

## **Customer Margin and Deficit Balance Disputes**

By Edward F. Donohue

Every severe correction in the securities and commodities markets since the Great Depression has brought with it a wave of customer liability claims peculiar to the halcyon days before the fall. Coupled with excessive speculation on margin, there are always peculiarities in the chemistry of factors leading to an unanticipated decline.

In early 2000, the Federal Reserve Bank which regulates and tracks all forms of margin debt was concerned with “pyramiding,” an artificial inflation in stock prices which occurs when too much value is traceable to borrowed funds. The problem has contributed to the magnitude of every major crash including the “Asian Contagion” decline of 1997. In that instance margin debt reached \$100 Billion before the market correction. Chairman Greenspan noted the problem on the eve of the April 2000 freefall. Margin debt had reached \$250 Billion. However, the Fed declined to raise margin requirements on the grounds that there was no evidence that tampering with margin rules had a predictable effect on stock prices. In the Summer of 2000, after the fact, the NASD began cracking down on on-line brokers that aggressively pushed margin debt. It also adopted a new model margin disclosure statement which must be used in form or substance and circulated annually to customers.

For retail customers, margin speculation positions were a major component of margin debt. However, since the development of cash management accounts in the early '80s another type of customers has been caught up in the margin liquidation fray. Such customers do not margin to trade but margin to borrow. Checking with investor credit line and debit card privileges are widely available to retail customers. The registered representative has little incentive to push these services. Customers are lured into margin based credit arrangements by teasers in their account statements such as “available credit”, “purchasing power”, “borrowing power” and the like. Such pure consumer debt has grown as a component of margin debt in light of the practice of emerging growth companies of loading executive compensation packages with company stock and options. Thus, “portfolio rich” customers spent the marginable value of their unrestricted and Rule 144 stock alike, a moving target which seemed to move upward without pause through the 1990’s.

Disputes regarding such accounts bring to a head of unresolved questions regarding the legal liability of broker-dealers to margin account customers.

In mid-western states where the courts have refused to recognize fiduciary duties on non-discretionary accounts, claims regarding minimum notice and no notice liquidations have been rejected. E.g., Refco, Inc. v. Troika Investments Ltd., 702 F. Supp. 684 (N.D. Ill. 1988); D.L Baker & Co. v. Acosta, 720 F. Supp. 615 (N.D. Ohio 1989) (no notice liquidation provision upheld). Courts in these jurisdictions have also rigidly rejected suitability claims at variance with signed margin risk disclosure forms and unqualified margin credit terms in account agreements. E.g., Mada Trading Co. v. Wimbish, 530 F. Supp. 757 (N.D. Ill. 1982); Oberweis Securities, Inc. v. Dines, 1992

WL 119272 (Bankr. N.D. Ill. 1992). Claims regarding failure to mitigate losses in the handling of margin liquidations have also failed. **Stotler & Co. v. Dierschke**, 1993 WL 128141 (N.D. Ill. 1993). Philosophically these courts have aligned themselves with early CFTC pronouncements that exchange and regulatory guidelines on maintenance margins are not consumer protection provisions. Rather, such rules are designed to protect the solvency of futures merchants and securities dealers to guaranty a stable market place. **Stotler, supra, citing, Friedman v. Dean Witter & Co.**, [1980-82 Transfer Binder] Com. Fut. L. Rep. (CCH) ¶ 21, 307 at 25, 573 (CFTC 1981).

Unfortunately, for broker-dealers courts in other jurisdictions have seen it otherwise. **E.g., Merrill Lynch , Pierce, Fenner & Smith v. Perelle**, 514 A.2d 552 (Pa. 1986); **Piper, Jaffray & Hopwood, Inc. v. Ladin**, 399 F. Supp. 292 (S.D. Iowa 1975). These courts have ignored the boilerplate of account disclosure forms and looked to NASD suitability standards and New York Stock Exchange Rule 405 to resolve margin liquidation disputes. Similarly, NASD arbitration panels typically like to call such cases as they see them. Local law is often loosely applied or ignored in deference to the hazy and subjective standards of the suitability and “know your customer” rules.

