Why Securities Laws, Rules & Decisions Trump Case Law

by Douglas Schulz[1]

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Introduction

At the heart of every Financial Industry Regulatory Authority (FINRA) arbitration claim between an investor and a FINRA member broker-dealer and/or broker is a list of securities regulations/laws that the claimant says were violated, thereby causing losses/damages. In response, Wall Street defense lawyers – both in pleadings and at the final hearing -- routinely attempt to minimize the applicability and dull the teeth of securities regulations/laws by directing FINRA arbitrators to case law they claim either narrows or overrules the plain language of the regulations/laws. The defense knows that one or more members of the arbitration panel are lawyers and are often more comfortable and therefore prone to rely on case law rather than the dry text of regulations/laws.[2]

Claimants must be prepared to overcome this defense obfuscation tactic by educating panels about the relevance and – most pointedly – the regulatory interpretations and applications of the rules to similar fact patterns. To that point, there is an enormously helpful body of the Securities & Exchange Commission (SEC) and FINRA decisions and declarations on which claimants should anchor their presentation and that defense lawyers prefer to ignore. After all, these are the very entities that enforce the rules and discipline broker-dealers and brokers on a daily basis.[3]

For 36 years, I have been one of the leading securities experts in the country. From the get-go in 1989, just two years after the 1987 Supreme Court ruling that forced all broker-dealer clients into arbitration, I have been confronted with an irritation when giving sworn testimony. When I apprise the arbitration panel or jury of the duties of registered stockbrokers and licensed investment advisors, I refer to the securities regulations that outline those duties - federal regulations of the SEC, FINRA regulations, and various state securities regulations. But often after my direct testimony, the defense lawyer attempts to impugn my credibility by bringing to my attention state or federal case law that may conflict with those securities regulations. This prompts a debate between the opposing counsel and me as to what dictates the

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[2] The “case law” this article is critical of is limited to case law that contravenes securities conduct regulations/laws and interpretations.

[3] My thanks to Tracy Pride Stoneman, a nationally recognized securities lawyer, who has litigated securities cases and arbitrations since 1993. www.brokeragefraud.com. Ms. Stoneman helped greatly with the legal case cites.

actions and requirements of these licensed securities professionals: a) the securities rules and regulations or b) state and federal court decisions. This is the first article that I am aware of that addresses this issue.

Quick History of Securities Regulations

Let's assume for the sake of argument that the broker-dealer defense lawyers are correct in their legal argument that the various 50 state and federal court rulings dictate the activities of brokers and advisers. And whenever these state or federal court rulings conflict with a specific securities regulation, the court ruling preempts. How would that work in the real world of the brokerage and advisory business? Let's start by giving a quick primer on securities regulations.

There were sparse securities regulations in the United States in the 1800s; it wasn't until 1911 that Kansas created the first set of securities regulations addressing the registration of securities and brokers who sold securities in that state. Kansas felt that unscrupulous salesmen were selling investments to prospects where the assets that backed the investments were as empty as the "blue skies of Kansas". The term "Blue Sky Laws" came to signify state-level securities regulations designed to protect investors from fraud. In 1929 the Uniform Securities Act was passed to bring some cohesiveness to the various state securities regulations.

The great 1929 stock market crash, which pushed the United States into the Great Depression, prompted the federal government to pass its first meaningful securities regulations/laws. The first was the Securities Act of 1933 (the '33 Act). It deals primarily with the requirements to register securities and to require full disclosure in registration documents.

The second major piece of federal securities regulation that came out of the '29 crash was the Securities Exchange Act of 1934 (the '34 Act). Where the '33 Act dealt primarily with the initial registration of securities, the '34 Act dealt more with the regulation of those securities once they traded in the public market. One of the key sections of the '34 Act is the anti-fraud provision 10b- 5 which addresses fraudulent acts in the sale of securities.

Shortly thereafter, the Investment Company Act of 1940 was enacted, which deals mainly with the regulation of investment companies and mutual funds, and the Investment Advisors Act of 1940, which dealt with the licensing and registration of individuals who are not necessarily stockbrokers but instead rendering investment advice mainly through being a Registered Investment Advisor (RIA).

The National Association of Securities Dealers, NASD, was created in 1939 by the Maloney Act. NASD was to be a self-regulatory body of Wall Street broker-dealers under the supervision of the SEC. In 2007, when the NASD merged its Arbitration and Enforcement Departments with that of the New York Stock Exchange, the name was changed to FINRA, the Financial Industry Regulatory Authority. FINRA's mission is to protect investors and safeguard the integrity of the capital markets to ensure that everyone can invest with confidence.

The Enforcement of Securities Regulations

When contemplating the potential conflict between securities rules/regulations and case law, one must first address the enforcement of securities regulations, because it's at the heart of why this conflict is so important. Once the three bodies of securities regulations were codified, it was then the job of the various securities enforcement agencies to make sure the regulations were followed and enforced.

