

Below is article written by a long term friend of the association. His experiences are very real and concerns should be heeded by the marketplace. It is the opinion of the editor that these are not unique experiences and DO represent real risks to our industry participants. What's wrong with the FINRA arbitration process?

## THE ARB PROCESS IS BROKEN

I don't think there is a single person who believes the FINRA arbitration process is fair, because the system is broken. When first developed as a forum to provide investors a place to have their grievances heard in a timely and low cost format, the creators forgot to take into consideration the abuse of the system by the plaintiff's bar. Although the system makes sense for investors to use when their broker has actually done something wrong or illegal, it has mutated into a system that seeks to repay investors where they have lost money in an investment (no matter the cause). This is not the fault of FINRA, but ultimately they have to be the one that fixes the system.

I have been registered for almost 30 years and have always been one of the top producers for every firm I have been associated with. I have never had a written complaint from a client and of course have never been accused of any sales violation. This is not to brag, but to simply show I tend to follow the rules and do what is in the best interest of my clients. With that in mind I decided along with another person to start my own BD at the beginning of the decade.

From the time we started the BD until about the time I decided I did not want to be part of a BD and preferred personal production (about two years ago), the BD had no written complaints, no arbitrations, was profitable, and grew to about 100 reps. To be fair I had nothing to do with the management of the BD, compliance, or supervision. My role was limited to the due diligence area and working with other BDs. It was also obvious the auditors who came to visit the BD from both FINRA and the SEC, although very professional, did not understand many of the things the BD was doing. I personally spent many hours educating the auditors and explaining how certain things actually worked. In each and every meeting they came away thanking me for helping them understand certain processes and business lines. My attitude and philosophy had always been if you are not doing anything wrong you have nothing to hide. I am not sure I believe this today.

Fast forward to 2010. I don't think anyone is unaware of what happened to the economy and virtually every real estate investment over the last two years. I also don't have to tell you how there has been a proliferation of advertising by attorneys seeking new clients who have lost money with their brokerage firm or broker. As one attorney told me "each new disaster

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This past year has seen a significant amount of change. If you are one of the many professionals who are part of that change this year, please provide us with your updated information. That would include changes in BD, RIA, address, phone, fax, email, credit card, securities and insurance licenses, and of course **we want to know about changes you have made to your business.** What kinds of changes have you made to address this environment? What are doing differently to mitigate your risks? Have you visited our new site yet?

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(bad economy) brings more opportunities.” What you may not be aware of are the non attorneys who are soliciting clients for FINRA arbitration along with attorneys who know nothing about the FINRA arbitration process. It’s like the wild, wild, west where anything goes.

In the last six months I have been named in six arbitrations from persons I have never met or never worked with. How is this possible? The simple answer is the arbitration process allows it. OK it is a well known fact that anyone can sue anyone else if they so desire. In the Court system if you do that you can get an action dismissed, obtain a summary judgment, file a demurrer or get the other party sanctioned. In the FINRA arbitration process this is not allowed. What’s worse is even if the arbitrators find that the claimants were dead wrong in bringing arbitration, they have no power to force them to pay you for their wrongdoing. From the claimants viewpoint it’s a win-win situation. Other than the modest filing fee there is no risk. You can name as many respondents as you like for one low price. Does this seem equitable? Is there no accountability that can be imposed on frivolous claims? To make matters worse FINRA states if you try to get dismissed for any reason, you are subject to monetary sanctions. Effectively if you are an officer or owner of a BD you can be held liable for something you had no control of or the ability to control. **THE FINRA ARBITRATION SYSTEM IS BROKEN.**

I am not taking the position that investors do not need a forum that is cost effective if they have been wronged. That is what the arbitration system was supposed to do. But it must be

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## EYES WIDE OPEN

Brad Watt



## PART IV

of a 4 part series

As we enter a new year, I am struck by the seemingly incoherent range of economic forecasts. On one hand, economic growth is back, the credit crisis is over, real estate values have bottomed out, banks have cleaned up their balance sheets, consumer spending has spiked, corporate earnings are up nearly 50%, corporate bond default rates are near historic lows, interest rates remain extremely low (thanks to QE2, stimulus spending, and other government-backed bailouts), and a relentless surge in the stock market has vaulted the S&P 500 up 65% from its March '09 lows—sparking talk of Dow “14,000.” The wave of optimism is eerily reminiscent of the sentiment leading up to the great crash in equities that started in October 2007. On the other hand, opposing forecasts are pointing to a major depression ahead. Numerous books, newsletters, and blogs are increasingly sounding warning signals that generally point to “The Coming Economic Armageddon.” Here’s what the doomsayers suggest: The Euro is teetering on extinction; the sovereign debt of developed countries is soaring and related currencies are falling; global inflation is in play; state and local governments can’t make payroll, let alone fund nearly \$2

