

# **Unauthorized Trading, Time and Price Discretion & The Mismarking Of Order Tickets**

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Unauthorized Trading.....3  
    Public Misunderstanding.....5  
The Mismarking of Trade Tickets “Unsolicited” .....6  
Time And Price Discretion .....11  
Proving Unauthorized Trading and the Mismarking of Order Tickets .....16  
    Phone records.....17  
    Inaccessible Client .....17  
    The Art of Reviewing Order Tickets.....17  
    Patterns of Trading in Other Accounts .....18  
    Memory Jogs .....18  
    Commission Discounting or Lack Thereof .....19  
    Supervision.....20  
    Concentration.....21  
    Bunching .....23  
Conclusion.....24

It has been over seven years since I wrote the predecessor to this article entitled, “When is an Order an Order? Unauthorized Trading by Securities Brokers”.<sup>1</sup> Over the years, I have been told that this article has been used in arbitrations and hearings around the country. As the author, I felt an obligation to take up the gauntlet and update the material.

When I wrote the first article, I addressed in two sub-chapters “time and price discretion” and “solicited versus unsolicited” trades. As it turns out, these two subchapters have garnered more attention than the topic itself of unauthorized trading.

I believe that one of the major reasons for the attention to time and price discretion is because most of the brokerage firms have failed to provide their brokers with proper guidelines for the use of time and price discretion. As for the solicited order versus the unsolicited order, it has generated a lot of attention because though easier to define, I still see many brokers and brokerage firms trying to redefine these two words to fit their needs or defenses.

As in the first article on this subject, I undertook an investigation of sorts and surveyed individuals from all walks of the securities industry, such as brokers, compliance officers, and regulators, for their opinions.

## **Unauthorized Trading**

It would be hard to imagine a more serious securities violation than that of unauthorized trading. Imagine that your local car dealership called you one day and asked for you to come down and pick out the new \$40,000 car that the dealer has billed to your credit card, without conferring with you. When a broker makes an unauthorized trade, it can be and usually is much more damaging. Your credit card company is more likely to believe you when you protest the car purchase, than your brokerage firm might when you complain of the unauthorized stock purchase. And even if you were stuck with the car, you might be able to sell it immediately, whereas a stock could drop dramatically in price and you would be stuck with the stock and the losses. Being stuck with a 40,000 car is pretty bad, but a broker can commit a client to ownership of hundreds of thousands of dollars of stock purchases.

One item that separates the car purchase from the stock purchase is that 100 percent of the population would recognize immediately the serious mistake of a car purchase showing up out of the blue. Not so with a stock purchase. Though there are more people involved in the securities markets than ever in the history of the United States, we still have a fairly ignorant investing public, especially when it comes to the rules and regulations of the securities industry. Many investors have no idea that in the absence of written discretionary authority, it is wrong for their broker to make trades in their account without a very specific and detailed conversation just prior to the entry of the order.

NASD rules 2110, 2120 and 2510 and NYSE Rule 408(a) all prohibit a broker from making trades in a customer's account on a discretionary basis (that is, without first discussing the trade in detail prior to the entry of the order). Many state securities regulations also prohibit such activity and make the trade rescindable, if it is established that the trade was unauthorized.

There is also legal argument that unauthorized trading constitutes a 10b and 10b-5 violation. The SEC has held that "...unauthorized trading in a customer's account is a violation of the requirement to observe just and equitable principles of trade."<sup>2</sup> In another case, the court held that unauthorized trading is a 10b and 10b-5 violation due its fraudulent nature. The court stated, "Drexel failed to inform them that Poder [the broker] was making unauthorized transactions...the relevant omission alleged is the failure to inform the investor that defendant was making purchases and sales. No omission could be more material than that."<sup>3</sup>

Discretionary trading by a broker in a customer's account requires written, prior approval before any such trade can take place. Many times you will hear a broker at an arbitration testifying that he was given verbal permission to make a specific or a group of discretionary trades by the customer. This would be a violation; there is no such thing as verbal authority for discretionary trading, regardless of how, when, or why it is given (save for time and price discretion, discussed later).<sup>4</sup>

Brokers are not even allowed to make legal, discretionary trades where the trade is considered a "principal" transaction. This would include trades where the brokerage firm is the market maker or where the investment is an initial public offering (IPO).<sup>5</sup> The rules that forbid fiduciaries from self-dealing support such a prohibition.<sup>6</sup> In this situation, it makes no difference if the broker has obtained written, discretionary authority. Some firms allow

exceptions to the rule, for example, by having the client sign a special form. Alternatively, brokers sometimes obviate the need for the form by simply marking the ticket “unsolicited.” I discuss this practice in more detail later.

To date, I have not been witness to anyone, including industry personnel, espousing that unauthorized trading is not a serious and actionable violation. Additionally, almost every one of the numerous supervisory or compliance brokerage firm manuals that I have reviewed specifically address the severe restrictions surrounding unauthorized trading.

### Public Misunderstanding

One of the major defenses launched by brokerage firms to a claim by investors that there was unauthorized trading in their accounts is, “Why didn’t the investor complain about the unauthorized trading two years ago when it began?” The brokerage firm claims that the investor had to have seen the trades on the confirmations and monthly statements and by remaining silent, the investor has ratified the trades. The Securities and Exchange Commission has taken issue with this view.<sup>7</sup> As I mentioned earlier, the reality is that a lot of investors do not know that a broker is required to discuss each and every trade in detail just prior to the trade. With stockbrokers touting titles these days, such as Vice President Investments, Asset Manager, Senior Vice President Portfolio Manager, Financial Planner, and Financial Advisor, investors mistake stockbrokers for registered investment advisors who typically only manage money on a discretionary basis. Nowhere in the brokerage firm booklets or in the Customer Agreement is it explained that brokers are not money managers and are not supposed to make trades without first discussing the trades with clients. And most brokers don’t explain this regulation and concept to clients from the get-go. The end result is when brokers make unauthorized trades in clients’ accounts, far too many investors think that the broker is just doing his job. It may even be years later, after the broker has traded away all of the client’s money and the client is talking to a securities lawyer or expert that the client discovers that what she thought was proper activity by their stockbroker was, in fact, a very serious securities violation.

