 article did. At that time, I gave a lecture for the training department of NASD top investigators with a focus on unauthorized trading, "Auditing Brokerage Branch offices – Red Flags, Supervision and Securities Violations." Douglas J. Schulz, Slide Show and Presentation to the NASD Enforcement Department–Investor Protection, Washington D.C., (January 2004).

detection. It is not really luck; under the regulations, these BDs are required to have these policies. [32]

Firms such as Ameritrade, Edward Jones and Wells Fargo forbid their brokers to use time and price discretion at all. Some go so far as to forbid discretionary trading entirely, whether time and price discretion or full discretionary authority, such as Ameritrade and Edward Jones.[33]

Edward Jones's compliance manual advises the firm's supervisory staff that they should look for trends and patterns when attempting to detect unauthorized trading and that client contact by supervisors is an additional important step in investigating possible unauthorized trading. The manual also stresses that trade blotters should be reviewed to see if multiple orders for a particular brokers' accounts all were entered in a very short timeframe. This red flag is reiterated in several Wall Street compliance manuals.

Wells Fargo advises its supervisors that potential red flags for unauthorized trading are a pattern of trades marked: a) canceled, b) "as of", or c) problems relating to nonpayment of trades or extensions of credit.[34]

Perhaps the most illustrative and persuasive case for a court or an arbitration panel is the 2013 SEC *Murphy* case quoted throughout this article. It is particularly applicable on the issue of supervision:

> Whether a supervisor's actions constitute "reasonable" supervision" 'is determined based on the particular circumstances of each case. We have held that [t]he duty of supervision includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation. Once indications of irregularity arise, supervisors must respond appropriately. [R]ed flags and suggestions of irregularities demand inquiry as well as adequate

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32. In a 2018 examination report encompassing a significant portion of Wall Street broker-dealers, FINRA addresses broker-dealer supervision. *See* FINRA's 2018 Report on FINRA Examinations Findings, *supra* note 6. ("FINRA has observed situations where some firms or registered representatives exposed investors to unnecessary risks and firms had not established controls—including those to comply with obligations under NASD Rule 2510 (Discretionary Accounts)—to mitigate those risks.).

33. FINRA's 2018 Report on FINRA Examinations Findings, *supra* note 6 at p. 8. FINRA has observed that some firms prohibit the use of all discretionary customer accounts.

34. Another red flag for detecting unauthorized trading or the mismarking of order tickets is the purchase of Initial Public Offerings (IPOs). Under FINRA Rule 5121(c) Discretionary Accounts, brokers cannot buy IPOs even in discretionary accounts without a separate written signed agreement.

> follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the securities laws.[35]

Some firms will not allow any broker who is on "heightened supervision" to handle any accounts on discretion. And, if a broker is guilty of similar misconduct in the past that is happening again, that would be a red flag that's on fire.[36]

Brokerage firms today have a host of tools to detect unauthorized trading. Some, such as Morgan Stanley, record all phone calls incoming and outgoing between brokers and their clients, including local calls. In such cases, all the branch manager needs to do is examine the phone records to determine if unauthorized trading occurred. The branch manager could approach the broker and confront her with the phone records. If the broker responds that her cell phone was used or there were meetings with the client, then the manager should ask to see the broker's cell phone records and records of the meetings. The proof will be in those records.

Phone records, if available, are the best evidence in an unauthorized trading case. And, of course, the evidence of what proactive measures the supervisor took to detect unauthorized trading is also important.

The unethical or incompetent branch manager, who worries far too much about his branch's bottom line, may end his inquiry with the broker and not look further. This reaction eviscerates the point of the supervision rules. It is about as effective and productive as a police officer rushing over to a bank whose alarm has sounded and sees backing out of the door a man with a mask holding a gun and a bag of money. The police officer asks, "Is everything okay in the bank?" The robber says, "Yes", and hightails it.

Kudos to the numerous brokerage firms whose compliance manuals specifically recommend calling the individual clients directly to investigate unauthorized trading, with no warning or input from the broker in question.

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35. In the Matter of the Application of William J. Murphy, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *27-28 (July 2, 2013), *aff'd sub nom*. (hereinafter referred to as *Murphy*).