It's axiomatic that each of these enforcement departments is 100% reliant on the securities regulations. All of these enforcement agencies work collectively to enforce each of the other agencies' securities regulations. For example, the Colorado Securities Commission in addition to enforcing the securities regulations of Colorado, likewise will enforce the securities regulations of both the SEC and FINRA. But you will rarely see the SEC or FINRA enforcing state securities regulations; generally, the federal regulators defer to each individual state securities commission for enforcement of state regulations.

Both the SEC and FINRA have Enforcement Divisions that file cases against financial professionals and firms that violate FINRA and SEC regulations/laws. The SEC brings cases against not only stockbrokers and brokerage firms but also RIAs.[4] The SEC files a disciplinary action against one of these individuals and/or the firm by initiating an investigation, which can be triggered by complaints, market surveillance, or whistleblower reports. If evidence of wrongdoing is found, the SEC can either file a lawsuit in federal court or bring an administrative proceeding against the violator, often seeking settlements to resolve the case without going to trial. The most severe action could be referring the case to the Department of Justice for criminal prosecution.

When FINRA determines that violations of securities regulations/rules have occurred and formal disciplinary action is necessary, the Enforcement Department files a complaint with the Office of Hearing Officers (OHO). What happens next is not unlike a securities arbitration: a three-person panel hears the case and the evidence and renders a decision. The panel is chaired by a hearing officer who is an employee of the Office of Hearing Officers. At the hearing, the parties present evidence for the panel to determine whether a firm or individual has engaged in conduct that violates FINRA or SEC regulations/laws. For each case, the hearing panel will issue a written decision explaining the reasons for its ruling.

On a monthly basis, FINRA publishes detailed summaries of the actions it took against stockbrokers and/or brokerage firms. Law firms that specialize in defending broker-dealers routinely analyze ongoing and significant SEC and FINRA decisions in order to advise their clients on acceptable conduct.

The National Adjudicatory Council (NAC) is a FINRA committee that reviews initial decisions rendered in FINRA disciplinary and membership proceedings. The NAC may affirm, dismiss, modify, or reverse any finding, or remand for further proceedings. The NAC's decision represents FINRA's final action. A firm or individual can appeal FINRA's decision to the Securities and Exchange Commission.[5]

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[4] SEC Division of Enforcement has numerous other enforcement responsibilities such as Investment Companies, Mutual Funds, publicly listed Companies, etc.

[5] https://www.finra.org/rules-guidance/adjudication-decisions/national-adjudicatory-council-nac#

The result is that there is a wealth of reported opinions analyzing the securities rules and regulations emanating from both the SEC and FINRA. FINRA has two sets of reported decisions arising from conduct violative of its securities rules/regulations – OHO decisions and NAC decisions.

Importantly, the SEC and FINRA regulations are national in scope and do not vary by state. This is beneficial to all members of the securities industry, because imagine the nightmare it would be if brokerage firms in different states were forced to write their compliance and supervisory manuals differently depending on state or federal case law. The SEC and FINRA have no need to adjust their monitoring, supervision, and enforcement of the regulations any differently between each of the 50 states. Brokerage firms can write one set of manuals that applies to all of their licensed brokers and supervisors for the entire nation.[6] All employees can be hired, trained, monitored, and supervised under one consistent, nationwide set of regulations by the SEC and FINRA.[7] A stockbroker who has worked 10 years in the Merrill Lynch office in New York City can quit and take a job with a Wells Fargo office in Phoenix and not have to take any new additional training; all the securities regulations are the same at both firms at both offices in both states.

Falling generally under FINRA's "Enforcement" umbrella are what for years were called Notice to Members (NTMs) and currently are called Regulatory Notices[8]. These Notices are sent to every licensed broker-dealer in the United States. FINRA notices are considered important guidance and should be taken seriously as they outline expectations for compliance with FINRA rules/regulations. Firms are expected to adhere to the practices and procedures outlined in the notices to avoid potential regulatory issues; if a firm chooses to deviate significantly from the guidance, it could face disciplinary action from FINRA if a violation occurs.

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[6] FINRA supervision rule 3110 requires all broker-dealers to have WSPs, Written Supervisory Procedures, addressing all regulations, internal policies, and all actions of their licensed brokers and advisers.

[7] Of course, separately in those states where the broker-dealer or advisor operates, it does need to be familiar with and enforce any of the specific state securities regulations.

[8] Many FINRA notices address conduct regulations/rules and thus can serve as additional evidence for the arbitration panels as to whether regulatory violations occurred.

Regulatory Decisions Preside Over Case Law Decisions

As a Certified Regulatory Compliance Professional (CRCP)[9], often my main job when testifying in securities litigation is to explain to the trier of fact the rules and regulations of the securities industry, often supplemented with the norms and standards. Working with counsel in a FINRA hearing, the objective is to try to get the arbitration panel to focus on the securities regulations/laws that were violated. This needs to be established very early on in the arbitration and throughout the case through a combination of the statement of claim, the pre-hearing and post-hearing briefs, the opening and closing, and expert testimony. The panel should focus on securities regulations that have been violated, instead of being distracted by some court ruling from 40 years ago in a state or district that doesn't even apply. You won't find case law in brokerage firm compliance or supervisory manuals. What dictates brokers' standards of conduct, as outlined in their compliance manuals, are the FINRA and SEC rules.