At least from my perspective, as a person who reviews numerous portfolios and is queried about various potential customer claimants on a constant basis, the complaints about unauthorized trading have not diminished over the years. Unauthorized trading has historically been and remains one of

the largest claims filed with the NASD in arbitrations. It is claimed 40% to 50% more often than churning is claimed.<sup>8</sup>

### **The Mismarking of Trade Tickets “Unsolicited”**

The mismarking of tickets “unsolicited” seems to be on the rise. This practice can sometimes be associated with the violation of unauthorized trading, but it is rare. I have been involved in cases where the broker not only made unauthorized trades in the clients’ accounts, but he had the nerve to add insult to injury by marking the tickets “unsolicited.”

There are two distinctly different concerns when it comes to the issue of whether a trade is solicited or unsolicited. The first is the central issue of proper marking of the ticket and the second is the duty of both a brokerage firm and its broker when a trade is solicited versus unsolicited.

Almost every brokerage firm has a place on the order ticket for the broker to record if an order is solicited or unsolicited. This is true for most all order tickets, even if the ticket is entered electronically on a computer. The exception would be some of the online firms, which by firm policy make no recommendations at all. Still many firms, like E\*Trade, have the word “unsolicited” on all of their orders. There is a strong argument that an online brokerage firm that advertises for business and introduces investors to various products, investment services, and initial public offerings is, in fact, soliciting trades. But, that is too broad a subject to enter into in this article.<sup>9</sup>

It is the industry standard and understanding that if, for some reason, the trade ticket is not marked solicited or unsolicited, the trade is considered to be solicited. The reason for this is that at the majority of full service brokerage firms, the broker in fact solicits the vast majority of the trades. It is assumed that if an investor were going to initiate and make most of the investment decisions himself, he would do this activity at a discount, or deep discount brokerage firm, wherein he would save considerably on commissions.

Why is it necessary in the first place to designate a trade as solicited or unsolicited? No securities regulation specifically requires the notation of solicited or unsolicited on an order ticket, though it is the standard in the industry and almost every brokerage firm requires it. The answer is that it is mainly a supervisory and regulatory requirement. In the securities industry, there exists a multilevel system that is designed to monitor and evaluate the

trading of brokers in order to determine if there are any violations of the securities industry – or any red flags that might be indicative of a violation. A licensed supervisor at the branch level is required to review every trade made by a securities broker. Additionally, branch offices and the NASD or NYSE are required to routinely conduct audits of firm practices, which includes a scrutiny of the firm brokers' marking of order tickets.

One of the most violated rules of the securities industry is that of suitability. The NASD rules are that a broker cannot recommend an investment that is not suitable based on investors' investment goals and needs. Without getting into the heated argument of whether a brokerage firm has duties on both solicited and unsolicited orders, I will point out the undisputed fact that most of the industry treats solicited trades differently than unsolicited trades. The industry mentality is that it has heightened duties with respect to solicited trades versus unsolicited trades. Therefore, the marking of tickets either solicited or unsolicited can effect the supervision level and attention given to orders.<sup>10</sup> When a supervisor or regulator is reviewing trade tickets to check for things like suitability or churning, he will give stronger weight and concern to solicited trades, than unsolicited trades.

Brokers are very aware of this predisposition of management to give less scrutiny to unsolicited trades. And this is where the serious conflict comes into play. As a securities expert who has been involved in hundreds and hundreds of complaints and arbitrations, I have seen an alarming number of cases where brokers have systematically marked tickets "unsolicited," when in fact they were solicited.

Because most firms provide their brokers with order tickets that require the denotation of solicited or unsolicited, it is the mismarking of the order ticket that gives rise to a violation of a number of securities regulations. As a preface, a mismarked order ticket will almost always be a negligence violation, in that the brokerage firms' compliance manuals will set out the duty of filling out order tickets completely and accurately. In addition, SEC Rule 240.17A(a)(3)(4) requires the filling out and maintenance of complete and accurate trade records. The practice also violates NYSE Rule 410, Records of Orders and NASD rule 3110 Books and Records.

The false mismarking of a ticket can also be considered to be a fraudulent act. I quoted an earlier court that said an unauthorized trade could be a 10b and 10b-5 violation because the broker would be omitting to tell a customer a

material fact. Mismarking a ticket “unsolicited” when in fact it was “solicited” is making a false statement. Rule 144-130 of the Arizona Securities Act specifically prohibits “[e]ngaging in a pattern of marking order tickets as unsolicited when the dealer or salesman directly or indirectly recommended the transaction or introduced the customer to the security.” Lastly, this practice of falsely marking order tickets would also be a violation of NYSE Rule 401, Good and Ethical Business Practices, NASD Rule 2110, Standards of Commercial Honor and Principles of Trade, and NASD IM-2310-2, Fair Dealing with Clients.

An investor’s allegation of mismarked order tickets invariably is coupled with other securities violations, such as churning, suitability, or unauthorized trading. And every claim of mismarked order tickets necessarily brings in a claim of failure to supervise. This logically follows, because the primary motivation for a broker to mismark a trade ticket is to circumvent proper supervision. One might ask, “How can there be a lack of supervision when it is the broker who mismarked the order ticket? The securities industry is quite aware that there is a problem with the mismarking of order tickets. Many supervisory manuals contain guidelines for management to monitor and detect the mismarking of order tickets. The defense of, “We didn’t know” usually doesn’t fly.

