Cross-Examination of a Broker in a Product Case

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Product cases present issues that do not often appear in garden-variety public investor suitability cases. This article seeks to explore many of these issues. Specifically, the following topics will be discussed: (i) concentration issues; (ii) incentive to sell; (iii) due diligence by the broker; and (iv) conflicts of interest between the firm and broker. Product cases are unique in that one needs to figure out whether the broker is upset about the product and/or the firm's involvement in the product, since the broker may not be as "adverse" to the customer as in other types of cases.

I. Concentration Issues

All investment recommendations made by a broker must be suitable for public investors, and the same is true of recommendations to purchase financial products, such as non-traded REITs, limited partnership interests, auction rate securities ("ARS"), and the like. One aspect of suitability is whether the recommendation of a product will improperly expose a public investor to concentration risk.

Concentration risk may be as simple as placing a large bulk of an investor's investible assets in one product or sector, which would expose the investor to the risk if the value of that particular product or the sector drops, such as non-traded REITs to the real estate market. Concentration is usually the biggest problem when the securities are speculative, but over-concentration in one product may also cause a substantial portion of an investor's assets to become illiquid, such as ARS when the market seized in 2008.

Establishing whether an investor has been inappropriately concentrated in a security product may be done through expert analysis, or simply through a review of the customer's statements, such as where a large percentage of a customer's investible assets have been placed in one product or sector.[1]

The broker should be questioned regarding the suitability analysis performed initially when the Claimant became a customer. Because concentration increases the risk to the product investment, it is very likely that the concentrated position will evidence how the position may not have been suitable.

Was it objectively reasonable to concentrate any investor in this product, given due diligence performed? Was it suitable to place this Claimant in the concentrated position? If so, how and why? What risks was the broker aware of? What was the broker's supervisor saying about the concentration, if anything? Were there exception reports (why/why not)? What was the firm's view on concentration of this product? Ultimately, this testimony will be used with the suitability expert to expose the fallacy in the broker's analysis.

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[1] FINRA has issued directives to its members regarding concentration in products, noting in Notice to Members 05-18 the general proposition that "[c]oncentration of an investor's assets in a single asset class, however, is not suitable for many investors. Members must, with respect to each customer for whom they make a recommendation, consider the risks from over-concentration against the benefits of tax deferral and the investment potential of the underlying real estate asset(s)." *See, e.g., Stephen Thorlief Rangen*, 52 S.E.C. 1304 (1997) (finding a broker's recommendations were unsuitable where they recommended 80% of the equities in the customers' accounts being concentrated in one stock); *Dane S. Faber*, 2004 SEC LEXIS 277, at *26 (Feb. 10, 2004) ("We have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk.").

II. Incentive to Sell

Even though motive is not an element of a securities claim, “What was in it for the broker/broker-dealer?” is a question most arbitration panels like to have answered. The incentives for the broker to sell the specific product complained of instead of a more appropriate product can serve as compelling support for a Claimant’s case.

In a product case, those incentive typically fall into three categories: 1) Commissions and Other Monetary Compensation; 2) Broker-Dealer Proprietary Product; and 3) Broker-Dealer as a Market Maker. Although all three may not always apply in all cases, no cross of a broker in a product case is complete without addressing every one that does. Did the firm play a role in the market or marketing of this product?

A. Commissions and Other Monetary Compensation

Commissions and other monetary compensation are a clear incentive to sell a product to a public customer. When the customer has purchased a high commission product, the incentive for recommending the product over a lower commission alternative are largely self-evident.

Non-traded REITs are a classic example. On Investor.gov, the Securities and Exchange Commission advises:

> Non-traded REITs generally have high up-front fees. Sales commissions and upfront offering fees usually total approximately 9 to 10 percent

> of the investment. These costs lower the value of the investment by a significant amount.

Real Estate Investment Trusts (REITs), Investor.gov. http://investor.gov/investing-basics/investment-products/real-estate-investment-trusts-reits (last accessed April 22, 2015).

When compared to a more traditional security that typically pays a commission of between 1% and 4%, these higher fees make the sale of a REIT significantly more lucrative for the broker and the broker-dealer. On a $500,000 investment, the difference between a 3% commission and a 10% commission is $35,000.