The claimants' opening should highlight the fact that the very conduct at issue before the arbitration panel has been litigated by the SEC and FINRA, not in court, but within the regulators' enforcement departments. Who better than these entities to interpret and adjudicate the seriousness of the violation than the very industry in which the broker or advisor works? The written decisions of both the SEC and FINRA resulting from their respective enforcement proceedings provide an abundance of varied scenarios in which their regulations have been interpreted and applied.

Within the securities arena, even courts have granted deference to securities rules, regulations, disciplinary actions and member notices. In 2002, the Supreme Court deferred to the SEC's interpretation of § 10(b) of the Securities Exchange Act because its interpretation of "in connection with the purchase or sale of any security" was reasonable.[10] And courts have held that the SEC's interpretations of FINRA Rules are entitled to deference so long as they are not unreasonable.[11]

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[9] The FINRA Institute at Georgetown Certified Regulatory and Compliance Professional (CRCP)® program provides compliance, legal and regulatory professionals with an in-depth understanding of the foundation, theory and practical application of securities laws and regulation.
[10] S.E.C. v. Zandford, 122 S.Ct. 1899, 1900, 535 U.S. 813, 813 (U.S., 2002).
[11] Wiley v. Securities and Exchange Commission, 663 Fed.Appx. 353, 358 (C.A.5, 2016), See Intercontinental Indus., Inc. v. Am. Stock Exch., 452 F.2d 935, 940 (5th Cir. 1971).

In a 2016 California federal court case, the court deferred to the SEC's interpretation of a FINRA conduct rule, as well as to NTMs (now Regulatory Notices), "because of the Commission's expertise in the securities industry":

> *The Court Must Grant Deference to the Commission's Interpretation of SRO Rules and to the NTMs Themselves. Both Support the Court's Holding Here.*
>
> *The Commission's interpretation of FINRA Rule 3280 supports the Court's holding. The Ninth Circuit has previously granted the Commission deference in determining the meaning of SRO rules. For example, in Krull v. Sec. Exch. Comm'n, 248 F.3d 907 (9th Cir. 2001), the court considered whether the Commission had properly upheld a violation of an NASD rule. In affirming the Commission's determination, the court recognized the Commission's responsibility "to approve all rules, policies, practices, and interpretations prior to implementation" and held "[b]ecause of the Commission's expertise in the securities industry, we owe deference to its construction of NASD's Rules of Fair Practice." Id. at 911–12 (citing Alderman v. Sec. Exch. Comm'n, 104 F.3d 285, 288 (9th Cir. 1997)). Thereafter, the Krull court proceeded to quote an SEC administrative case, In re Winston H. Kinderdick, 46 S.E.C. 636, 1976 WL 162399, *1, 1976 SEC LEXIS 783, at *8 (Sept. 21, 1976), in which the Commission elaborated on trading that violated a specific NASD rule, to support the court's application of the rule. Krull, 248 F.3d at 912–13.*[12]

The written opinions of the SEC and FINRA resulting from their respective industry trials, often detailing the facts and the rationale and authority for the decision, are like a court case opinion. And just as court opinions are accessible on Westlaw and Lexis, so are the SEC and FINRA disciplinary decisions. But they are far more applicable and persuasive than a court decision by a judge who hears arguments on a wide variety of issues, other than securities. So be wary of the defense lawyer who waives a court decision around intimating that the panel must follow it. It is likely not binding or precedent for a few reasons such as it's in a state or district other than the state your arbitration is in. And because the case is not binding, there are likely other cases that say the opposite. But there is no reason to go down that rabbit hole, showing opposing

[12] Milliner v. Mutual Securities, Inc., 207 F.Supp.3d 1060, 1069 (N.D.Cal., 2016)

case law. The arbitration panel should not give case law any weight when there exists much more credible guidance in the regulatory findings and opinions.

If a regulatory opinion is more on point factually, it's easier to argue that the panel should feel more comfortable giving weight to the regulators tasked with enforcing the securities regulations when addressing the same situation. When citing the regulatory opinions in claimants' brief, be sure to also provide the Lexis/Westlaw citation, which may boost the credibility of the decision in lawyer panel members' minds. FINRA even states to its OHO decision makers that it should consider prior "SEC, and NAC decisions to determine if violations occurred."[13] Unlike court cases which often can be diametrically opposed, SEC and FINRA decisions do not contradict each other. In sum, these regulatory decisions and opinions should be very persuasive to arbitration panels and should garner much more attention than court cases.

Both federal securities regulations and FINRA securities regulations can sometimes be a bit dry, and sometimes not as specific and detailed as they could or should be. So, it is common practice for supervision and compliance professionals to study, review and rely on the regulatory notices and case findings, because they are an excellent source for finding more specifically how the regulators interpret and enforce their very own regulations. It is appropriate for claimant's lawyers and securities experts to use these excellent sources when explaining the regulations, norms and standards of the securities industry to arbitrators and triers of fact.