36. *See Murphy*, at *30, 31("Indeed, because [the broker] had been disciplined for conduct very similar to that at issue in this case, [the supervisor] should have been particularly vigilant to investigate the red flags suggesting unauthorized trading…the failure to heighten supervision in the face of a relevant disciplinary history is a supervisory violation").

A Simple Phone Call is All it Takes

Another reason the majority of the unauthorized trading cases that I'm involved in as an expert witness either settle or the claimant is awarded damages is that, from a supervisory standpoint, there is yet another easy way for the branch manager or the compliance officer to quickly determine if unauthorized trading took place.

If alerted by a red flag to the potential of unauthorized trading – by prior discipline of the broker or unsolicited markings across multiple clients for the same investment - management/compliance should just pick up the phone and call the client.

In *Murphy*, the SEC sanctioned the supervisor because, despite numerous "red flags" of unauthorized trading, the *supervisor never called the client* to determine if the trades were authorized.[37]

As FINRA stated in a 2015 disciplinary order: "Proof of unauthorized trading often comes from the testimony of customers. As the National Adjudicatory Council has observed, 'a customer's testimony alone if credible, is sufficient to establish unauthorized trading.'" [38]

In arbitration on direct examination, this is a process that I often role-play for arbitration panels:

> *"Hello, Mrs. Jones? This is Bob Smith, here at Merrill Lynch. Do you have a minute? First, I want you to know that Merrill Lynch, your broker Fred and I want to thank you for your years of being a loyal client of the firm. This is just a routine call to make sure we are doing everything that we can do in servicing your needs. Before I start, do you have any questions for me? I just have a few questions - how often do you talk with Fred? When was the last time you spoke with Fred? So, you haven't talked to Fred and neither has your husband for two weeks, is that correct? So, I noticed from your trading records that you made a few buys and sells in your account last week. I know you said you haven't talked to Fred for two weeks, but is there any chance that you talked to him last week about these buys and sells? Thank you, Mrs. Jones, I appreciate you giving me your time. Unless you have some additional questions for me, I don't have any other questions for you."*

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37. *Murphy*, at *28 ("But it would not have taken an extensive investigation for [the supervisor] to have a candid conversation with [the client] about whether she was giving approval to [the broker] prior to every trade.").

38. *Lalley*, at p. 15 (citations omitted).

Now the branch manager has proof positive that at least in this one account, the broker made unauthorized trades. This information would call for an expanded investigation into other of Fred's clients, phone calls to many of Fred's clients, a full examination of trading records, phone records, interview with Fred to see just how extensive Fred's unauthorized trading has been. Depending on the results of such investigation and the seriousness of the violation, the firm should consider terminating Fred's employment.

Wall Street's Boilerplate Defenses to Unauthorized Trading

It is surprising for me to see broker-dealer respondents trotting out the same boilerplate defenses they have used for the last 30 years that I have been an expert:

- Suitability – If the trade was unauthorized, there is no harm because the trade was suitable.
- General approval – The client generally approved this investing/trading strategy.
- Each Trade was Approved by Client - the classic he said/she said.
- Phone Records
- Lots of phone calls or short phone calls
- Verbal discretionary approval – No such thing
- After the fact approval – the broker discussed each trade after they were executed
- Contributory negligence – the client should have caught us committing fraud
- Ratification – the client did not complain after receiving confirms and statements
- The broker was just trying to be accommodating
- The broker is not a bad guy; he just didn't understand the rules or made an honest mistake
- Time and price discretion – this defense has been fixed
- The unauthorized trading did not cause the losses – the market caused it.

Let me go through these individually in more detail:

1. Suitability – If the trade was unauthorized, there's no harm because the trade was suitable
    - This might be the most ridiculous defense of all. You are driving on the Interstate and you are pulled over for speeding. Under this illogical defense, you could get out of the speeding ticket by

saying to the ticketing officer, "But I haven't been drinking and my taillights are working." If you don't get a chuckle from the highway patrol officer, you might get arrested and dragged into the closest police station.