One of the guidelines is that a supervisory manager should “question” and consider it a red flag when a manager notices a large grouping of order tickets “marked unsolicited”.<sup>11</sup> This is the standard, again because it is rarity when most of a clients’ trades are “unsolicited” at a full service brokerage firm.

I was recently involved as an expert witness in a case where the brokerage firm restricted a group of brokers from soliciting any more purchases of a speculative security, due to the low price of the security and the large positions these brokers had built in the stock. One of the brokers thought he could get around this restriction by simply marking all of the tickets “unsolicited” from that date forward. There were numerous trades on the same day, by different investors in this one stock, all marked “unsolicited.” At the same time, the broker was purchasing additional shares in his own account and sending out research materials on the stock, admitting he was bullish on it. Yet all of the tickets the supervisors reviewed were marked “unsolicited,” a fact that no one in management ever questioned. You can see how the failure to supervise claim would take on almost as much importance as the primary wrongdoing by the broker.

## Pushing Stocks and Cocaine

Let's put aside for a minute the stockbroker who just marks everything "unsolicited" when he knows it is the farthest thing from the truth. There is another, almost as dangerous, practice of marking tickets "unsolicited" after the broker has initiated the investment idea and gotten the client hooked on the stock. It is not too unlike the cocaine pusher. If one is going to be a successful cocaine dealer, one has to have a lot of cocaine users to whom to sell the product. My understanding is that being addicted to cocaine is not something that one inherits; it is acquired. So, the cocaine pusher must find innocent individuals to turn on to cocaine. The pusher does this by giving free or discounted samples of cocaine to encourage the addiction. Once an individual is hooked and the person addicted, the addict will come back to the dealer for more and more, thus securing for the dealer a consistent income.

I have seen numerous individuals who could not even describe what an option was, much less have any particular interest in trading them. But the broker introduced options to these novice investors by playing up the positives and ignoring the negatives. A few profitable option trades and the client may very well become addicted – the broker then introduces him to more and more complex option trading strategies. The broker may be honest enough to mark these initial trades "solicited," but once the client starts calling to see what other option ideas the broker has, the tickets conveniently become marked "unsolicited." When the volume increases and management questions the broker about the suitability of the option trading, the broker responds with, "He's a sophisticated option trader and knows what he's doing."

With my twenty one years in the business and having read the compliance manual of just about every major brokerage firm, not to mention the securities regulations and interpretations, it is my opinion that the industry standard is that when the broker or firm introduces the investment strategy or the particular investment to the investor, from that point forward, the trades and order tickets must be marked "solicited". The following is how one brokerage firm describes the issue of whether a trade is solicited or unsolicited:

## Definition of an “Unsolicited” Order

Any order for a particular security or commodity which was initiated by the customer and which was not recommended or otherwise suggested in any manner by the Investment Executive. Effectively, the Investment Executive’s participation in the order is limited to merely giving the customer specifically requested statistical information, such as the current quote or known (not estimated) earnings, dividends, etc., and taking the order at the customer’s direction.

Whenever there is any doubt as to determining whether an order is “unsolicited”, the Investment Executive should discuss the order origin with his Branch Manager or an officer of the firm. If any doubt persists, the order is to be marked “solicited”.

## Definition of a “Solicited” Order

Any order placed by a customer for the purchase or sale of a specified security or commodity which results from the selling efforts or at the suggestion of the Investment Executive. The act of bringing a security (or commodity) situation previously unknown to the customer to his attention may be termed a solicitation. Furthermore, any selling efforts which results in an order is a solicitation, albeit a lapse in time may have occurred between the discussion and the order’s placement.

Summarized, a “solicited” order may be the result of either:

- (a) Oral or written communications which suggest or recommend a specific security or commodity; or
- (b) Furnishing or mailing of any research report, market letter, or other written communication concerning a specific security or commodity

There could very well arise a time when a broker who was responsible for originally initiating the investment idea to a client could legitimately mark subsequent tickets “unsolicited.” One such scenario might be if a significant amount of time had elapsed from the broker’s original recommendations. “Significant” means a number of months and would not be measured in days or weeks. Of course, if a broker truly feels that an investor’s trade is not only unsolicited, but also unsuitable, a mere marking of the ticket unsolicited may not be sufficient. You would be surprised how many times answers by brokerage firms in suitability cases state that the broker warned the client against certain investments or activity. I am always glad to see this, because I feel that a broker, due to his license, does have a duty to warn clients against unsuitable investments, even if the investment is unsolicited. But far too often, I find, and the arbitrations panels find, that the only warning issued by the firm was in the firm’s arbitration answer – a bit late. It is an industry standard that a broker and his manager, as well as compliance personnel, should document any warnings where they feel an investor is conducting transactions that are unsuitable. An undocumented warning has very little credibility.

## **Time And Price Discretion**

The issue of the proper use of time and price discretion is no clearer now than it was seven years ago when I first addressed it. Despite this, certain regulators have quoted my first article when questioned about time and price discretion, and I hope that this article will be equally as useful.

When there is an accusation of unauthorized trading, a very common defense raised by brokers and brokerage firms is that there was no unauthorized trading. Instead, the broker was exercising time and price discretion.

I consider time and price discretion a loophole in the securities regulations that allows a broker to make a trade without the strict guidelines mandating a complete discussion and agreement by the investor prior to entry of the trade. Basically, the time and price exception rule allows a broker to get verbal permission to have some flexibility as to the exact time and the exact price in which the broker executes the order. It is a concept that is often misused and abused. Just as many brokerage firms disallow or discourage the

use of discretion, some firms also disallow or discourage the use of time and price discretion.