When I testify for the claimant, I routinely quote regulatory decisions and opinions that interpret the securities laws and rules. I do not get tripped up when defense counsel exclaims, "Mr. Schulz is not a lawyer and should not be permitted to discuss what happened in some SEC or FINRA enforcement hearing". Au contraire, these opinions are industry-level enforcement actions which do not require legal analysis but rather the analysis of a securities expert witness such as me. Whether I am writing one of my many published securities articles, expert reports or giving sworn testimony, I routinely refer to SEC and FINRA decisions, as well as FINRA's Regulatory Notices as a basis for my opinion that regulations/rules were violated.

[13] https://www.finra.org/rules-guidance/adjudication-decisions

Fraud

Claimants in securities arbitration can bring state common law fraud claims, as well as state deceptive trade statutes, but they would be remiss if they didn't also rely upon the very strong FINRA and SEC rules and regulations governing fraud. Both FINRA and SEC regulations/laws have anti-fraud provisions. First, codified in the federal register is the Federal Securities Regulation/law known as 10b-5, a rule promulgated by the SEC, which provides as follows:

> *17 CFR § 240.10b-5 - Employment of manipulative and deceptive devices.*
>
> *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*
> *(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.*
> *(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)*
> *[13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]*

Second, is the Investment Advisors Act of 1940 on anti-fraud:

> *It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—*
>
> ***(1)*** *To employ any device, scheme, or artifice to defraud any client or prospective client;*
> ***(2)*** *To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client…*[14]

[14] 15 U.S. Code § 80b–6 - Prohibited transactions by investment advisers.

The Uniform Securities Act (USA), the state-level law that serves as a model for regulating securities within each state has the following language in its anti-fraud law:

> *[ARTICLE] 5 FRAUD AND LIABILITIES*
> *SECTION 501. GENERAL FRAUD. It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly:*
> *(1) to employ a device, scheme, or artifice to defraud;*
> *(2) to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading; or*
> *(3) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.*

FINRA also has an anti-fraud regulation:

> *2020. Use of Manipulative, Deceptive or Other Fraudulent Devices*
> *No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.*

FINRA's rule 2210 also addresses misleading communication and fraud through omission:

> *FINRA RULE 2210. Communications with the Public*
> *(d) Content Standards (1) General Standards*
> *(A) All member communications must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. No member may omit any material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading.*
> *(B) No member may make any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication. No member may publish, circulate or distribute any communication that the member knows or has reason*

to know contains any untrue statement of a material fact or is otherwise false or misleading.

These anti-fraud laws and regulations are very straightforward: a licensed securities professional, whether a stockbroker or an RIA, cannot lie to or deceive a prospect or client. Additionally, they cannot omit any material facts in the recommendation of a security.

The Brown v. E. F. Hutton Defense

One of the oldest and most blatant efforts of defense counsel to confuse arbitration decision-makers was the introduction of a line of cases, starting with the *Brown v. E.F. Hutton* case, which in essence held that as long as a broker hands a customer a prospectus or a private placement memorandum (PPM), it doesn't matter if the broker contradicts the document and lies to the customer, even if the customer didn't read the prospectus or PPM!

The following is a typical defense argument found in both defense answers and briefs, which relies heavily on Brown v. E.F. Hutton and its progeny:

> *Claimant cannot recover on her fraud claim because she was provided a prospectus which disclosed the risks, regardless of what the broker may have said to her that contradicted those risks. The disclosures in the offering documents are so clear and unequivocal that an investor's reliance on contrary oral representations is unreasonable as a matter of law. See, e.g., Brown v. E.F. Hutton Group, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990) ("Reliance on statements which are directly contradicted by the clear language of the offering memorandum . . . cannot be a basis for a federal securities fraud claim"); Kennedy v. Josephthal & Co., 814 F.2d 798, 804-05 (1st Cir. 1987) (offering memorandum's candid warnings made any reliance unjustified as a matter of law); In re Hyperion Securities Litigation*, 1995 U.S. Dist. LEXIS 10020 *(S.D.N.Y. July 12, 1995)("Any investor who relied on those statements, which flew in the face of the numerous cautionary statements in the written offering materials, clearly did so unreasonably"); Zobrist v. Coal-X, Inc., 708 F.2d 1511*

(10th Cir. 1983) (""the knowledge of information contained in a prospectus or an equivalent document authorized by statute or regulation, should be imputed to investors who fail to read such documents.")

Why Brown v. E. F. Hutton Case Law Defenses Should Fail

In the early nineties, I was the claimant's expert in hundreds of Prudential expedited hearings resulting from the famous SEC case against Prudential. The SEC found that Prudential along with its licensed brokers made false statements and omitted material facts, usually the risk, in selling risky limited partnerships to their clients across the country. The case was so big that a book was written about it called Serpent on the Rock by Kurt Eichenwald.

Prudential's legal team used the Brown v. E.F. Hutton case law defense in virtually every case in which I was involved. The defenses did not work in the Prudential expedited hearing cases and they should not work today, considering the clear and unambiguous SEC and FINRA interpretations and decisions to the contrary. Licensed brokers and advisers cannot lie or omit material facts to either a prospect or a client in the purchase or sale of a security, regardless of what some state or federal court decides. Case law does not dictate what a broker or adviser must do under the securities regulations.

