

H G & G U P D A T E

Hofheimer Gartlir & Gross, LLP

Winter 1998

Abuses by, and Disputes with, Securities Brokers

Although the securities industry is very heavily regulated, there is still potential for fraud. Some of the most common ways in which a securities broker (also called a registered representative) can defraud a customer are described below:

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1—Unsuitable Trades

If a registered representative's brokerage firm is a member of the New York Stock Exchange (the "NYSE"), then it is bound by NYSE rules. Rule 405 of the NYSE requires a broker to "know" his or her customer.

Although this rule was originally designed to protect a broker from unscrupulous customers, the current interpretation is that a broker should learn about and understand the customer's financial situation in order to be able to provide appropriate investment advice.

How is the "know your customer" rule reflected in dealing with a broker? A good broker should ask his customer's age, marital status, career goals, prior investment experience, net worth and, most importantly, investment objectives. The broker records this information on a New Account Form, a copy of which the customer should request in order to verify its accuracy. Once the broker has all this information, he or she should only recommend securities that are compatible

with the customer's profile. For example, a broker should not recommend options trading for a customer who is a retiree with no or limited investment experience.

The National Association of Securities Dealers ("NASD"), a self-regulatory organization, has similar rules on suitability. Rule 2310 of the NASD's Rules of Fair Practice states that recommendations to customers must be suitable based upon the information given to the registered representative concerning other securities holdings and the customer's financial situation and needs. This means that an NASD-registered broker should obtain the same new account information from his customer as a NYSE registered broker does. In addition, the Rules provide that brokers, when dealing with members of the public, have a responsibility for fair dealing. The Rules stress that suitability is what determines whether registered reps have fair dealings with their customers, not whether a trade is profitable. A broker who makes money for a customer still may have breached his responsibility for fair dealing, since a trade that results in a profit nonetheless may be unsuitable.

2—Churning

Brokers can only recommend to a customer securities trades that are consistent with the customer's investment objectives. If a registered rep is ignoring the objectives and interests of the client and recommending trades solely to increase his own commissions, then he is "churning" the account. Churning can

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occur even if the customer agrees in advance to every trade. Although there is no objective test to determine if an account is being churned, a large number of securities transactions, typically with minimal overall profitability, raises the presumption of churning, especially if the customer has stated that he has conservative investment objectives such as "income" or "safety of principal." It is also important to examine the type of securities the broker is trading. For example, the NASD has stated that trading in mutual fund shares on a short-term basis is a violation of a broker's responsibility for fair dealing, because "normally these securities are not proper trading vehicles and such activity on its face may raise the question of [churning]."¹

3-Unauthorized Trading

Registered reps should only make a trade in a customer's account after receiving specific oral or written authorization from the customer. Unauthorized trading occurs when a broker makes transactions in a customer's account without authority or, more frequently, in excess of that authority. A common example is when a broker executes a trade for more shares of stock than the customer approved.

The only exception to this rule is when the customer has a discretionary account, *i.e.*, an account in which the customer has given the broker a limited or full power of attorney. A limited power of attorney gives the registered representative the right to buy or sell securities. A full power of attorney, which is rarely granted, also allows the rep to remove assets from the account on the customer's behalf. The written power of attorney must be kept on file at the brokerage firm, and the broker is required to specifically note on the New Account Form if, and to what extent, the account is discretionary.

Customers should receive a confirmation slip within a few days after each securities transaction. If the confirmation is incorrect, the customer should immediately call the broker and report the error. If the broker insists it is correct, the customer should ask to speak to the branch manager or the compliance director and document his complaint in a letter to the compliance director *and* branch manager of the brokerage firm.

4-Unsolicited Phone Calls

The most common method used by securities firms that employ high-pressure sales tactics is the "cold call," an unsolicited phone call (frequently made to the customer's home at night) in which the broker recommends a "hot stock" or "special situation," which typically is a low-priced speculative stock, the trading in which is dominated by the broker's firm. In fact, the NASD has stated that "this practice, by its very nature, involves a high probability that the recommendation will not be suitable for at least some of the persons solicited."

Protecting Yourself

How can you protect yourself? The best way an individual can avoid being defrauded is to choose your broker very carefully. Ideally, a broker should be obtained through a personal recommendation. But regardless of how you meet a broker, perform due diligence as if you were purchasing a business or a parcel of real estate. Learn if the broker has any disciplinary history by calling the NASD's public disclosure hotline at 1-800-289-9999 or going to its web site at www.nasdr.com. You also can learn from the NASD, among other things, whether the broker has any (1) pending customer-initiated arbitrations or civil proceedings involving investment activity, (2) customer-initiated arbitrations or civil proceedings

A customer should perform due diligence when choosing a broker.

that resulted in an award to the customer, or (3) criminal felony charges and convictions. Then, if you are still interested in the broker, ask for his *curriculum vitae*.