- Since when in federal or state court, much less in arbitration, does the fact that you did not breach a different securities regulation give you a "free pass" to breach other securities violations? Unauthorized trading and suitability are separate violations. Though they can occur on the same trade, they may not, and one is not dependent on the other. An unauthorized trade on its own is a serious breach of SEC, FINRA and state securities regulations, as shown above.
- The brokerage defense lawyers know the panel is not going to buy the argument that if a trade is suitable, it does not matter if it was unauthorized. But they will argue suitability anyway to deflect the panel's attention from unauthorized trading and to muddy the waters: did the client want growth or aggressive growth?
- How much risk was the client willing to take? Defense counsel will attempt to gray things up in the panel's mind. That is why in most of the unauthorized trading cases in which I have been retained, we spend the bulk of the claimant's case proving illegal, discretionary trading while the defense goes on and on about suitability almost exclusively.

2. General Approval – The client generally approved this investing/trading strategy
   - This is sort of a compound, catch-all broker-dealer defense. "Well, maybe we didn't have signed forms granting discretionary powers (Limited Power of Attorney) and maybe the broker didn't have the required discussion just prior to the trade, but at the outset of the account, a month before the trading, the broker and the client agreed on an overall investment trading plan."
   - There is no such exception to FINRA's Discretionary Trading Rule 3260. There is not even a Notice to Members or Regulatory Notice from FINRA or the NASD that even hints that this undefined approval is acceptable under the securities regulations.[39]

39. *See* In the Matter of the Application of Charles D. Tom for Review of Disciplinary Action Taken by the Nat'l Ass'n of Sec. Dealers, Inc., Release No. 31081, 1992 WL 213845 (Aug. 24, 1992). The SEC sustained a ruling that the broker had violated the rules concerning unauthorized trading. The broker admitted

- This defense makes a mockery of the rules on its face, but brokerage firms continue to use it.

3. Each Trade was Approved by Client – The classic he said/she said
   - If the broker did, in fact, have a sufficiently detailed conversation just prior to each buy and sell transaction and the client, during that specifically detailed conversation, gave his or her approval of said trade – that ends the inquiry. There is no unauthorized trade violation.[40]
   - The reality is, though, that this defense is easily belied by phone records.
4. Phone Records
   - Phone records are the number one way to prove an unauthorized trading case. FINRA Discovery Rule 12506 has "Document Production Lists" that are required to be produced by the brokerage industry within 60 days from the answer. The following are those sections of the list that relate to telephone records and documents relating to discretionary authorization:

     > LIST 1 Documents the Firm/Associated Persons Shall Produce in All Customer Cases
     > 1)(c) All agreements with the customer parties, including, but not limited to, account opening documents and/or forms; cash, margin, option, and discretionary authorization agreements; trading authorizations; and powers of attorney.
     > 4) For claims alleging unauthorized trading, all documents the firm/associated persons relied upon to establish that the customer parties authorized the transactions at issue, all documents relating to the customer parties' authorization of the transactions at issue, and all order tickets for the customer parties' transactions at issue.
     > 8) All recordings, telephone logs, and notes of telephone calls or conversations about the transactions at issue that

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that the details of each trade (mostly options) were not discussed with the client but that the client was aware of the "overall strategy." This carried no weight with the SEC.

40. *See* Schulz, *supra* note 3, at chapters 16–24 (discussing in detail how to prove an unauthorized trading claim). Both earlier unauthorized trading articles can be found at http://www.securitiesexpert.com/articles-by-douglas-schulz.html.

occurred between the associated persons and the customer parties (and any person purporting to act on behalf of the customer parties), and/or between the firm and the associated persons.

- Defense lawyers, knowing how crucial phone records are, have developed questionably creative ways to fight them. Often broker-dealers just fail to produce the required documentation, knowing that those attorneys who are not experienced in FINRA arbitrations may not follow up. And, the sad fact is that, from my observation, few arbitration panels these days apply sanctions for blatant discovery abuses.
- Phone records exist! I have yet to see a broker-dealer that does not keep detailed records of all incoming and outgoing phone calls. Of course they do; it is for *their* protection.
- A common complaint by investors, especially those who trade extensively, is something referred to as "order failure." Often the best defense of the brokerage industry, be it a brick and mortar firm such as Morgan Stanley or Wells Fargo or an internet/online firm such as Schwab and Fidelity are the phone records. The records show the originating phone number, the receiving phone number, date and exact time of call and the duration of the call.