The most common abuse of time and price discretion is when it becomes a timeliness issue. As I have stated in the past, time and price discretion is measured in minutes, hours or maybe a day or two at most, but certainly not days, weeks, or months. Tracy Pride Stoneman, a securities lawyer in Colorado Springs, Colorado represented an investor in arbitration where the broker defended the unauthorized trading claim by saying that he had time and price discretion for the trades. When questioned how much earlier than when the actual trades took place did the broker have the conversation about this trade with her client, the broker responded with, "Six months!" Tracy's client prevailed in the case. In their decision, the arbitrators sent a blatant message to the firm when they made written findings of the firm's failure to supervise in their award.

It is my opinion that the use of time and price discretion by brokers should be documented, if not always, then at least when the order extends beyond the time limit of a day or two. If a broker has a legitimate time and price exception order, which the broker feels is for a long period of time, that fact is a material element of the order (there is always the question of why the order could not have been handled with a Good Till Cancelled (GTC) ticket).<sup>12</sup> SEC Rule 17a-3 is entitled "Records to be Made by Certain Exchange Members, Brokers and Dealers" and states:

(a) Every member of a national securities Exchange ... shall make and keep current the following books and records relating to his business:

(6) A memorandum of each brokerage order, and of any other transaction, given or receive for the purchase or sale of securities, whether executed were on executed. Such memorandum shell show the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time of entry, the price at which executed and, to the extent feasible, the time of execution or cancellation. Orders entered pursuant to the exercise of discretionary power by such member, broker or dealer, or any employee thereof, Shelby so designated. The term "instruction" shall be deemed to

include instructions between partners and employees of the member, broker or dealer. The term time of entry shall be deemed to mean that time when such member, broker or dealer transmits the order or instruction for execution or, if it is not transmitted, the time when it is received.

(7) A memorandum of each purchase and sale for the account of such member, broker or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where such purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing that time of receipt, the terms and conditions of the order, in the account in which she was entered.

The above rule makes it clear that information that is part of the order (be it either “conditions of the order” or “time when it is received”) must be documented on the order. Anyone with a thorough knowledge of the securities industry would have to admit that a time and price discretion order that allows the order to take place some time after it is was given by the investor should be documented. There is no better place to do that than on the order ticket. This is not to say that the mere documenting of the event necessarily makes it proper. I am still of the opinion that the rules do not allow for “extended” time and price beyond a day or two at most. But, if a broker is going to argue he had the right to have such an “extended” order, it clearly must be documented under rule 240-17a-3.

In further support of this interpretation, one can look to the language and concepts in the NASD Limit Order Protection Rule (Manning Rule). The Manning Rule addresses how limit orders should be handled and protected for over-the-counter orders when a market maker is involved. To help prevent disputes on exactly what limit order price is being protected by the market maker, the rule requires that the exact price be written down. An NASD Notice to Members expands on this concept by requiring that a market maker:

...must clearly document that it has obtained the authorization of its customer to work the order and must disclose to the customer that such discretion means that the firm may trade at the

same price or at a better price than that received by the discretionary order. In addition, it should be noted that, because the customer has granted the market maker the discretion to work the order, the market maker, as agent, has a clear responsibility to work to obtain the best fill considering all of the terms agreed to with the customer and the market conditions surrounding the order. In the absence of a clear understanding between the trader and the customer regarding [the market maker's] activities in competing with the customer order, [the market maker] could potentially violate its fiduciary duties to its customer in the way it "works" the order.<sup>13</sup>

Importantly, the NASD once again requires that the conditions surrounding an order be documented. One brokerage firm's Compliance Manual has the following guidelines:

#### Time and Price Discretion

- Time and price discretion may on occasion be acceptable for sophisticated clients who are difficult to reach. Before undertaking this limited discretion, the Investment Consultant must be satisfied that the client understands time and price discretion
- The Investment Consultant should write the order ticket immediately upon receipt of the order and mark the ticket as a time and price discretion order.
- The ticket should be dated and retained by the Investment Consultant pending order execution.

My suggestion would be that any rule or interpretation by the NASD or NYSE should contain the following minimum standards:

1. Firms must require their brokers to explain time and price discretion to their clients before they take a time and price discretion order.

2. Brokers must confirm with clients at the time a specific order is taken that there is an agreement that time and price is to be utilized on that order and only on that specific order.
3. The broker, as with a normal ticket (be it a paper ticket or computer generated ticket,) must immediately fill out the ticket after receiving the order from the client.
4. Firms that allow their brokers to utilize time and price discretion must have order tickets that have a box that must be checked whenever time and price is utilized.
5. Brokers should be required to discuss and agree with the client exactly how long the time and price discretion can be utilized.
6. Brokers should be required to indicate on the order ticket next to the above referenced box the length of time the broker and investor have agreed upon for the use of time and price discretion.
7. Any ticket checked for the use of time and price discretion wherein the broker failed to mark down the time period should default to no greater than two trading days from the date of the order.
8. All time and price discretion orders must be time stamped immediately after the broker writes the order.
9. Brokers must obtain a duly authorized manager's approval within a reasonable time, say within 24 hours, after time stamping the ticket.
10. If and when the trade is executed, the confirmation should state that the trade was executed as a time and price discretion order.
11. Brokerage firms should be encouraged to educate their clients as to the advantages, disadvantages, conflicts and differences between regular orders, good till cancelled orders, discretionary orders, and time and price discretion orders.
12. Brokerage firms should make sure their policies and procedures, as well as ongoing educational programs, remind brokers of the limitations

surrounding the use of time and price discretion. And that even when time and price discretion is taken, the broker is nonetheless required to fulfill all of the standard duties and disclosures relating to order taking. Specifically, the broker must still discuss and gain permission as to the specific security and the number of shares to be transacted.<sup>14</sup>

13. Under no circumstances can a time and price discretion order be good for more than 60 calendar days from the date of the initial order. A broker can only extend the time period by initiating contact with the investor and re-discussing the details of the order, and once again gaining specific permission to reenter the order and agreeing with the client how many days the time and price order is for.

