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FLAWED RULING CREATES LIABILITY RISK FOR SECURITIES BROKERS

by

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Late last summer, an arbitration panel ordered Merrill Lynch to pay a Pennsylvania couple $7.7 million, a largely overlooked decision which broadens the circumstances under which securities firms could be liable for customer losses. *In the Matter of the Arbitration Between Millar v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* JAMS Case Number 1410003079 (2001) ("*Millar*"). The panel ruled, in a 2-1 decision, that Merrill Lynch breached its contractual obligations and duties to Mr. and Mrs. Millar by failing to assist them in formulating and implementing strategies to protect their investment and failing to execute an order they placed to sell part of their holdings in FreeMarkets Inc., an internet stock of which they had substantial holdings. The decision presents a Wall Street investment industry already beset by legal and regulatory challenges with a new and unjustified liability threat.

Millar diverges from established precedent by ignoring the fact that the Millars' account was non-discretionary, meaning that the Millars retained the right, power and obligation to make decisions about their investments. Brokers are typically found liable in cases where the firm had investment discretion over the account in question and the court or arbitration panel finds that the firm made inappropriate investments on the client's behalf. In this case, the arbitration panel impugned liability to Merrill Lynch despite the non-discretionary nature of the Millars account. The lone dissenter on the *Millar* panel disagreed with the majority decision, concluding that Merrill Lynch was not liable "for its necessarily limited role in handling the non-discretionary accounts of the experienced and knowledgeable claimant." *See* Dissenting Statement of Arbitrator Harris, *Millar.*

According to the court documents, the Millars opened a CMA account with Merrill Lynch in January 2000 and deposited into the account 175,572 shares of FreeMarkets stock. The majority of the arbitration panel found that the Millars' instructions included a "clear and unambiguous indication" of their desire to sell a significant part, 100,000 shares, of their holdings in FreeMarket on September 5, 2000. In their holding, the panel referenced that the Millars instructions were acknowledged by an agent of Merrill Lynch.[1] The panel

[1]Merrill disputes the factual basis of this finding, pointing out that the "alleged" instructions were given at the "conclusion of [a] round of golf" to the Merrill Lynch financial consultant and noting opportunities the Millars had to raise the issue of the allegedly placed order and failed to do so. *See* Complaint to Vacate Arbitration Award, *Merrill Lynch,*

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went on to find as follows:

> [F]rom August 29, 2000 through September 5, 2000, FreeMarkets stock had finally reached a level at which sale of 100,000 shares would achieve Claimants' clearly stated objectives. Accordingly, Respondent is liable for not effecting the requested, and plainly called for, sale of 100,000 shares on September 5, 2000.

Final Award, *Millar*, ¶ 2 (July 15, 2002) ("Final Award").

The arbitration panel's majority found that the Millars were not contributarily negligent and then ruled, seemingly somewhat arbitrarily, that the Millars' duty to mitigate their damages kicked in as of December 26, 2000. Thus, the panel found that the Millars' damages should be measured as the difference between the net proceeds of a sale of 100,000 shares of FreeMarkets stock at the average price in effect on September 5, 2000 and the average price in effect on December 26, 2000, plus an increment to compensate the Millars for the cost of money during that time period and the adverse tax consequences of the award being treated as ordinary income. In total, the majority of the panel awarded damages of $7,741,305, with one arbitrator dissenting. *Id.*, ¶3-4.

The arbitration panel's majority ruling begins by finding that the Millars had placed a clear and unambiguous sell order with Merrill Lynch which Merrill Lynch did not execute. Merrill Lynch strenuously disputed this claim as a factual matter both prior to the ruling and in its Complaint to Vacate Arbitration Award, filed with the U.S. District Court for the Western District of Pennsylvania. *See* Complaint to Vacate Arbitration Award, *Millar*, *supra*. To the extent that the arbitration panel determined this factual matter in favor of the Millars and against Merrill Lynch, the panel was not breaking new ground and its finding, assuming supportable on the evidence before the panel, should be upheld.