Match up all the phone records and all the trades in chronological order; in discovery in addition to the order tickets and confirmations, you should obtain the trade blotters, which will give the exact minute of entry of each and every order. With these tools, the panel should easily see with undisputed documentary evidence that there was no conversation between the broker and the client and that, therefore, the broker (and firm) violated the discretionary trading rules.

5. *Lots of Phone Calls or Short Phone Calls*

Phone records reveal the duration of each phone call, which is often a key factor. I cannot tell you how many times I see this defense refrain in their Answer, brief and opening statement: "This claim of unauthorized trading is frivolous – there are hundreds of phone calls."

Yes, there were hundreds of phone calls over the multi-year life of the account, but what opposing counsel failed to mention to the panel is that most of those phone calls were not on trade dates. And, on the trade dates, the phone calls were short – like less than one minute and many 2.5 minutes. The call may be so short that you can safely state that the phone call was nothing more than a recorded voice message. But even a 2.5 minute phone call may not be enough time to satisfy the long list of specific items the broker must discuss with the client when recommending a buy or sale transaction required by the rules, not to mention enough time to obtain the client's approval after answering any questions. All of this is almost impossible to do under 2.5 minutes.

Additionally, be sure to compare the number of phone calls or personal meetings versus the total number of trades on different days. 220 calls/meetings in an account that did 475 trades is, on its face, a meritless defense.

6. Verbal Discretionary Approval – There is No Such thing

This is such a worn-out, inappropriate defense, but defense lawyers still regularly use it. Let me be clear: THERE IS NO SUCH THING AS VERBAL DISCRETIONARY AUTHORITY – END OF STORY. Hopefully, my all-caps convinces you. But, your expert should have an easy time convincing an arbitration panel, a judge or a jury that every regulation on discretionary trading makes it absolutely clear that all trading authority must be in writing, on the proper forms (limited power of attorney or discretionary trading authority), signed by the client and approved by a supervisor in advance of any trade.

Long ago, the SEC stated, essentially, that there is no such thing as verbal trading authority.[41] Broker Fabio had argued the defense that the client had given him verbal discretion to "go ahead" and "find appropriate investments." The SEC disagreed, confirming the findings that the broker had no authority to make the trades despite being given verbal discretionary authority.[42]

Such proclamations were reaffirmed in the 2013 *Murphy* case: "[O]ral permission is insufficient to exercise discretionary power in a customer's account under Rule 2510." Similarly, an "associated person is responsible for

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41. SEC Release 34, 39383, File No. 3-9269 (Dec. 2, 1997).

42. *See also* Dep't of Enforcement v. Jordan P. Zaro*,* Complaint No. 20070098511 (May 12, 2010) ("broker exercised control over [client's] account, which he traded under oral discretionary authority"… broker "effected discretionary transactions in the account of [client] without having obtained prior written authorization from [client] and prior to written acceptance of the accounts as discretionary by the Member.").

obtaining his [or her] customer's consent prior to purchasing a security for the customer's account."[43]

All of this, though, does not stop a crafty defense lawyer who gets an investor to admit on the stand that he did give the broker verbal authority to make trades without first speaking to him in the hope that a sympathetic arbitration panel will give this some credence. The fact that an uninformed layman innocently gives verbal discretionary authority should only serve to highlight the claimant's naiveté, not help the brokerage firm defend the case. The arbitration panel should give it absolutely no weight whatsoever.

7. *After the Fact Approval – Broker discussed trades with the client after they were executed*

After the fact approval is another common defense designed to mislead the arbitration panel about the securities regulations and garner sympathy from the panel. "Well, the client did approve the trade at some point; it just happened to be after the trade was executed." For example: "Hey Bob, just thought I would give you a jingle and tell you about the trades I made in your account yesterday."