Some might feel these guidelines are a bit draconian. I recently surveyed a number of compliance officers and regulatory individuals who agree that time and price discretion is abused and far too often is merely an excuse used when accusations of unauthorized trading are levied. Keep in mind that a time and price discretion order is most dangerous, because it is an order that sits hidden and unknown on a broker's desk or worse in a broker's memory. It is an order that may not be reviewed by management or compliance or regulators, much less the client. An undocumented time and price order is unlike a standard order or GTC order, which are immediately routed through the brokerage firm system, documented, monitored and supervised. It is time for time and price order tickets to be brought into the 21<sup>st</sup> century.

### **Proving Unauthorized Trading and the Mismarking of Order Tickets**

As with a number of securities violations, unauthorized trading can sometimes result in a he said/she said scenario. The claimant said the broker never called her, and the broker said that not only did he call her, they discussed each trade in minute detail. The panel is left deciding who is more credible. The one thing good about this kind of testimony is that it is so black and white that someone is clearly lying. It becomes slightly tougher when the client remembers a conversation but says it wasn't as detailed as the broker claims. The following are some topic areas and documents that can assist managers, compliance officers, regulators, lawyers and arbitrators in assessing the issues of unauthorized trading and mismarking of order tickets.

## Phone records

Phone records are the quickest and easiest method of proof in some cases that involve unauthorized trading. Since all conversations about an order must be in detail and just prior to entry of the trade, phone records can be very telling records. Far too often, there are no phone records (because all of the calls were local, not long distance) and it is once again the word of the claimant against the broker. But in an unauthorized trading case when dealing with a truly unethical broker who has done more than just a mere one or two convenient unauthorized trades, that is, where you have a broker who is treating the account as if he had legal discretion, the phone records can be invaluable. If the broker and or client use mobile phones for much of their contact, those records can also be helpful.

## Inaccessible Client

One of the easiest ways to sniff out unauthorized trading is to find out if the claimant was inaccessible during part of the alleged unauthorized trading. Hospital stays, remote vacations, an intense business conference, overseas travel and camping trips can constitute such scenarios. If the claimant testifies and can establish that he was not accessible during these time periods, this can go a long way toward supporting his claim of unauthorized trading.

## The Art of Reviewing Order Tickets

The he said/she said problem can sometimes be eliminated by a detailed review of all order tickets, full commission runs and trade blotters. As an expert, I have been hired hundreds and hundreds of times to review order tickets. It is truly an art. Given enough time, and the luxury of the trading records of all of a broker's accounts, including his personal and family accounts, the comparative analysis between trades can be incredibly enlightening. Both the inconsistencies and the consistencies of the marking of tickets can be telling when assessing the mismarking of tickets and unauthorized trading. As I discussed earlier, all of the tickets marked "unsolicited" across client accounts is almost certain proof that the tickets are being mis-marked. Inconsistently marked tickets may be almost as telling, whether that inconsistency is within one client's account or across other clients' accounts. Under the guidelines in this article and in the industry, it would be improper for a broker to be marking the tickets for a particular security within a single account "solicited,"

then “unsolicited,” then back to “solicited,” and so on. There might be excuses given by the broker for such activity, but they would remain just that - excuses.

Additionally, having one set of clients where trades are being marked “solicited” and another set of clients where the trades are marked “unsolicited” makes little sense. The brokerage firms are keenly aware how damaging these kinds of trading patterns can be to their defenses and so you can rest assured they will go to great lengths to keep the claimant from being able to obtain the broker’s other trading records and will fight doubly hard to swart any attempts to determine if the trading in those other accounts was “solicited” or “unsolicited.” It seems hard for me to imagine how anyone can buy the argument that those documents are not relevant in any claim of unauthorized trading or the mismarking of order tickets, certainly once red flags have been established through a review of the unredacted commission runs.<sup>15</sup>

### Patterns of Trading in Other Accounts

Probably the single best indicator, other than finding the exact same securities in the broker’s other accounts, of whose idea particular investments or strategies are; is by studying a broker’s personal trading records and those of all of his clients to look for patterns. For example, let’s say the investor has claimed that the broker made numerous unauthorized trades in her account and included in those trades are short sales. Though a review of the broker’s other accounts may not find the exact same stocks being shorted, does the broker have a habit of making short sales in his other clients’ accounts? Another investor might claim that a broker was making unauthorized trades and many of these trades were relatively short term in nature. Does the broker’s other trading accounts reveal a pattern of short term trading? Lastly, there’s the investor who has complained that a broker concentrated his account in a Vancouver oil stock. A review of the tickets shows the broker marked them all unsolicited. If a review of the broker’s accounts shows a history of buying similar oil related stocks, one might justifiably give credence to the investor’s claim.

### Memory Jogs

Additional testimony that can support unauthorized trading is the practice of going through the particular trades with the claimant at a hearing. If one of the companies that was supposedly purchased without authorization has a particularly unusual name, such as Fly-By-Night-Airlines, a detailed

questioning of the claimant can be quite revealing. The testimony might go as follows: “Mr. Jones, how is it that you can be so sure that Mr. Broker never discussed the purchase of this security with you?” Answer: “I may not have the best memory, but I can guarantee you, I would remember if someone called me up and tried to convince me to put money in a stock called Fly-By-Night-Airlines.” This name recognition can also be an important part of an inquiry relating to trades that were marked “unsolicited” versus the trades being unauthorized. A client will often be able to testify that he would remember if it was his idea to buy a stock with a name like Fly-By-Night-Airlines, but what can be additionally enlightening testimony is when there is something unique about the company or the industry itself.