FINRA has soundly rejected the Brown v E.F. Hutton case and its twisted reasoning. FINRA stated in a May 2023 Regulatory Notice to member firms:

> *Associated persons also should not detract from or minimize the risk factors known to them or disclosed in the offering documents when recommending an offering to a customer. FINRA has found that associated persons violated suitability rules and anti-fraud provisions when they orally misrepresented terms of an investment that did not conform to the disclosures in the PPM. See Dep't of Enf't v. David Joseph Escarcega, Complaint No. 2012034936005, 2017 FINRA Discip. LEXIS 32 (FINRA NAC July 20, 2017) (finding that despite the risk disclosures in the PPM, the registered representative's recommendations were unsuitable when he misrepresented to customers that the security offered "guaranteed returns"). See also Dep't of Enf't v. Jorge A.*

*Reyes, Complaint No. 2016051493704, 2019 FINRA DISCIP. LEXIS 59, at *41 (FINRA Hearing Panel Dec. 17, 2019) (finding that "written disclosures found in a PPM do not excuse Reyes's responsibility to ensure that his oral representations are not misleading").*[15]

In Complaint No. 2016051493704, FINRA NAC Decision, October 7, 2021, FINRA's NAC stated:

"In this respect, the testimony of customers made clear that Reyes falsely told them that the promissory notes were safe investments like fixed-income securities. He did not inform the customers that the promissory notes were in fact high-risk, illiquid instruments that carried with them the risk of total loss. These misrepresentations and omissions were innately material. See SEC v. Fife, 311 F.3d 1, 10 (1st Cir. 2002) ("These misrepresentations and omissions were material because a reasonable investor would want to know about the risks involved in the [investment].")... And in any event, his delivery of the private placement memoranda does not excuse his material misrepresentations and omissions concerning risk. See Larry Ira Klein, 52 S.E.C. 1030, 1036 (1996) ("Klein's delivery of a prospectus to Towster does not excuse his failure to inform her fully of the risks of the investment package he proposed.")"

Earlier regulatory case decisions evidenced this same, consistent interpretation:

In re Dawson-Samberg Capital Management, Inv. Adv. Act Release No. 1889 (Aug. 3, 2000)("The standard of materiality is whether a reasonable client or prospective client would have considered the information important in deciding whether to invest with the adviser.")

In re Joseph J. Barbato, Securities and Exchange Act Release No. 41034 (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

[15] FINRA Reminds Members of Their Obligations When Selling Private Placements, FINRA Regulatory Notice 23-08

factors and negative information about the stock, the representative violates the anti-fraud provisions.")

FINRA's repeated pronouncements are the exact opposite of the holdings in Brown v. E.F. Hutton and its progeny. The regulations and the regulatory interpretations of them are quite clear: you can't make misstatements, and you can't omit material facts to a prospect or a securities client in the purchase or sale of the security, regardless of whether they received a PPM or prospectus with contrary language.

Unauthorized Trading

As serious a violation as fraud, and one of the top categories of investor complaints in FINRA arbitration, is unauthorized trading.[16] The securities regulations against unauthorized trading are strong, forceful, and unambiguous.

Unauthorized trading violates FINRA Rule 3260:

FINRA RULE 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

[16] I have written three articles on the issue of unauthorized trading: When Is An Order An Order? Unauthorized Trading By Securities Brokers, Securities Arbitration Practicing Law Institute (PLI) 1994; Unauthorized Trading, Time and Price Discretion & The Mismarking Of Order Tickets, Securities Arbitration 2001, Practicing Law Institute (PLI); Unauthorized Discretionary Trading 2020, PIABA B.J., Vol 27, No 1 (2020)

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.

FINRA Rule 3260 governing discretionary accounts is clear: a licensed broker cannot make a trade in a client's account without written authorization from the client, approval of the account by a compliance or supervisory individual, and review and approval of all discretionary orders by management.

Unauthorized trading also constitutes securities fraud under federal law. SEC Rule 10b-5, codified at 17 C.F.R. § 240.10b-5, prohibits engaging in fraudulent schemes, misrepresentations or omissions, and deceitful practices in connection with the sale or purchase of a security. The SEC has long considered unauthorized trading a deceitful practice:

In re Donald A. Roche, Securities Exchange Act Release No. 38742 (June 17, 1997), the SEC wrote:

> *"In general, unauthorized trading violates the anti-fraud 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 the anti-fraud provisions by making unauthorized trades in these two accounts." See Donald A. Roche Page 9.*
>
> *"In determining the sanctions, the Commission noted that Roche committed serious anti-fraud violations, and his actions demonstrate a pattern of sales abuse that should not be tolerated from anyone involved in the securities industry." See Securities Regulation & Law Report, Volume 29 Number 26 Friday, June 27, 1997, ISSN 1522-8797.*

In re Dale E. Frey, Roger A. Rawlings, and William C. Piontek, Initial Decision Release No. 221 (February 5, 2003). 57 S.E.C. 79 (2003), the SEC wrote:

> *"...a broker who trades in a customer's account without authorization commits fraud if there is accompanying deceptive conduct...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."*