trillion in underfunded pension liabilities; the \$3 trillion muni-bond market is sinking badly and now drawing comparisons to the meltdown in sub-prime mortgages; Case-Schiller is predicting another 20% drop in home values; unemployment and underemployment remain stubbornly high at nearly 20%, as globalization and technology converge to structurally undermine a rebound; and commodity prices are soaring due to increased demand by developing countries and weather related shortages. Capping all of this bearish news is the fact that many analysts are calling for the inevitable “day of reckoning” as nearly \$1.4 trillion of outstanding commercial real estate loans and mortgages mature in the next 18 months—50% of which are deemed to be under water (i.e. the debt balance is more than the property’s market value). In light of all of this conflicting data, our emotions are tossed back and forth like the wind swaying between hope and denial, faith and fear, and optimism versus despair. We are asking questions like; “is it structural or is it cyclical, are we returning to normal, or is this the “new normal,” do we have fundamentally improving conditions or is the unanimity of expert opinions in Washington and the self-serving bias of “wall street” masking the stress cracks? These are good questions, and ones that we must ask—the stakes are very high. In his book, *How the Mighty Fall*, Jim Collins (author of *Good to Great and Built to Last*), offers some good advice on how to make decisions in the face of ambiguous or conflicting data. He says to ask these three questions: What’s the upside, if events turn out well? What’s the downside, if events go badly?

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changed to address the new law that plaintiffs' attorneys are trying to create by trying to hold the BD, its officers, and its management team liable for things that they have nothing to do with. Every BD is at risk if action isn't taken to help address these problems. Customers are at risk by having the system clogged with frivolous actions that delay getting a hearing in a timely manner for cases where there is actual wrongdoing.

Other than the obvious, is that as these cases are filed and officers and owners of BDs (including CCOs) are named in these arbitrations, the enforcement division may step up and start suspending licenses. I can tell you if I were a regulator and see the same person named in multiple arbitrations in a short period of time I am going to take action. The embarrassment of Maddof and Stanford are foremost on the minds of the regulators and better to take action without cause than to wait until later just in case there was something nefarious. The phrase, shoot and ask questions later, comes to mind. I can now tell you from personal experience many product providers are refusing to allow firms or RR to do business with them a result of these frivolous claims.

I have never been one to believe the system doesn't work—until now. Maybe I have been naive all these years. I'm telling you the system does not work. Unless you want to take the risk of being put out of business simply because the system is broken, now is the time to take a proactive approach and try and get the rules changed that make it fair and equitable. But there has to be consequences for the plaintiff's attorneys who are leading people down a road that is a dead end. Promising their clients that they should sue everyone at a BD because they can is simply wrong.

As a result of this, even though I have done absolutely nothing wrong, other than owning a piece of a BD, I may be forced to file BK and give up my licenses. Unlike the win-win for the plaintiff's attorneys mine is a lose-lose proposition.

The most recent example of the overreaching by this process involves an arbitration filing that only names me and the CEO of the BD and not the RR or their supervising principal. Because the RR has left the business the attorney representing the claimant is trying to establish a new way to abuse the system in the hopes of squeezing out a settlement. What is most interesting in the pleading is there is never any mention of any wrongdoing other than by the RR. I find this analogous of naming a family member for something another family member may have done. Although I am not an expert in either criminal or civil law, something tells me this type of accusation would be thrown out of court in a heartbeat. Again, there is no downside to the claimant or the attorney representing the claimant. Under the current rules the claimant can file a claim against anyone they want as long as they are a FINRA member, regardless of the facts and circumstances. If I were an attorney representing a client why not name as many parties as possible? I know it sounds ridiculous but from the claimants viewpoint there is absolutely nothing to lose in doing this.

**WIDE OPEN CONT.**

Can you live with the downside? Truly? In terms of investment decisions, we need to be careful about a cheery consensus that pushes our animal spirits to take more risks. Again, for many investors, they won't get a mulligan. So what do we do when we are half way up the mountain in the middle of a storm and don't know whether to keep going or to turn around and climb down? Here are some suggestions:

**1 Simplicity.** Investment should be rational, logical and understandable. If you don't understand it—don't do it. Remember, investments are not just numbers on a statement but rather a derivative of fundamentally solid business models.