During the cross of the broker, this fact should be highlighted to the Panel. A good tactic to take would be to slowly and methodically question the broker about the commissions due to be paid as disclosed in the prospectus and/or other offering materials, establishing the broker's knowledge of the commission to be paid. The broker should then be questioned on the total commission actually paid by the customer to the firm, including the broker's payout of that commission. This can be done using the commission runs provided by the broker and/or broker-dealer in discovery. Finally, a comparison should be drawn to a different product sold to the customer at a lower commission percentage using those same commission runs, if possible.

B. Broker-Dealer Proprietary Product

In addition to the broker, the broker-dealer may also be incentivized to sell a particular product over alternatives. Such is the case where the broker-dealer is selling its own proprietary product/fund. When presented with a situation such as this, the prospectus can be a critical piece of evidence; one should also look to other marketing materials, as well.

Underwriting fees and the like should be highlighted as an incentive for the broker-dealer to promote the product within. Underwriting fees for a particular product or family of products can comprise a significant revenue source for a broker dealer as a whole or a subsidiary or group of that broker dealer. This means there are individuals within the firm whose job and bonuses are dependent upon the creation and sale of that product or product family. While these issues may require that the claimant call other witnesses from within the broker-dealer, these issues can still be highlighted to the arbitrators through the broker's cross examination.

Therefore, the broker should be questioned about the firm's internal promotions of the product. Some examples of ways firms can internally promote proprietary products are through the use of proprietary financial plan generating software, "internal use only" sales literature, and increased payouts for brokers on the sales of particular products. Therefore, it is important for the claimant's attorney to explore these avenues in discovery to ensure that the needed documentation is available for this line of questioning.

This area can create an interesting dynamic where the firm's interests are not aligned with that of their broker, which will be discussed in section IV below.

C. Broker-Dealer as a Market Maker

The broker-dealer's role in the marketplace for a product is fodder for cross-examination of the broker. Broker-dealers regularly serve as market makers in particular products. Frequently, these products are proprietary. In situations where a firm makes the market in a particular product, the firm can oftentimes be the primary (if not sole) source of liquidity in that market. When the product is viable, this can operate relatively smoothly. However, when

a product becomes distressed, the responsibility of market-maker can significantly stress the firm. News of a distressed product can result in supply-demand imbalances in the market, with sellers significantly outnumbering buyers. This forces the firm to buy more of the product to maintain the market price for the product and liquidity. When the firm stops supporting the market in this way, the market can freeze and the value of the product can plummet precipitously. Typically, firms will stop supporting the market as a result of reaching internal inventory limits. A recent example of this is the freeze of the Auction Rate Securities (ARS) market in 2008.

Such involvement in the marketplace, including the decision to no longer support the same, is critical material information. In such a situation, the broker should be cross examined on what they knew about their firm's involvement in the market. Assuming the customer was unaware of the full extent of the firm's participation and decision to stop the same, there is no bad answer when asking the broker what they knew. Based upon the answer, the questioning should go in one of two directions.

If the broker was aware of (or at a minimum had access to information concerning) the firm's involvement and/or decision to pull out, the questioning should focus on the information that was omitted from the recommendation. The goal in this instance to emphasize to the arbitrators 1) the importance of the omitted information; and 2) that it was accessible to the broker but not transmitted to the customer. Documents that can be used are inventory reports made to brokers about current firm inventory of the product and the firm's inventory limit for that product. The questioning should cover the causal impact on price and liquidity discussed above in connection with how those risks affect suitability.

If the broker was unaware of the firm's participation and decision to pull out, the questioning should focus on shifting blame on the firm for not providing the broker with all necessary information. In essence, the questioning should permit and encourage the broker an avenue to shift blame away from themself and to blame the firm.

Like B. above, this area can also create the potential for a conflict of interest between the broker and the broker-dealer, as will be discussed in section IV below.