There is no such thing as post-trade or after-the-fact discretionary approval, whether verbal or in writing. Both legally and technically, this defense does not work and should fail. Some fabulous language is found in *Murphy*:

> Murphy further argues that, despite "frequent contact" with him, "Lowry never expressed a concern about the type of options transactions effected" in her account. But the fact that Lowry did not complain about the uncovered option positions in her account does not mean that Murphy's trading was authorized. Lowry believed that Murphy was pursuing only a covered call strategy, and she lacked the sophistication to understand that Murphy was, in fact, significantly deviating from that strategy. Moreover, even if Lowry's apparent acquiescence were viewed as ratification of Murphy's uncovered options trades, "*we have held repeatedly that after-the-fact 'acceptance' of an unauthorized trade does not transform that transaction into an authorized trade*. (citing to *Sandra K. Simpson*, Exchange Act Release No. 45923, 55 SEC 766, 2002 WL 987555, at *13 (May 14, 2002); *see also Edgar B. Alacan*, Exchange Act Release

43. *Murphy*, at *11, 12.

> No. 49970, 57 SEC 715, 2004 WL 1496843, at *6 n. 27 (July 6, 2004); *Janet G. Katz*, Exchange Act Release No. 61446, 2010 WL 358737, at *22 ("[R]atification of a transaction after the fact does not establish that trades were authorized before being executed.").
> And, as FINRA recognized, given Lowry's lack of investment experience and Murphy's repeated false assurances that her account was profitable, any absence or delay in complaints from Lowry was most likely "a consequence of misplaced trust" in Murphy, "rather than approval of his actions." (citations omitted)[44]

8. Contributory Negligence – The clients/investors should have caught us committing fraud

I'm not a lawyer, but I was a criminal justice major and a special investigator for the public defender's office, so I learned early in my career that when it comes to fraud, there is no such thing as contributory negligence.

Think about the defense: "You should have been smart enough to catch us defrauding you." This absolutely does not work in the most highly regulated industry in the country - securities. And, besides, the brokerage industry cannot shift its duty and burden to the clients. Clients are not licensed and have not passed securities industry tests. The conduct of brokers and managers, though, is dictated by numerous regulations and policies governing compliance and supervision. The onus is on the licensed individuals at the broker-dealers, not the client/investors.

But, as mentioned in my previous articles, there is a second fallacy with this concocted defense. Investors do not know the rules and regulations of the securities industry.[45] Though I have maintained it would be a good idea, Wall Street does not hand out to each client a pamphlet that explains the rules and regulations of the securities industry. For example, investors do not know that there exist rules and regulations against unauthorized trading. Most investors do not even understand the difference between a Registered Investment Adviser (RIA), a Series 7 Registered Representative, a managed account, a wrap account and a discretionary account.

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44. *Murphy*, at *14.

45. In 2002, I co-authored a book titled, BROKERAGE FRAUD – WHAT WALL STREET DOESN'T WANT YOU TO KNOW, Dearborn Publishing, which was an attempt to educate investors about the rules and regulations of the securities industry.

A very large percentage of investors think that all brokers—to a degree—can act as money managers who can buy and sell without having to talk to the client.[46] Therefore, they are not on notice of any wrongdoing or anything amiss when they see trade confirmations and statements showing trades in their accounts. This is as they expect it to be. The defense refrain of "We expect our clients to notify us if there are any unauthorized trades" simply does not fly.

In addition, many clients/investors are oblivious to wrongdoing in their accounts because they trust their brokers and rely on their services and advice. However, the mindset of the client is irrelevant to whether or not there has been a violation. Clients are entitled to trust their brokers and assume they are honest and not be penalized if their trust is misplaced in a bad apple.

9. Ratification – The client did not complain after receiving confirms and statements

The ratification defense is found in every single case where an unauthorized trading claim is made. In both their Answer and their brief, brokerage firms will go on *ad nauseum* about how the claimant ratified the unauthorized trades. Having been involved as an expert in many unauthorized trading cases, I have read a lot of defense firms' prehearing briefs. As a non-lawyer, it always seems a bit hypocritical to me that the defense goes to such great lengths to argue that one state's laws should apply to the case and then in their brief quote case law from all over the country.

However, there is some very good case law for investors to combat the ratification defense with:

- "Ratification of unauthorized trading occurs only when it is clear from the circumstances that the customer intends to adopt the trade as his own. Knowledge of the pertinent facts and the clear intent to approve the unauthorized action is a precondition to ratification."[47]

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46. A 2011 SEC Study found that investors did not understand the difference between investment advisers and broker-dealers. SEC, *Study on Investment Advisers and Broker-Dealers*, (January 2011), available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf.