The Ratification Defense

Just as Wall Street defense lawyers attempt to use case law to lessen the severity of the anti-fraud securities laws/regulations, they do the same with unauthorized trading. The following are some of the standard case law defenses to the claim of unauthorized trading. The ratification defense is often grouped together with waiver and estoppel. Here are the typical defenses, pulled from defense briefs and answers:

> *The Claim Is Barred by Ratification, Waiver and Estoppel.*
> *Courts regularly reject claims made by investors against their brokers under the doctrine of ratification, as well as waiver and estoppel, where the investor delays in objecting to the purported wrongful conduct. See, e.g., First City Sec., Inc. v. Shaltiel, 44 F.3d 529, 532 (7th Cir. 1995); Ocrant v. Dean Witter & Co., 502 F.2d 854, 859 (10th Cir. 1974) (nine month delay barred claims); Altschul v. Paine, Webber, Jackson & Curtis Inc., 518 F. Supp. 591, 594 (S.D.N.Y. 1981) (two year delay); Streckert v. Blunt Ellis & Loewi, Inc., 1981 U.S. Dist. LEXIS 11841 at *27-28 (N.D. Ill. 1981) (six month delay). Ratification occurs when a customer delays in complaining of an alleged wrongful act or continues with a broker after alleged unauthorized acts. See Jakish v. Thompson McKinnon Securities, Inc., 582 F. Supp. 485, 497 (S.D.N.Y. 1984). The policy of ratification is simple — to prevent the investor "who loses his innocence and then waits to see how his investment turns out before he decides" to seek redress under the securities laws. Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962). Here, Claimants benefited from the income received from LUBAX and watched LUBAX's price fluctuations without objection. Indeed,*

they continue to instruct Morgan Stanley to make additional purchases of LUBAX over the course of a year, which reflects not only that they ratified it, but also that it was suitable. For these reasons, the entire Claim is barred based on the doctrines of ratification, waiver and/or estoppel.

And from another defense brief:

Claimants' claims are barred by the doctrines of ratification, waiver, and estoppel.
An investor's decision to hold securities after he discovers wrongdoing—such as a misrepresentation made in connection with the initial purchase—"constitute[s] a new decision on his investments." Alexander v. Evans, No. 88 Civ. 5309 (MJL), 1993 WL 427409, at *12 (S.D.N.Y. Oct. 15, 1993)(holding an investor's "conscious decision . . . to hold the securities after the alleged fraud was discovered constitute[s] a new decision on his investments" and "the law does not insure his investments against loss"). *The investor is barred from recovering any losses incurred after making that second investment decision, which "which broke the chain of causation" between such losses and the alleged wrongdoing. Alexander cite. Courts consistently hold that, by failing to object to transactions within a reasonable amount of time, or by continuing to deal with their broker thereafter, customers adopt the trading in their accounts and relinquish the right to seek damages. Brophy v. Redivo, 725 F.2d 1218, 1220–21 (9th Cir. 1984) (customer's inaction precluded claim); Gordon v. duPont Glore Forgan, Inc., 487 F. 2d 1260, 1262 (5th Cir. 1973) ("[A] customer who knows of his broker's breach of duty and takes no action will be barred from bringing suit.")*

Why Ratification Case Law Defenses Should Fail

The SEC has long held that a customer's failure to complain does not make trades authorized.[17] In the Matter of Justine Susan Fisher, SEC Release No. 40335 (August 19, 1998), the SEC wrote*:*

[17] It is extremely common that investors do not complain about unauthorized trades because they are totally unfamiliar with the securities regulations prohibiting unauthorized trading.

Broker appealed a negative ruling by NYSE, and the SEC sustained the NYSE findings of unauthorized trading. The SEC stated: "Fischer [the broker] also claims that Van Campen [the customer] never complained about or repudiated any trades [the unauthorized trades]. That Van Campen did not complain about the transactions is not a defense…we have repeatedly held that <u>ratification</u> of a transaction after the fact does not mean trades were properly authorized." See also, Neil C. Sullivan, 51 SEC 974, 976 (1994); Frank J. Custable, 51 SEC 643, 650 (1993).

In re Dale E. Frey, Roger A. Rawlings, and William C. Piontek, Initial Decision Release No. 221 (February 5, 2003). 57 S.E.C. 79 (2003), the SEC wrote:

The Commission found that respondent broker William C. Piontek committed securities fraud by executing unauthorized trades in his clients' accounts. Further, The Commission rejected Piontek's defenses that a) his clients authorized the trades in question, and b) that even if the trades were unauthorized, that his clients ratified the transaction because of their first-hand knowledge of the risks involved. The Commission so found despite Piontek's evidence of his clients' sophistication and past speculative trading. See Securities Regulation & Law Report, Volume 35, Number 8, Monday, February 24, 2003, ISSN 1522-8797.

In the Matter of William J. Murphy and Carl M. Birkelbach, SEC Release No. 69923 (July 2, 2013)*,* the SEC wrote:

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."

FINRA has often faced the ratification defense made by brokers in disciplinary actions. Time and again, FINRA's disciplinary bodies – the NAC and the OHO - have rejected brokers' defenses that their customers ratified the wrongdoing—whether it be an unauthorized trade or an unsuitable transaction—because the customer never complained.