I remember a case where the broker had marked a purchase of Federal Express stock unsolicited. The client testified that he earlier had a business run-in with Federal Express and since that time, he has hated the company. He not only would have never asked a broker to purchase Fed Ex stock, he said that if the broker would have suggested it to him, he would have vehemently rejected any recommendation to buy Fed Ex. This type of supportive evidence can go a long way toward convincing an arbitration panel who is telling the truth.

### Commission Discounting or Lack Thereof

One indication that tickets are being marked incorrectly can be commission discounting. If an investor has his account at a full service brokerage firm, the vast majority of the time, a significant portion of the trades should not be marked “unsolicited.” A sophisticated investor, who is truly in control and calling all of the shots, is smart enough to know that he could do his trades at a much lower commission rate and get every bit as good an execution at a discount or online brokerage firm. Because of this, it is not unusual for brokers to charge a standard commission rate for the investments he recommends (solicits) and a lower commission rate for trades that are not his idea (unsolicited). Therefore, looking at the discounting or lack of discounting can sometimes be revealing.

One lawyer I am working for has a case where the broker has marked virtually all of the hundreds of option order tickets unsolicited. Yet his client will testify that the broker solicited each of those trades and that he had done no option trading prior to being introduced to them by this broker. In addition, the evidence will show that the broker had given a speech on the use of options

prior to client's opening his account. It is these kinds of facts and documents that help the trier of fact determine if violations have taken place.

## Supervision

I have mentioned these telltale signs to help attorneys and arbitrators who are involved in unauthorized and mismarking of ticket claims. But these comments should be every bit as useful to those who are in management and compliance departments at brokerage firms. Through their supervisory licenses and experiences, these individuals should be well aware of these telltale signs, which are referred to in the business as "red flags." But sitting through as many arbitrations as I have, I have often wondered if some of these folks skipped the "red flags" class.

It always surprises me when a manager or compliance individual testifies that he saw nothing unusual about the marking of tickets unsolicited when it is fairly well established that the investment or the trading strategy couldn't have been more unsuitable for the investor. For example, take the retired elevator operator who is trading index options in hundred lots. The trading is probably unsuitable regardless of what the client's stated investment objectives are. The broker tries to justify the activity by marking the tickets unsolicited and telling the panel that the client was a dice rolling speculator. Both this broker's manager and eventually the arbitration panel might question why this client would want to purposefully take such incredible risks, exposing his entire life's savings. They should take the broker's word with a grain of salt. The huge commissions the broker has generated by this option trading is an accepted conflict of interest. Both the unsuitability of the investment activity coupled with such an obvious conflict can and should be used as measuring sticks when evaluating unauthorized trading and the mismarking of order tickets.

Establishing that the client had no or limited ability to have generated the stock idea in the first place is also helpful. For example, if the client did not subscribe to any financial publications nor had a propensity to study investments, the likelihood that the client is coming up with investment ideas on his own may be remote. Always be on the lookout for indicators. In the case I mentioned earlier, where the broker started marking all of the trades "unsolicited," the manager knew that in this very stock, the broker had a personal relationship with an insider of the company.

## Concentration

I listed concentration after supervision because it is as much a lack of supervision violation as it is an individual broker violation. I have found that one of the times that brokers tend to mismark order tickets is when the broker is concentrating a client or a group of clients in one particular security. It is a given fact that when an investor does not properly diversify his account and has far too high a percentage of his portfolio in one or a few securities, that it increases the risk of loss to the portfolio. It is for this reason that most reputable brokerage firms have language in their compliance manuals either discouraging or prohibiting brokers from recommending that their clients buy too high a percentage of a particular or small group of securities. The broker who wants to limit the oversight of his manager and the compliance department to this concentration issue can attempt to do so by mismarking order tickets.

I use the word “attempt,” because any adequately trained and ethical supervisor should easily detect these falsely marked tickets. Those attorneys and experts with a long history in securities litigation know far too well that one of the most damaging practices is when a stockbroker becomes too enthralled with a particular security. It often starts out innocently with a broker becoming interested in a particular company’s stocks or bonds. As the broker purchases and recommends more and more of the security to his clients, he tends to conduct additional research and become more captivated with the stock. This problem is often exacerbated when the broker has some personal contact with one of the officers of the company.

The problem of concentration usually worsens if the target security drops in price. The broker was recommending the security to his clients at \$20 and now at \$10 a share he’s on the phone urging his clients to double up or average down. The percentage of his clients’ portfolios in the concentrated security grows as the stock continues to plummet and the broker keeps adding to the positions. As a larger portion of the broker’s client base becomes concentrated in the security, potential disaster not only awaits his clients, it also threatens the broker’s business if the stock does not recover soon. For these reasons, the broker is now living and breathing the security. He is the master of all knowledge concerning the security. He ignores all negatives and trumpets any positive news. As the ship continues to sink, he doesn’t allow any of his clients to get in the life raft. When they call panicked and concerned that they are

losing their life savings, he not only talks them out of selling, he talks them into purchasing more shares at even lower prices.

Far too often in this situation the tickets are being falsely marked “unsolicited.” A properly run supervisory system should already have detected the concentrated activity, and the broker and his clients should have been questioned in detail concerning this potential powder keg. You would be shocked at how many cases I have seen where not only has this activity fallen on blind eyes but to make matters worse, no one took notice that the tickets were marked “unsolicited.” It borders on the tragic when a manager or compliance officer says that he or she suspected no wrongdoing in the undue concentration because of the fact that the tickets were marked “unsolicited.” You’d had to have grown up in a cave and been asleep through your securities training and exams to not realize that the reason the broker is most likely falsely marking the tickets is to fool management and compliance. It is clear when viewing a broker’s accounts and seeing a particular security, not only in the vast majority of the broker’s accounts but in high concentrations, that the trades are likely due to the broker’s solicitation.