47. Syckle v. C.L. King & Assoc., Inc., Fed. Sec. L. Rep. (CCH) ¶ 97,701 at 97, 261 (N.D.N.Y. May 23, 1993).

- Moreover, "the principle of ratification . . . does not apply to cases in which a customer's consent is obtained through misrepresentations."[48]
- In *Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng*, the court held that "[r]atification occurs only when the customer, with full knowledge of the facts, manifests his intention to adopt the unauthorized transaction." [49]And, because the investors in Merrill Lynch "were not advised of their right to reject the unauthorized trades," the court concluded that "as a matter of law, there could not have been ratification."[50]

Standard brokerage Customer Account agreements do not contain language that clients have the right to rescind or disavow unauthorized claims. Without this, there can be no ratification, according to case law.

But there is more good news for claimants in unauthorized trading cases, especially when it comes to some of the technical, legal defenses such as ratification: Case Law Does Not Trump Securities Rules and Regulations.

The activities of Series 7 licensed registered representatives and the other licensed individuals at a broker-dealer are regulated and dictated by the rules of the SEC, FINRA and the individual state securities commissions in which those firms operate and in which the customers reside. The fact that some friendly Second Circuit Court of Appeals judge in Wall Street's home court has made some favorable ruling to the brokerage industry has no bearing on the requirements and obligations of brokers. It is easy to put it to the test—just ask the broker when he is on the stand.

Although ratification is a legal issue, when the regulators—such as the SEC and the NASD/FINRA—make proclamations about its applicability in the brokerage arena, such findings arguably supersede case law. This is a standard defense by brokerage firms in any unauthorized trading case and while the defense will argue case law until they are blue in the face, I am often called upon to educate the panel that the regulators have addressed the subject of ratification.

The SEC sustained findings of unauthorized trading, despite the fact that the client never complained about or repudiated any of the trades. The SEC stated that although the client never complained, that was no defense: "we have

48. *Eichler v. SEC*, 757 F.2d 1066, 1070 (9th Cir. 1985).

49. 901 F.2d 1124, 1129 (D.C. Cir. 1990).

50. *Id.* at 1129.

repeatedly held that ratification of a transaction after the fact does not mean trades were properly authorized."[51]

FINRA's disciplinary arm—the National Adjudicatory Council (NAC) — has often faced the ratification defense made by brokers in disciplinary actions. Time and again, the NAC has rejected brokers' defenses that their customers had ratified the wrongdoing—whether it be an unauthorized trade or an unsuitable transaction—because the customer never complained. In *Department of Enforcement v. Dane S. Faber*,[52] the broker argued that his clients ratified transactions because they never complained or instructed the broker they wanted to sell. The NAC rejected the broker's attempt to shift fault to his customers, stating, "Because [the broker] made misrepresentations and omissions, his customers were deprived of material facts regarding the investment. Again, the proper focus is on [the broker's] conduct, not the non-action or acquiescence of his customers…."[53]

Likewise, the SEC has stated, "Although [the client] eventually learned of the bulk of [the broker's] unauthorized trades from trade confirmations, such after-the-fact knowledge does not demonstrate that [the client] approved those transactions before [the broker] made them.[54]

Again, it is important to stress to the panel that the above references are not court decisions (which can result in opinions diametrically opposed on the same subject), but decisions by securities regulators—the SEC and the

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51. Neil C. Sullivan, 51 SEC 974, 976 (1994); Frank J. Custable, 51 SEC 643, 650 (1993). *See also Murphy*, at *14 (SEC gave no weight to the broker's argument that the client never complained).

52. Dep't of Enforcement v. Dane S. Faber, NAC Decision No. F010009 (NAC May 7, 2003).

53. *Id.* at p.15.