In OHO Decision 2019061942901 (February 28, 2024), the OHO wrote:

> *Colletti needed to obtain RM's specific authorization before executing each trade. As noted above, the Hearing Panel finds that Colletti did not obtain authorization for any of the 73 trades he executed in RM's account. Colletti notes that RM never questioned these unauthorized transactions, but this is not a defense. To the extent Colletti might be implying that the failure to complain constitutes ratification, it is well settled that ratification is not authorization and not a defense to the charge of unauthorized trading. Thus, as to all 73 trades, the Hearing Panel finds that Colletti engaged in unauthorized trading in RM's account in violation of FINRA Rule 2010.*

In the matter of Stephen W. Wilson, Case # 2007009403801, before the NAC, December 28, 2011, the NAC wrote:

> *Moreover, the fact that DL did not complain at the time she learned of the switches does not shield Wilson from liability or serve to impugn DL's credibility. See Janet Gurley Katz, Exchange Act Rel. No. 61449, 2010 SEC LEXIS 994, at *74 & n.50 (Feb. 1, 2010) ("[W]hile the confirmations may have provided post-trade approval, ratification of a transaction after the fact does not establish that trades were authorized before being executed."), aff'd, 647 F.3d 1156 (D.C. Cir. 2011); Neil C Sullivan, 51 S.E.C. 974, 976 & n.l (1994) (finding that applicant had engaged in unauthorized trading and noting that "[t]he fact that a customer ultimately accepts an unauthorized trade does not transform it into an authorized purchase"); cf. Wilshire Disc. Sec, Inc., 51*

S.E.C. 547, 552 n.15 (1993) ("[E]ven assuming that certain investors ratified or endorsed [respondent's] action, that would not alter the objective fact that [respondent] fraudulently departed from the . . . stated use of proceeds.")

The SEC and FINRA have not minced their words - the ratification defense is baseless.

The 10-Day Rule Defense

In addition to the ratification defense, Wall Street lawyers also use what is commonly called the 10-day rule defense.

Brokerage firm customer agreements all have language like the following from Raymond James:

> *Pursuant to the Raymond James Client Agreements, each Claimant agreed to promptly notify Raymond James of any concerns:*
> *(a). . . . (b) I will notify you of any error in a confirmation of order within 4 days of when it is mailed to me. I will notify you of any error in a statement within 10 days of when it is mailed to me. If I do not give you written notification of an error in the time specified above, then I accept the confirmation or statement as correct and I will not later claim the confirmation or statement is incorrect or the transactions shown were unauthorized.*

E*Trade's Customer Agreement states the following:

> *I agree that it is My responsibility to review order execution confirmations and statements of My Account(s) promptly upon receipt... confirmations will be considered binding on Me unless I notify Robinhood of any objections within two (2) calendar days from the date confirmations are sent. Account statements will be considered binding on Me unless I notify you of any objections within ten (10) calendar days after My Account statements are posted online.*

In claimant securities lawyers' parlance, these contract provisions are known as the 10-day rule defense, though the time frames vary depending on the firm. The bottom line, according to the customer agreement, is that investors have a matter of days to review confirmations and monthly statements and if no complaint is made within that short time, the investor is contractually barred from bringing any complaint regarding transactions in the accounts. Wall Street defense firms invariably latch onto this language in defending unauthorized trading with arguments and case law as follows:

> *Claimants' failure to object within the specified time precludes their right to recovery. In re Klein, Maus & Shire, Inc., 301 B.R. 408, 419 (Bankr. S.D.N.Y. 2003) ("Evidence of a timely written response is essential in disputes regarding securities. . . . [T]hepurpose of the 10-day written complaint clause in the customer agreement is to require the customer to memorialize his or her complaint soon after receipt of the account statement rather than waiting to see if the trade is profitable. The writing requirement of the clause insures [sic] that unauthorized trading disputes are not relegated to 'swearing contests' between broker and customer.") Lefkowitz v. Smith Barney, Harris Upham & Co., Inc., 804 F.2d 154 (1st Cir. 1986) (granting summary judgment against customer alleging unsuitable and unauthorized trading, reasoning that customer had forfeited his right to complain about transactions when he failed to object to them within ten days of receiving confirmations advising him of existence of trades).*
>
> *Like ratification, the doctrines of waiver and estoppel also bar these claims. Customers such as Claimants who receive confirmations and monthly account statements are estopped from subsequently asserting claims when they fail to object to the trades at the time of the transactions. Murray v. Dominick Corp. of Canada, Ltd., 117 F.R.D. 512 (S.D.N.Y. 1987) (defenses of estoppel and ratification established where customer paid attention to his account and failed to object at time of transactions). Either before or after each trade, Claimants approved every investment now claimed to be improper. Carr v. Warner, 137 F. Supp. 611, 615 (D. Mass. 1955) (customers barred from recovery where they repeatedly accept "confirmations and accounts, which fully disclosed all aspects of the transactions" and failed to act on the facts of which they are informed), Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Ca. 1968) (customer*

who regularly received confirmation slips and monthly account statements barred from recovery by estoppel and waiver)