Let me give you a real life example. I was involved in an arbitration where a broker purchased a particular, risky security in 125 of his clients’ accounts. This particular brokerage firm, like most, required brokers to fill out a non-solicitation form and get it approved by the brokerage firm for any securities that were not on the firm’s recommended list. The security in question was one such security. The form was required to be filled out and re-approved every 6 months. The stock in question eventually dropped to around \$2 a share, and the brokerage firm rejected the next non-solicitation form submitted by the broker. So, the broker could no longer solicit any purchases in the stock. What I’m going to tell you next I hope you find shocking. The broker from that point forward just began marking all of the tickets unsolicited – for multiple accounts. And the broker himself continued to purchase the stock in his own account. When the branch manager was asked on the witness stand if he didn’t think it was an indication that the broker was falsely marking the tickets unsolicited when there were so many tickets for so many unrelated accounts beginning just when the broker’s non-solicitation request was rejected, he replied with a glib “No.” This manager wouldn’t recognize a red flag if it was on fire and falling on top of his head.

## Bunching

The act of bunching order tickets can sometimes help in shedding light on an unauthorized trading or mismarking of tickets case. Bunching is the practice wherein a broker, instead of writing a separate ticket for each trade, groups or bunches a number of his individual client orders into one single order, be it a purchase or a sale. Bunching is, in some ways, the retail version of the institutional practice of block trades. Professional money managers almost always manage money on a discretionary basis. But unlike a mutual fund that has only one account, a money manager has separate accounts. Since he has discretion over all of his accounts and usually manages them in the same style, it would be inefficient for the manager to enter individual trades for each account. Therefore, block trades are almost always used. A block trade is almost always 10,000 shares or greater. There is little conflict in this type of trading, and it is the norm in the institutional business.

The retail business is a totally different animal. Brokers are not allowed to commingle accounts. Brokers have individual accounts. Nor do brokers do most of their business on a discretionary basis.

Some brokerage firms allow their brokers to phone in their orders directly to order desks. This is done when a broker has a large, important order and time is crucial. Supposedly by phoning in the order, the broker can save some precious time over going through the normal ticket writing and entering procedure. Many firms disallow the practice because there is so much room for abuse. When it is allowed, there are very strict rules that must be followed – of both the firms and the industry.

There is already enough conflict of interest in the securities industry without allowing bunching. Bunching just elevates the conflicts to a new level. One abuse is as follows. If a broker enters one large trade without designating exactly for whom each and every share is for, prior to entering the trade, he has incredible power and ability to do wrong. He can wait to see if the execution is a good one, and if he is trading in volatile securities and securities where a  $\frac{1}{4}$  of a point can mean a lot of money, like options, he can then turn in the account numbers and the amounts which are most beneficial to him, not necessary to his clients.

An example might be where a client tells her broker that she is going to move her account because she is losing so much money. For the next couple of

weeks, the broker dumps more of the “winning” trades into that client’s account, while placing the less favorable trades into a client's account with whom he is dissatisfied with at the moment. It is because of the incredible conflict potential that even those firms that allow limited bunching, do not permit the bunching to include the account of the broker.

I mention bunching because it often takes place when there is unauthorized trading and the mismarking of tickets. The key point to remember is that it would be almost impossible to have an unsolicited order when it is part of a bunched trade. To ascertain if there was bunching, you need the full commission runs and the trade tickets not only for the client’s account, but also for those other accounts that also traded in the same stock on the same day.

## **Conclusion**

Unauthorized trading, the improper use of time and price discretion, and the mismarking of order tickets are all serious violations. The regulators and the brokerage firms can do a better job of educating, monitoring and supervising brokers for these infractions. In addition to the tools the brokerage firms already have, they could use some of the suggestions in this article to help in their supervisory process. Additionally, investors could be better educated and warned about these possible infractions, so that they would be better equipped to spot these violations on their own.

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Mr. Schulz is President of Invest Securities Consulting PC. based in Westcliffe, Colorado. He is a Registered Investment Advisor (RIA). He was previously licensed with the Securities and Exchange Commission (SEC) and is currently with licensed in various states as an RIA. Through 1998, Invest managed up to \$25 million. Mr. Schulz also analyzes investments, investment strategies, and performance results and performs due diligence and investigations for merchant bankers, investment bankers, and the brokerage industry. He has held numerous securities licenses and currently holds the NASD title of Certified Regulatory and Compliance Professional (CRCP) and a General Securities Principal license. Mr. Schulz is a securities consultant and expert witness and has testified as an expert in federal and state courts, and arbitrations over 300 times. He has testified in cases, which have resulted in arbitration awards or settlements totaling over \$50 million dollars, including several significant punitive damage awards. He is an NASD and NYSE arbitrator.

Mr. Schulz has worked in the securities industry for over 20 years, which has included such firms as Merrill Lynch, Bear Stearns and IDS. He assisted the New York U.S. Attorney General's office and the SEC in connection with their investigation of Prudential Securities' nationwide securities fraud involving the sale of limited partnerships to investors from 1980 through 1992. Mr. Schulz has written numerous publications for PLI, Securities Arbitration Commentator, Practitioners Publishing Company. . He co-authored the book "Brokerage Fraud – What Wall Street Doesn't Want Investors to Know" His article on unauthorized trading is still used extensively in arbitration He has been quoted in Quoted in Wall Street Journal(5), American Lawyer, Money Magazine, Newsweek, New York Times(4), BusinessWeek(3), Kiplinger's Personal Finance, Dow Jones Investment Advisor, Financial Times (London), Institutional Investor, Boardroom Inc., Medical Economics Journal, Sun-Sentinel, Times Record News, Dallas Business Journal, Dallas Morning News, Tampa Tribune, St. Petersburg Times, Colorado Springs Business

Journal, The Denver Post The Charlotte Business Journal, Philadelphia Inquirer, and Registered Representative

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<sup>1</sup> “When is an Order an Order? Unauthorized Trading by Securities Brokers” by Douglas J. Schulz, Practicing Law Institute (PLI) 1994. The current article supplements and greatly expands upon the 1994 article. For this reason, readers are encouraged to read the original article wherein numerous basic topics are addressed that will not be repeated, such as why the rules concerning unauthorized trading were written and the required communications when a broker solicits a trade.