54. In the Matter of Ralph Calabro, Jason Konner, and Dimitrios Koutsoubos, SEC Admin. Proc. File No. 3-15015 at p. 15 (May 29, 2015). *See also* In re Simpson, Exchange Act Release No. 45923, 2002 WL 987555, at *13 (May 14, 2002) (rejecting argument that customers who "received monthly statements and other forms notifying them of [unauthorized] transactions but filed no complaints" ratified the trades because, among other things, "after-the-fact 'acceptance' of an unauthorized trade does not transform that transaction into an authorized trade"); In the Matter of the Application of Neil C. Sullivan for Review of Disciplinary Action Taken by the New York Stock Exch., Inc., 51 S.E.C. 974, 1994 WL 46344, at *2, n.1 (Feb. 10, 1994) (finding that applicant made unauthorized trades and noting that "[t]he fact that a customer ultimately accepts an unauthorized trade does not transform it into an authorized purchase").

NASD/FINRA. As such, the arbitration panel should rely on this more authoritative evidence, as opposed to the defense's court cases.

10. The Broker was Just Trying to be Accommodating

I often hear defenses by brokers who made unauthorized trades such things as:

- "The client was out of town and couldn't be reached."
- "I know the client would have approved the trade if I could've gotten a hold of her."
- "I was just trying to be accommodative."

FINRA has addressed these emotional defenses, most recently in its 2018 report:

> **No Authorization** – Some registered representatives exercised discretion in customer accounts without the customers' prior written authorization or the firm's approval of the discretionary account. In some instances, this occurred when a registered representative executed transactions in a single security across multiple customer accounts in a short period of time. Additionally, FINRA found that some registered representatives violated the requirements of NASD Rule 2510 (Discretionary Accounts) when they executed transactions in customer accounts *as an accommodation* without receiving specific customer authorization to execute that transaction.[55]

"This defense is similar to the defense that it was the client who requested a particular rate of return, requiring the broker to make trades to meet that goal. The SEC has rejected that defense.[56]

11. The Broker isn't a bad guy; he just didn't understand the rules or made an honest mistake

This is yet another warm and fuzzy defense tactic. This is why I recommend to lawyers who I work for, that it is a good strategy, when I start

55. FINRA's 2018 Report on FINRA Examinations Findings*, supra* note 6.

56. *Murphy*, at *13 ("Lowry's alleged demand for a particular investment outcome does not mean that Murphy was permitted to pursue unauthorized trades in pursuit of that goal.").

my testimony, to explain to the arbitration panel that the securities industry is one of the most highly regulated industries in the United States and the reasons for that. Again, lucky for the investor, most FINRA arbitrations are populated with arbitrators who are lawyers. They are aware, from their legal training and experience, that a lack of knowledge of the regulations is never a defense in almost any legal proceeding.

This defense is also easily dispelled because almost every brokerage firm's compliance or policies and procedures manual spells out clearly the absolute duty for their brokers, management and compliance staff to read and be aware of all rules regulations and internal policies and procedures. Many firms require their brokers to sign an annual attestation stating that the broker has received, reviewed and is fully responsible for following all the rules and regulations and policies. Under the various supervision rules and releases—both from the regulators and internally within the brokerage firms—is language and policies that requires the supervision and compliance staff to constantly test, monitor, and diligently supervise all their registered representatives and document and certify that these individuals are fully aware of all the regulations and are following them.[57]

Regulators also are not likely to excuse even honest mistakes made by brokers in conducting unauthorized trades. In the *Lalley* case, FINRA's Department of Enforcement concluded that the broker "mistakenly made the unauthorized trades" because it was the broker's "consistent practice to speak with clients with nondiscretionary accounts."[58] Nonetheless, FINRA ruled:

> As FINRA's National Adjudicatory Council has noted, there are many cases in which a registered representative under certain circumstances believed "honestly but mistakenly that he or she was authorized to trade" but nonetheless the trading was unauthorized and violative of FINRA rules. Thus, despite Lalley's argument to the contrary whether or not she had a good faith belief that she had spoken to [the client], if she executed the trades without authorization, she violated FINRA Rule 2010.[59]

57. *See* FINRA Supervision Rule 3110 and a laundry list of regulatory notices and interpretations on the issue of proper supervision.

58. *Lalley*, at p.16.

59. *Id*. at p.17.

12. Time and Price Discretion –this defense has been fixed

The "time and price discretion" defense was only ever merely that: a defense. It was a defense conjured up by defense lawyers to attempt to justify actions when their client/broker was clearly making illegal, discretionary trades in his client's accounts. If the claimant proved there was no communication just prior to the trade, the broker could claim that he earlier had obtained "time and price discretion" from the client for the trade, making phone records of calls on trade dates moot. This is because, prior to the 2004 amendment to FINRA Rule 2015, defense counsel could use the "time and price discretion" defense willy-nilly because nothing required documentation of its use.