III. Due Diligence on Products

FINRA requires that its member and member-employed registered representatives perform due diligence in order to understand a product before making a recommendation to public investors.[2]

A. Training

The broker is the ideal person to be questioned about any training received from the member (if any). Don't just take the Firm's compliance or supervisory personnel's word for it. NTM 03-71 makes clear that each broker must be trained regarding many core aspects of each product before any recommendations may be made, including:

- The liquidity of the product
- The existence of a secondary market and the prospective transparency of pricing in any secondary market transactions

[2] *See* NTM 03-71 (Non-Conventional Investments) ("this Notice to Members reminds members offering NCIs of their obligations to: (1) conduct adequate due diligence to understand the features of the product").

- The creditworthiness of the issuer
- The creditworthiness and value of any underlying collateral
- Where applicable, the creditworthiness of the counterparties
- Principal, return, and/or interest rate risks and the factors that determine those risks
- The tax consequences of the product
- The costs and fees associated with purchasing and selling the product[3]

Each of these required due diligence items is fair for cross-examination. While the broker may be able to identify a market on which a product trades, he or she may have a harder time recalling the credit worthiness of the issuer, or the tax consequences of the product.

Many brokers may be able to recall (with a document refreshing their memory) what the costs and fees associated with the purchase may have been, but do they recall the attendant costs and fees when attempting to sell a product? For some relatively illiquid product, such as non-traded REITs, the only place an investor can sell the product is on a secondary market at a substantial discount.

It is likely that the Claimant's attorney has also sued the FINRA-registered broker-dealer that employed the

[3] NTM 03-71, pg. 767, 769.

registered representative, so any testimony from the agent will be helpful when questioning the firm's compliance or supervisory personnel.

B. The Prospectus

The prospectus is also a great place to start your cross-examination. Prospectuses are generally dense documents that list the substantial risks associated with the product. A substantial portion of your cross-examination will involve questioning the broker about the prospectus (which the broker is unlikely to have ever read). Were all of those risks explained to the Claimant? The broker was required to explain the risks, as well as any associated rewards to each investment to the customer as part of the suitability analysis.[4]

NTM 03-71 explains that reliance upon materials such as a prospectus may not be sufficient for a member to satisfy its due diligence requirements. What other materials did the registered representative review that was provided by the issuer or the firm?

C. Other Due Diligence

In addition to understanding the characteristics, risks and rewards of each product, the member and broker must perform additional due diligence as the need arises. The broker must consider the circumstances in which she makes her recommendations: it is highly unlikely that a product entirely reliant on real estate valuations (such as non-traded REITs) would be a sensible recommendation during the 2008 financial crisis. If it is a product the firm makes a market in,

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[4] *See* FINRA Rule 2111 (Suitability).

ongoing information, studies, evaluations and strategies by the firm need to be explored.

The savvy Claimant's attorney would have already performed at least a cursory search of publicly available information regarding the product. This can and should be used in the cross-examination. Was the broker aware of the news article describing the product as Ponzi-like? Was this communicated to the investor? If not, wouldn't this be the sort of necessary disclosure when making the required "fair and balanced" disclosure to the investor?

IV. Conflicts of Interest between the Firm and Broker

As mentioned in sections II (B) and (C) above, there may arise a situation where a failed or distressed product creates a conflict of interest between a broker and their firm. The situation may be one where the inappropriate recommendation to the customer was the result of misconduct on the part of the broker-dealer more so than the broker. Such a case may arise where a firm's goal is to unload a product onto customers, and it misleads its brokers (as well as its customers) to do so. It is important to ascertain as early as possible, who is the party that was incentivized to sell the product to the customer, and what took place.

In such a case, the broker's interests would be conflicted with the interests of the broker-dealer. Therefore, the cross-examination of a broker should first focus on getting a feel for whether this broker is going to toe the company line or testify in a way that defends themself and blames the broker-dealer entirely.

If the broker is toeing the company line, the conflict of interest is of less benefit to the claimant's case. However, in the event the broker appears willing to completely blame

the broker-dealer, the cross-examiner should exploit this. While one should probe the story cautiously at first, the ultimate goal of the cross-examination is to provide that broker an avenue to tell the arbitration panel exactly what the broker-dealer did wrong.

Ultimately, whether the arbitration panel blames the broker or the broker-dealer is immaterial, so long as an award is rendered in the Claimant's favor.