The problem with the panel's decision is evidenced in the second sentence from its opinion quoted above. The majority's opinion states that "FreeMarkets stock had finally reached a level at which sale of 100,000 shares would achieve Claimants' clearly stated objectives." In this sentence, as is true with other language in the opinion,[2] the majority is impugning to Merrill Lynch responsibility for considering and attempting to achieve the Millars' strategic investment objectives. However, the Millars account was non-discretionary, meaning the Millars, rather than Merrill Lynch, had investment control over the account.[3]

In *Lieb v. Merrill Lynch*,[4] the court articulated six duties associated with non-discretionary accounts:

1. the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis;

2. the duty to carry out the customer's orders promptly in a manner best suited to serve the

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Pierce, Fenner & Smith, Inc., v. Millar, No. 02-1408, (W.D. Pa.), ¶ 21 (2002).

[2]*See also* Final Award, ¶ 3 (discussing the duty to mitigate, "the majority finds . . . [the meeting] left Mr. Millar with the feeling that Merrill Lynch representatives were not being honest in assuring him that they could achieve all of his objectives if given sufficient time . . . .") This language implies that Merrill Lynch had such a duty.

[3]*See Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952 (E.D. Mich. 1978), *aff'd* 647 F.2d 165 (6th Cir. 1981) (defines a non-discretionary account as "an account in which the customer rather than the broker determines which purchases and sales to make.") *See also De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 2002 WL 21086924 (2d. Cir. 2002).

[4]*See Lieb*, 461 F. Supp. at 953 (*citing Cash v. Frederick and Co.*, 57 F.R.D. 71 (E.D. Wis. 1972); *Hanly v. S.E.C.*, 415 F.2d 589 (2d Cir. 1969); *Richardson v. Shaw*, 209 U.S. 365 (1908); *Robinson v. Merrill Lynch*, 337 F. Supp. 107 (N.D. Ala. 1971), *aff'd,* 453 F.2d 417 (5th Cir. 1972); *Chasins v. Smith Barney & Co.*, 438 F.2d 1167 (2d Cir. 1971); *SEC v. Capital Gains Bureau*, 375 U.S. 180 (1963); *Shorrock v. Merrill Lynch,* CCH Fed. Sec. L. Rep. P 96, 251 (D.Or., Nov 18, 1977)). *See also Vestax Securities Corporation v. Desmond*, 919 F. Supp. 1061, 1072 (E.D. Mich. 1995) (regarding "hybrid" accounts).

customer's interests;

3. the duty to inform the customer of the risks involved in purchasing or selling a particular security;

4. the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security;

5. the duty not to misrepresent any fact material to the transaction; and

6. the duty to transact business only after receiving prior authorization from the customer.

The *Lieb* court goes on to state the following with respect to non-discretionary account:

> A broker has no continuing duty to keep abreast of financial information which may affect his customer's portfolio or to inform his customer of developments which could influence his investments. Although a good broker may choose to perform these services for his customers, he is under no legal obligation to do so.

Lieb, 461 F. Supp. at 953.

Given that responsibility for the account was retained by the Millars, Merrill Lynch did not violate any of its duties to the Millars unless Merrill was directed to sell the Millars' shares. Where the majority finds that Merrill Lynch was clearly directed by the Millars to sell such stock, the panel seems to be on solid footing in finding Merrill Lynch liable. Even as to a discretionary account, the broker has a professional responsibility to execute the instructions of the customer. *Robinson v. Merrill Lynch*, 337 F. Supp at 112. *See also Clayton Brokerage Co. of St. Louis, Inc. v. Commodity Futures Trading Commission*, 794 F.2d 573, 582 (11th Cir. 1986) (broker for a non-discretionary account has a duty not to misrepresent risk of trading).

However, the fact that the opinion does not stop there is troubling. The majority of the panel found it necessary to further justify its decision by finding that Merrill Lynch did not pay attention to the Millars' investment objectives. This reasoning imputes a professional responsibility on a securities firm to take a paternalistic approach to discretionary accounts, requiring them to out think their customers as to investment-making decisions. The majority seems to have been uncomfortable with the factual finding that they made, which they were of course entitled to, and tried to further support their opinion with legal underpinnings which were inapposite to the majority of established precedent.[5] Under *Lieb* and its progeny, Merrill Lynch had no duty to implement specific investing strategies for the Millars. In fact, Merrill Lynch would have been violating its customer agreement with the Millars as well as the applicable legal precedent if it had implemented strategies at its own discretion.[6]