FINRA Rule 2510 has now eliminated the "time and price discretion" defense because it now requires that "any exercise of time and price discretion must be reflected on the customer order ticket". Therefore, just like the price and the quantity of the security, this is a subject that must be discussed between the broker and the client. Not only must the broker specifically ask for "time and price discretion," but the client must also specifically give permission for the broker to use "time and price discretion" on a trade. And, then the broker must document that he is using "time and price discretion" on that particular order. To repeat, "time and price discretion" is to be used on a per-order basis and not on a group of orders.

You might think that FINRA's remedying the time and price discretion loopholes would fix the proliferation of illegal, discretionary trading. No such luck. Just in the last year, a decent percentage of the securities cases in which I have been involved as an expert have still involved unauthorized trading and the defense lawyers raise the issue of "time and price discretion." Nothing has changed, except for the claimant's ability now to dispute it with the trade ticket.

13. The Unauthorized Illegal Trading did not Cause the Losses - the Market Caused Them

This is a backhanded causation argument, one to which panels and courts give little credence. It is almost comical that the brokerage industry uses this defense to just about every claim or cause of action: "It's not our fault your client lost money because the market went down."

Of course, that defense is not working so well recently since we have been in roughly a 10-year bull market. Even in a bear market, though, the defense carries little weight. Just take it to its illogical conclusion.

- So what if we omitted material facts? It did not cause the losses.
- So, what if we flipped and churned mutual funds? It did not cause any losses.
- So what if we had a total breakdown in compliance and supervision of this broker and these accounts? It did not directly cause the losses.

Other than it just being an illogical defense, it is fairly easy for an expert to deflate: show the panel the market comparative damages to prove that the "market" had almost nothing to do with your client's damages, but rather it was the list of inappropriate, unsuitable, violative activities by licensed individuals.

Conclusion

Unauthorized trading cases can often be proven or disproven by phone records and order tickets. Mismarking of trades can be determined by confirmations and frequently a mismarked trade is an unauthorized trade. A stockbroker who commits unauthorized trades and mismarks order tickets is a broker who has little regard for the rules that govern his conduct.

Much of the support for the points made in this article are regulatory decisions by the SEC and NASD/FINRA and its enforcement division. These decisions should carry great weight in general and particularly in unauthorized trading cases. At the very least, they should overcome case law from other states.

We have come a long way in 20 years, and I applaud most of the advancements. But it is clear to me that unauthorized trading will remain a problem for Wall Street and investors for the foreseeable future.

Appendix A FINRA Rule 3260 Discretionary Accounts

3260. Discretionary Accounts

(a) Excessive Transactions

No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

(b) Authorization and Acceptance of Account

No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Rule 3110.

(c) Approval and Review of Transactions

The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.

(d) Exceptions

This Rule shall not apply to:

(1) discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed, except that the authority to exercise time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer. This limitation shall not apply to time and price discretion exercised in an institutional account, as defined in Rule 4512(c), pursuant to valid Good-Till-Cancelled instructions issued on a "not-held" basis. Any exercise of time and price discretion must be reflected on the order ticket;

(2) bulk exchanges at net asset value of money market mutual funds ("funds") utilizing negative response letters provided:

(A) The bulk exchange is limited to situations involving mergers and acquisitions of funds, changes of clearing members and exchanges of funds used in sweep accounts;

(B) The negative response letter contains a tabular comparison of the nature and amount of the fees charged by each fund;

(C) The negative response letter contains a comparative description of the investment objectives of each fund and a prospectus of the fund to be purchased; and

(D) The negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.

Amended by SR-FINRA-2019-009 eff. May 8, 2019.
Amended by SR-NASD-2002-162 and SR-NASD-2004-116 eff. Jan. 31, 2005.
Amended by SR-NASD-92-14 eff. Dec. 10, 1992.

Selected Notices: 75-33, 76-30, 91-39, 91-80, 92-25, 93-1, 04-71.