<sup>2</sup> Robert Lester Gardner, Exchange Act Rel. No. 35899 (June 27, 1995), *aff'd*, 89 F.3d 845 (9th Cir. 1996); Jonathan Garrett Ornstein, 51 S.E.C. 135, 137 (1992).

<sup>3</sup> Village of Arlington Heights v. Poder, 712 F.Supp. 680, 683 (N.D.Ill.1989); See also, In the Matter of Donald A. Roche, Exchange Act Rel. No. 38742 (June 17, 1997)( Roche violated the antifraud provisions by making unauthorized trades. “In general, unauthorized trading violates the antifraud 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 antifraud provisions by making unauthorized trades in these two accounts.”)

<sup>4</sup> SEC Release 39383, December 2, 1997, File No. 3-9269. Fabio appealed to the SEC a previous finding by the NYSE that there was an exercise of discretionary power without customer’s written authority. Fabio had argued the defense that the client had given him verbal discretion to “go ahead” and “find appropriate investments”. The NYSE said that the broker did not have the proper authority to make such trades in the client’s accounts even though he had been given verbal instructions to do so. The SEC sustained the NYSE’s findings. See also, SEC Release No. 34-31081, August 24, 1992, 1992 WL 213845. The SEC sustained a ruling by the NASD that the broker had violated the rules concerning unauthorized trading. The broker claimed he had “time and price” discretion and that the client had given him “oral discretion” The broker admitted that the details of each trade (mostly options) were not discussed with the client but that the client was aware of the “overall strategy.” This argument failed to defend the broker.

<sup>5</sup> NYSE Hearing Panel Decision 96-43, April 30, 1996, 1996 WL 286998 (NYSE). Findings against J.C. Bradford for allowing a broker to make discretionary trades of IPO’s. This practice “raises such a potential conflict of interest” and “is a violation of the anti-fraud provisions of the Federal securities laws.” dealing with underwriters. Additionally, most brokerage firm’s compliance manuals spell out that brokers cannot make principal trades in a discretionary account.

<sup>6</sup> Restatement of Trusts, 2nd/3rd, §§ 170 and 206, §170, comment h: "Sale of trustee's individual property to himself as trustee: The trustee violates his duty to the beneficiary if he sells to himself as trustee his individual property or property in which he has a personal interest of such a substantial nature that it might affect his judgment. It is immaterial that the trustee acts in good faith in purchasing the property for the trust, and that he pays a fair consideration."

<sup>7</sup> SEC Release No. 40335, August 19, 1998, File No. 3-9346. 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 ratification 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).

<sup>8</sup> NASDR Dispute Resolution Statistics Updated 4/26/01, Summary Arbitration Statistics March 2001, years 1997 – 2001.

<sup>9</sup> There is argument and support through notices of the regulators that even on unsolicited orders, the brokerage industry has a duty to make sure that trades are suitable even if they are unsolicited. I authored an article in August 2000, “No Duty – Does Suitability Apply to Internet Brokerage Firms?” that addressed the duties of online brokerage firms.

<sup>10</sup> SEC Release No. 37991, November 26, 1996, File No. 3-8639. SEC sustained NYSE finding of numerous violations including unauthorized trading. “Moreover, by failing to obtain the requisite written authorization,

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Faragalli [the broker] kept PW from discovering his control over these accounts, and prevented the firm from subjecting the extra degree of scrutiny normally accorded such accounts pursuant to firm procedures.”

<sup>11</sup> One major brokerage firm states in a compliance memo, “A series of orders marked unsolicited will be closely questioned on the theory that multiple unsolicited orders were, in fact, solicited.” Another major brokerage firm once put it this way in its Branch Manager’s Supervisory Manual, “When reviewing the order tickets, a Branch Manager must consider the following:.. A series of orders marked “unsolicited” for the same stock from a client or clients of the same Financial Consultant. The marking of order tickets as “unsolicited” will not protect the Branch Manager if the circumstances are suspicious, in which case the Branch Manager must determine if the orders are, in fact, solicited....”

<sup>12</sup> See, “When is an Order an Order? Unauthorized Trading by Securities Brokers” by Douglas J. Schulz, Practising Law Institute, 1994. The article discusses the proper use of GTC tickets versus the use of time and price discretion.

<sup>13</sup> NASD Notice to Members 97-57, NASD Interpretations Of SEC Order Handling Rules, NASD Limit Order Protection Rules, And Member Best Execution Responsibilities.

<sup>14</sup> NYSE Hearing Panel Decision 86-16, June 26, 1986, 1986 WL 178842. The NYSE panel found that a broker who claimed he had not violated Rule 408(d) due to his use of time and price discretion did not meet the strict limitations because the broker had also selected the stocks to be traded.

<sup>15</sup> Defense firms argue that claimants are not eligible to receive these very important documents because the current NASD Discovery Guidelines only list partially redacted commission runs under a churning claim. However, the NASD Discovery Guidelines do not address the violations of concentration or the mismarking of order tickets, highlighting that the Discovery Guidelines are just that – a guide – and are not intended to address every conceivable scenario.