Members

Red Flags: Identifying Potential Broker Misconduct

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As a Certified Public Accountant, many times you stand as the first person able to identify if your client is the victim of wrongdoing due to misconduct on the part of a financial professional. As you may be aware, when an investor opens an account with a financial professional, the account agreement generally requires that all disputes be brought in the arbitration forum, not civil court litigation. The entire arbitration process is very unique and beyond the scope of this article. However, this article will discuss two possible grounds upon which an investor may bring an arbitration claim against her financial professional. Given your unique position in advising clients, particularly during tax preparation, you have the opportunity to look for particular signs that may help determine if your client may have been a victim of financial abuse.

1. When reviewing transaction histories for the year, you may notice an unreasonable amount of transactions. This may be churning. Churning is the excessive buying and selling of securities in an account by a broker without regard to investment objectives resulting in increased commissions. Usually churning occurs when the broker exercises control over the trading in the account, either expressly or implicitly. A commonly used analysis to determine if someone may have been the victim of churning is the calculation of an annualized turnover ratio. Turnover ratio is calculated by taking the total amount of purchases of securities and dividing by the average monthly equity balance in the account. The outcome is then divided by the number of months constituting the period in question and multiplied by twelve. A turnover ratio of four or more is generally cause for concern and a strong indication that excessive trading, churning, may have occurred. Churning is a violation of both Federal Securities Laws, as well as, FINRA Rules of Conduct.

2. When reviewing annual statements in preparation of the Schedule D, you may notice investments which are inappropriate (unsuitable) given your understanding of the investor's risk profile and objectives. Suitability is the concept that a financial advisor should have a reasonable basis in recommending a security to their client. This doctrine is sometimes referred to as the "know your customer" rule. It can be very clear, in certain situations, to determine when the client has been recommended investments that are well beyond their risk tolerance and contra to their stated objectives. A common example is an elderly widow with no prior investment experience whose primary goal is capital preservation and whose risk tolerance is low being placed into high tech start-up company stocks. FINRA and other regulatory agencies have promulgated rules and regulations in an attempt to address suitability issues.

This is by no means an exhaustive list. However, financial professionals must adhere to laws, rules and regulations promulgated by government agencies and self regulatory organizations (i.e. the Securities and Exchange Commission, New Jersey Bureau of Securities, and Financial Industry Regulatory Authority) designed to protect investors. Their websites offer a vast amount of information and can be a valuable resource. Violations of these laws, rules and regulations by a financial professional may make them liable for the financial harm suffered by the investor. If you suspect that a client is having problems with their financial advisor, has been the victim of wrongdoing or if you have any questions regarding securities arbitration in general, you should contact one of the regulatory organizations listed above or speak with a legal professional.

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December 8, 2008

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