Unlike the broker for a non-discretionary account, the broker for a discretionary account is considered a broader fiduciary for his customer. *Lieb* outlines the duties of a broker of discretionary account as the following, all to be undertaken without obtaining authorization for each transaction. *Lieb*, 461 F. Supp at 953 (*citing Rolf v. Blyth Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978); *Robinson, supra*; *Stevens v. Abbott, Proctor and Paine*, 288 F. Supp. 836 (E.D. Va. 1968):

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[5]*But see Erlich v. First National Bank of Princeton*, 208 N.J. Super 264, 505 A.2d 220 (Super. Ct. N.J., 1984) (court found that bank violated higher duty to customer as an investment manager despite non-discretionary nature of the account). The *Erlich* court found the bank had additional investment advisor duties and thus a higher standard should be imputed to the bank. To the extent that the *Erlich* court was in effect finding that the relationship of customer to broker in that case exceeded the standard non-discretionary account relationship, the ruling can be squared with *Lieb*. However, to the extent that the court held a regular non-discretionary relationship to this higher standard, this author believes the *Erlich* court's holding is problematic for the same reasons set forth herein.

[6]For example, *see* the recent jury verdict against Prudential Securities Inc. for $250 million in punitive damages related to unauthorized sales of securities from an account. Susanne Craig, *Prudential Unit Faces Payout for Damages*, WALL ST. J., Oct. 14, 2002, at C1.

1. manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history;

2. keep informed regarding the changes in the market which affect [the] customer's interest and act responsively to protect those interests;

3. keep [customers] informed as to each completed transaction; and

4. explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.

If the Millars' account had been a discretionary account then the panel would have been justified in basing a decision against Merrill Lynch on a failure to meet stated investment objectives where meeting such investment objectives was found to be possible. However, it is also probable that if the account had been discretionary, Merrill Lynch would have taken a more active approach towards managing this account and, very possibly, the facts of this case would never have arisen. By opening a non-discretionary account, the Millars made the decision that they wanted to maintain control over investments in their account rather than have Merrill Lynch make those decisions.

The majority's reasoning creates additional risks for securities firms in handling non-discretionary accounts for customers. If the courts or subsequent arbitrators follow the line of reasoning set out in *Millar*, securities firms would need to exercise additional levels of care with respect to non-discretionary accounts — assessing more carefully investment objectives and advising customers more frequently of investment strategies and market-related risks. However, in an industry of increasing atomization and decreasing customer service, it is hard to imagine brokerage firms making the additional investment of manpower necessary to address these issues. Moreover, to the extent that it is merely a matter of costs and expenses, these costs would ultimately be borne by customers, by way of higher transaction and account service fees.

This additional responsibility would also create a difficult dilemma for a broker. What should a broker do if it believes a customer's stated investment objectives require that customer to take a certain action in a non-discretionary account and the customer refuses that advice? Under *Lieb*, the broker has no obligation. The customer has the final decision-making power and if they decide not to follow advice from the broker, then the broker has no liability. However, we are now postulating a world where the broker could have some liability. One might argue that as long as the broker suggests a certain course of action, even under *Millar,* the broker would not be held liable for the customer's refusal to follow advice. However, even that rule places too high a standard on brokers. If a broker suggests a course-of-action and the customer refuses to follow it, how can the broker be held accountable for not meeting potential investment objectives in the future? Does the broker need to keep making suggestions that a customer can reject and then blame the broker for a loss of investment value? This problem is solved by the *Lieb* regime, where liability follows control of the account.

Finally, do customers really want this additional protection? Aside from the fact that customers would always like to be able to blame a securities firm for a loss of value, customers probably do not want their broker looking over their shoulders to the extent that the *Millar* panel advocates. Many customers want to control their own investment strategies and horizons. For many people, constant advice from a broker is seen as a nuisance rather than an aid. Particularly in the wake of recent scandals regarding the research departments of investment houses, most investors just want a brokerage house to be their conduit for their accounts. That is what a non-discretionary account was set up to be. The *Millar* panel was wrong to find otherwise and should not be followed.