Even after you have found a broker you can trust, be aware of what a broker can and cannot do for you. Unless he has additional training, he cannot give you tax or legal advice, which you should obtain from your accountant or attorney. A broker also

cannot guarantee, and, in fact, is prohibited from guaranteeing, any securities transaction against loss. Beware of any broker who makes these promises to you.

If you have any questions relating to broker-dealer issues, please call your attorney at the firm or Richard G. Klein, Esq., our partner specializing in securities matters.

¹ NASD manual, IM-2310-2(b)(3).

■ Rights of Condominium and Cooperative Boards to Collect Rents from Tenants of Defaulting Unit Owners or Shareholders Broadened.

Recent changes in the law apply to all cooperatives and condominiums in existence after July 22, 1998. They are of interest to cooperative and condominium Board Members, to non-occupant owners of condominium units or cooperative apartments who rent their units or apartments and to tenants occupying condominium units or cooperative apartments under a lease.

Under previous law, a condominium or cooperative Board had collection remedies only against a sponsor or investor who had succeeded to the rights and obligations of the sponsor under an offering plan (a "holder of unsold shares or units").

Under the General Business Law, in effect since July 23, 1991, if the sponsor or its successor defaulted in the payment of monthly charges, the Board could require the tenant in occupancy to pay rent directly to the condominium or cooperative. That section has now been replaced by more far reaching statutory authority. The General Business Law (for cooperatives) and the Real Property Law (for condominiums) address default on payments due from *any* non-occupant owners, authorizing Boards to collect rents directly from tenants until the defaulting owner is once again current in paying monthly charges.

The statutes have specific notice and time provisions and relieve the rental tenant from the obligation to pay that rent to the non-occupying owner, when it is paid to the Board.

Under the statutes, a Board controlled by owners in occupancy may elect to exercise or not to exercise the new provisions in a particular case. Thus, the relationships of the parties and the facts of each situation take on particular importance. For further information, please call your partner at the firm or Sharon M. Zimmer.

■ Taking Advantage of Appreciated Real Estate

Today's real estate boom gives owners reason to examine transferring some of their properties, taking advantage of tax deferrals. For example, an owner of residential apartments can sell properties requiring intensive management and buy a property with one commercial tenant under a triple net lease, on a tax-free basis. The property acquired may then generally be managed by the owner's spouse or heirs in the future or by a management company at a reasonable rate and with fewer complicated decisions.

A Coop or Condominium can collect rent directly from tenants of non-occupant owners.

An owner can also take advantage of the boom in REITs, that is, real estate investment trusts, ending up with stock in a publicly traded REIT instead of real estate. The real estate can be transferred to an umbrella partnership REIT ("UPREIT") in exchange for partnership units in an umbrella partnership owned by the UPREIT. The units are usually convertible into shares of the UPREIT at any time in the future at the option of the unit holder. There is no federal income tax consequence unless and until the umbrella partnership units are converted into UPREIT shares.

As part of one's estate planning, conversion of the umbrella partnership

units can be delayed until death to utilize the stepped-up basis given to estates, avoiding any capital gains taxes.

Partnerships and limited liability companies, as well as individuals, can make these transfers. The transactions can even be tailored to accommodate those partners who do not wish to exchange their interests and want to remain as partners solely in the investment property.

These transactions are presented in simplified form primarily to provoke further thought, but they do require sophisticated planning. If these ideas have some interest, we recommend you confer with our tax and real estate partners before entering the market.

■ Project in Irvington

Hofheimer Gartlir & Gross was involved in the early stages of an unusual project in Irvington, New York. Sharon M. Zimmer drafted the condominium documents to create a two-unit condominium out of the 120-year-old Burnham Building, now under renovation, with one unit becoming the community library and the other low income rental housing. By combining preservation of a historical building, expansion of the library and the creation of affordable rental housing, the project met with extraordinary public support.

■ Project Star Program for Tax Relief

The STAR Program provides for school property tax savings on your principal residence in New York (with additional relief for senior citizens with total income of less than \$60,000). In many counties, the filing deadline is December 31, 1998. Our office has the application for the STAR exemption and can offer assistance.

About Hofheimer Gartlir & Gross, LLP

The firm conducts a general commercial practice. Our principal practice areas are:

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts and foreclosures)
- estate planning
- trust and estate administration
- general litigation
- matrimonial and family law
- taxation

Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.

We are pleased to announce the relocation of our law offices to

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as of December 11, 1998