The **Perelle** case illustrates the conflicting perspectives on how to treat margin loss claims. The majority applied fiduciary standards to every aspect of the margin relationship. This included communications with the customer on the margin call and the manner in which the margined securities were liquidated. The concurring judge agreed only with the result and vigorously disagreed that securities brokers have fiduciary duties disassociated with the actual sale of securities. As Judge Hoffman saw it, a broker in its capacity as lender has only arms-length contractual obligations.

In Ladin the court held that in margin to trade situations, NYSE Rule 405 and NASD Rule 2310 required not only an assessment of the suitability of the recommended investment but advice on the wisdom of margin trading. Indeed, fiduciaries are required to disclose all facts “material” to the customer’s interests, an inherently vague and subjective standard.

Margin to trade situations present the easier case in that there is a context for the broker to provide an assessment of any enhanced risk associated with trading on margin. The more difficult question is whether a broker has a more generalized duty to counsel clients on the risk of margining securities, including those that were not initially acquired on margin. Liability on that basis is difficult to support under the suitability rules because Rule 2310 expressly requires a nexus to a purchase, sale or exchange.

In contrast, Rule 405 could be interpreted to impose more generalized fiduciary obligations to check out the suitability of customers to exercise all forms of margin privileges. It requires due diligence not merely relative to every order but relative to “every cash or margin account accepted.”

At most firms the process of establishing margin privileges is mechanical. With some variations, the approval process consists primarily of back office credit checks. When an outside clearing firm is used the whole process is outsourced. The branch or outside bank may disapprove small accounts, moderate income customers or customers with bad credit. The customer receives written truth-in-lending and risk disclosure materials which few carefully review. The process does not involve judgmental oversight by a branch manager akin to that needed to establish option trading privileges pursuant to NASD Rule 2860.

From the individual broker's perspective an expansive obligation to counsel on margin account risks is hard to justify. Thus, many customers check the applicable boxes on credit privileges on the new account forms but never avail themselves of such privileges. The broker generally finds out about the level of a customer's credit use or abuse after the fact. Again, outside of the context of specific trades, there is a no ready forum for investment advice.

It remains to be seen whether NASD panels will come to the rescue of customers who were blindsided by losses on securities margined to support personal finances. Suitability arguments will certainly be made. Customers facing large losses or deficit balance claims traditionally make any and every argument available. Presumably, some panels will rule that a registered representative should not stand by and allow a customer to commit economic suicide by backing into the equivalent of an unsuitable speculative trading position. Again, there is no question that firms solicit customers to avail themselves of margin credit in subtle and not so subtle ways. Given the incident investment risk, it is difficult to justify holding the broker to compromised suitability standards.

On the other hand, the increased flexibility in the use of margin privileges highlights one of many incongruities associated with liberalization of Glass-Steagall firewall restrictions. A banker does not have to concern himself with the economic wisdom of a securitized loan from the customer's perspective. Other than accountability to the regulators to lend against securities in compliance with Regulation U<sup>1</sup> (the banker's equivalent of Regulation T) and to engage in safe and sound lending practices, a

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<sup>1</sup> Although Regulation U requires the bank to obtain a "purpose statement" from the borrower, the failure to do so normally does not give rise to a cause of action by the borrower.

banker's exclusive obligation is to the institution. Under state law, banks generally have no fiduciary duties to loan customers. **Price v. Wells Fargo Bank, N.A.**, 213 Cal.App.3d 465 (1989). Thus, query whether a stock broker, with inferior expertise in credit underwriting, should have heightened liability exposure.

Given the "zero sum game" of a lending relationship, fiduciary obligations from lender to borrower raise conceptual problems as well. Thus, a fiduciary normally should not be subject to such direct conflicts of interest.

In conclusion, it is unclear and debatable to what degree the multifaceted lending relationships of contemporary brokerage accounts should be subject to fiduciary standards. Convincing an NASD panel that such standards have no application to a customer whose life savings has been liquidated will be an uphill battle. The best strategy is to defuse the issue by focusing on the discrete risk of maintaining a margin account. Thus, from a disclosure perspective the stand alone risk of margin privileges is usually self-evident. When a customer spends "other people's money" in any fashion, the prospect that the loan will have to be repaid in some fashion isn't a risk at all but a virtual certainty. With the exception of certain disastrous liquidation scenarios associated with selling into fast market conditions, the majority of loss is usually traceable to the underlying investment and not the process of covering the position. The broker's counsel must be vigilant in countering exaggerated claims that use of margin unduly compounded the investment risk.

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