**2 Income.** Base your decisions on what you can see—not what you can't see. If your investments are fundamentally driven by growth strategies that depend upon continued economic improvements—think about rebalancing. Income is the ultimate “sincerity test” for any investment. Income helps hedge the downside loss and smoothes out the volatility.

**3 Diversification.** Concentrate on building wealth through your business or career—but diversify your investments for safety. Also, don't settle for simple diversification within the same sector (intra correlation), but make sure you break investment correlations by investing in both real assets and financial assets.

**4 Transparency.** Ask the hard questions to discover risk and determine value. What are the conflicts of interest? What are the total fees? Is external compensation aligned with investment performance?



## SANBAG AND RYDER GOING GREEN

The San Bernardino Associated Governments (SANBAG) has teamed up with Ryder Systems, Inc. for a groundbreaking heavy-duty natural gas truck rental and leasing project in Southern California. The is the first time that natural gas trucks will be deployed into a large commercial truck rental and leasing operation anywhere in the United States. SANBAG chose Ryder to partner with it to make use of \$19.3 million in state and federal American Recovery and Reinvestment Act of 2009 funding to implement the project. SANBAG is the council of governments and transportation planning agency for San Bernardino County, California, responsible for cooperative regional planning and furthering an efficient multi-modal transportation system to serve the county's two million residents. Ryder will purchase more than 200 heavy-duty natural gas powered trucks, including both liquefied (LNG) and compressed natural gas (CNG). These trucks will be deployed into Ryder's Southern California operations network, where Ryder's customers will be able to access them through short-term rentals, long-term leases, or through Ryder's dedicated logistics services. To support these trucks, Ryder will construct new natural gas refueling station within the region, as well as work with its customers to identify and use the existing natural gas refueling infrastructure already located in the area. The company will maintain the vehicles at its own maintenance facilities, each of which will be properly equipped for the indoor repair of natural gas vehicles. In addition to reducing emissions, with natural gas fuel prices significantly and consistently lower than diesel fuel, Ryder's commercial customers who include natural gas vehicles as part of their fleets will therefore have the opportunity to realize additional cost savings. When fully implemented, this project should replace more than 1.51 million gallons of diesel use annually with 100% domestically produced natural gas. The project should also reduce more than 9.2 million pounds of greenhouse gas emissions per year, more than 131 tons of nitrogen oxide emissions annually, and eliminate 2.65 tons of diesel particulate emissions from local neighborhoods. "This SANBAG-sponsored project represents a tremendous opportunity to expand our RydeGreen program to include natural gas vehicles and introduce our 1,200 commercial customers in the region to a new innovative, efficient, and environmentally sound fleet solution," said Tony Tegnalia, President of Ryder's Global Fleet Management Solutions. "Our intent is to use this project as a model that we can replicate in other parts of the U.S. where Ryder has a strong presence.

*"This article was rewritten from the "Energy Newsletter," Atlas Resources, LLC publication. "In time of cynicism and governmental distrust, this is an example of creative forward looking solutions to environmental concerns, energy self sufficiency and governmental support." Ed.*



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**5 Feasibility.** How is value created in the investment? Are those assumptions realistic? Can I tactically or actively manage my exit strategy? Have I stress tested the assumptions in light of worst case economic scenarios?

We believe that a portion of every portfolio should be allocated to core (income producing) real estate assets. We also believe these assets need to be anchored by demand-driven industries, credit worthy tenants, long term leases, and contractually guaranteed income with rental escalations as an inflation hedge. Regardless of whether you subscribe to the optimistic "green shoot" theory or the pessimistic view that the soil is parched and dry, one thing is for sure—we have a clear mandate for risk management. Now, more than ever, investors need confident investment strategies that work. They won't get a mulligan.

**Brad Watt** serves as President of Embree Capital Advisors, LLC and as EVP and Managing Director of Embree Capital Markets Group, Inc. He is responsible for directing strategic capital formation. He has 28 years of corporate and entrepreneurial experience in structuring, marketing, and managing private and public real estate investment programs, totaling more than \$4 Billion dollars in combined asset value. He holds FINRA Series 7, 63, and 24 general securities and supervisory licenses, is an active member of Real Estate Investment Securities Association and Investment Program Association, and is a frequent speaker on economic and demographic changes and how they impact current real estate investment trends.