Why the 10-Day Rule Defenses Should Fail

FINRA has specifically rejected the argument that a customer's failure to object to trades upon receipt of confirmations and monthly statements precludes claims of unauthorized trading. In a FINRA decision resulting in a stockbroker's ban from the industry, FINRA's OHO Department stated the following regarding the broker's 10-day rule defense:

OHO Decision 2021070337501 (March 21, 2024)

> *"[I]t is well established that after-the-fact notice of trades sent to customers in statements and confirmations is not evidence that the customers approved transactions before they were completed."*

The SEC agrees. In the Matter of Ralph Calabro, Jason Konner, and Dimitrios Koutsoubos, SEC Admin. Proc. File No. 3-15015 at p. 15 (May 29, 2015), the SEC wrote:

> *In any event, although Williams eventually learned of the bulk of Calabro's unauthorized trades from trade confirmations, such after-the-fact knowledge does not demonstrate that Williams approved those transactions before Calabro made them.*

In the case of In re Simpson, Exchange Act Release No. 45923, 2002 WL 987555, at *13 (May 14, 2002), the SEC rejected the argument that customers who "received monthly statements and other forms notifying them of [unauthorized] transactions but filed no complaints" because, among other things, "after-the-fact 'acceptance' of an unauthorized trade does not transform that transaction into an authorized trade".

In the case of 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), the SEC found that the applicant made unauthorized trades, noting that "[t]he fact that a customer ultimately accepts an unauthorized trade does not transform it into an authorized purchase".

According to the SEC and FINRA, it is clear that a) broker-dealers can't contractually limit a customer's time in which they can complain[18], b) confirmations and monthly statements fail to put customers on notice of unauthorized trading, and c) the fact that customers did not complain about unauthorized trading does not limit their legal rights concerning unauthorized trades.

Focus on FINRA Rules and Federal Securities Laws

When customers file FINRA arbitration complaints, they attempt to show, through their attorneys and expert witnesses, that specific securities regulations/laws were violated by the stockbroker and brokerage firm. Since the violation of securities regulations/laws serves as the basis for negligence, fraud and breach of contract causes of action, it is paramount that the arbitration panel, in providing "a fair hearing"[19] give deference to the securities laws/regulations and their interpretations.

It's beyond improper if a FINRA arbitration panel ignores or gives no serious weight to the proven securities regulations/laws that were violated; it could be grounds for an appeal.

> *[I]t is important that arbitrators not manifestly disregard the law. By doing so, your award may be vacated. In other words,* ***if the parties have provided the***

[18] Arguably, the 10-day provision is a time limitation not permitted by FINRA. FINRA has addressed brokerage firms' use of time limitations in customer agreements, stating "Some customer agreements attempt to shorten or extend applicable statutes of limitations. FINRA Rule 12206 allows arbitration claims to be submitted unless six years have elapsed from the occurrence or event giving rise to the claim…customer agreements may not be used to shorten or extend statutes of limitations" FINRA Regulatory Notice 21-16.

[19] For decades, FINRA arbitrators had a script that they would read at the conclusion of the hearing which included a question: "Will the parties state on the record, if they feel they have had a full and fair hearing." It is interesting, that FINRA chose to remove this question from the arbitrator's script.

panel with the law, the law is clear, and it applies to the facts of the case, the arbitrators should not disregard it.[20]

Motions to Vacate an Award - Motions to vacate—if any—must be made through the courts. Typically, parties challenge awards on the grounds of arbitrator partiality. An award may also be challenged because of an arbitrator's conduct, such as failing to disclose relationships with the parties or counsel, exceeding authority, prejudicial conduct at the hearing, ambiguities or mistakes on the face of the award, corruption or fraud, unreasonable refusal to hear evidence or postpone a hearing and ***manifest disregard of the law.***[21]

Additionally, FINRA makes a specific point to arbitrators in the 2024 Arbitrator's Guide[22] that they are to keep a keen eye out for securities regulations/laws that were violated based on the testimony and documents presented at the hearing. On their own volition, arbitrators can make disciplinary referrals for serious wrongdoing:

Making Disciplinary Referrals

If any matter comes to the attention of this panel during and in connection with this panel's participation in this proceeding, either from the record or from material or communications related to this proceeding, that this panel has reason to believe may ***constitute a violation of FINRA's rules or the federal securities laws, this panel may initiate a referral of the matter to FINRA for disciplinary investigation.***

[20] FINRA Dispute Resolution Services - Arbitrator's Guide, December 2024 Edition, p.64
[21] FINRA Dispute Resolution Services - Arbitrator's Guide, December 2024 Edition, p.85
[22] FINRA Dispute Resolution Services - Arbitrator's Guide, December 2024 Edition, p.83

Conclusion

Well-honed Wall Street defense lawyers have since 1987 perfected a bag of tricks to steer the trier of fact and arbitration panels away from securities regulations/laws, regulatory notices and regulatory findings. This article will assist even more experienced securities lawyers in defeating this tactic. It is only when the application and enforcement of the securities regulations/laws that govern the activities of licensed securities professionals are in the forefront of the minds of arbitrators, can a wronged investor have a fair chance of recovery.