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EXPERT'S CORNER:
MAXIMIZE YOUR EXPERT'S IMPACT IN REASONABLE BASIS SUITABILITY CASES

Frederick Rosenberg

Where equities and mutual funds constitute the principal portfolio investments, suitability claims are generally straightforward. Many FINRA investor claims are customer centered, with sophistication, financial condition, and misrepresentations at their cores. Experts, while not always essential in these market-based claims, are regularly offered at the end of Claimant's case to opine on suitability, supervision, and damages as plead in the Statement of Claim and as evidenced in the hearing.

Non-Conventional Investments (NCI), typically illiquid private equity offerings sold to qualified investors, range across a broad spectrum of enterprises. From an expert's perspective, the uniqueness of each offering and the analysis of its operation must be evaluated first on its "Reasonable Basis" suitability. It is a "know your investment" issue, *not a customer suitability or disclosure issue*. A Reasonable Basis analysis must be performed by a Broker-Dealer before offering the NCI to any specific customer. This requirement also applies equally to proprietary trading strategies in derivatives, options, market timing, and other management strategies intended to beat the market or provide limited risk exposure.

Below are several problem areas in which Attorneys fail to maximize the expertise they retain and potentially undermine expert impact.

1) **Superficial Understanding of the product or strategy:** Claimants' cases suffer when attorneys cannot or do not wield analytical expertise in their cross examinations and only focus on customer issues and disclosures until their expert's testimony at the end of their case. Many attorneys hope to drop-in a knowledgeable expert on day three or four of the hearing to testify to a panel. By then, it is often too late in the hearing to effectively introduce Reasonable Basis failure and/or the causation arguments that support damages. The delay makes the expert's testimony doubly difficult and less weighty.

   Most attorneys have only superficial understanding of the offending strategy and lack hands-on experience in conducting private equity due diligence. Many erroneously consider securities due diligence to be the

equivalent of private equity due diligence. From the expert's perspective, this makes supporting these cases in litigation problematic from the outset.

In the securities industry, "disclosure" is a primary concern, with Broker-Dealers maintaining "Due-Diligence" files of materials and subscription agreements.

Private equity due-diligence however, is about *risk analysis*. It delves far deeper than mere disclosures to assess all the risks that are germane to the enterprise, its operations, and its ability to repay the investment. Without a complete understanding of Reasonable Basis suitability, attorneys cannot fully address the risks or articulate how and why the losses occurred in any purported strategy. This leads to timid cross-examinations, muddled arguments, and confused arbitration panels. It is here, where Claimant's attorneys are often weakest, that reliance on an Expert should be greatest if the attorney is to be adequately prepared.

In market-based strategy claims, an expert analysis must go deeper than just calculating damages models. An analysis must determine if the broker actually did what he represented and promised. Even acknowledged conservative strategies when mishandled can create huge risk revealed only by an analysis. Market timing and options trading are two areas where trading typically varies substantially from what would be expected or promised, yet that wide variance is often ignored in Statements of Claim that focus on suitability, investor financial condition, and mis-representation.

In my early legal career, I was the associate to a very successful medical malpractice attorney who was not particularly brilliant or verbally blessed. Whenever a case came to him he would disappear only to return two or three days later prepared to take on the case. The attorney befriended the Coroner in the District of Columbia and before taking on a case he would attend autopsies over those few days in which the Coroner would explain the medical issues of the case. The attorney understood that his case would be made primarily in the cross examination of the opposing expert, and not simply on his expert's testimony and on every case he took, he made sure he understood what happened and why.

2) **Drafting inadequate pleadings**: An expert is not there to add a new theory of recovery or to save the case at the end of hearing, but rather is there to support the pleadings, evidence, and conclusions. This means an expert should be consulted prior to filing the Statement of Claim to assure it is drafted consistent with the theories of liability, that it affords proper

discovery, and that it pleads proper causation based on Reasonable Basis failures. If not, the expert's testimony cannot be completely effective.

3) **Overemphasis on Customer**: Product and strategy cases are about supervisory failures, due diligence weaknesses, and failure to adequately train and supervise representatives advising public investors on a potentially very large scale. Regardless of the customer's hard luck or great fortune, before a recommendation is made, the broker must understand the recommendation and accurately communicate the risks or no solicitation is permitted.

Investors never accept the risk that a broker does not understand what he is recommending. Arguably, Claimants are entitled to damages for negligent gaps in a broker's or manager's understanding or training that have predictable injurious outcomes when reasonably relied upon by a customer. If this is the case, that the client is ruined because of training failures, due diligence failures, and/or supervisory failures relating to the distribution of a product or strategy causally linked to the loss, then the primary the focus of the claim must be on those elements responsible for the loss, not the customer.

From the very outset, an attorney must assure that the arbitration panel understands the product and/or strategy, including its strengths, weaknesses, implementation, and all foreseeable outcomes. Attorney weakness in understanding products and/or investment strategies typically occurs with variable annuities, covered calls, market timing portfolios, structured products, and virtually all private placements in some fashion. Waiting until after lunch on the third day of the hearing to introduce critical product or strategy analysis to the Panel may prove to be ineffective advocacy that could compromise your expert's impact.

Lastly, "Book of Business" issues relate to customers treated as part of a group or subgroup of investors all with similar portfolios managed commonly or invested similarly. If the investor's account is under common management or common fund, that needs to be part of the case. Similarly, the financial importance of the category of business to the representative's revenue needs to be thoroughly considered. Yes, a client has an individual story to tell, but with these type of claims, the client is usually one of dozens if not scores of investors ranging across a spectrum of financial circumstances all getting the same recommendation suggesting supervisory and due diligence failures.

4) **Setting up for failure**. Some years ago, I was retained, mid-hearing, to testify on a relatively strong TIC case for Claimants. The hearing, on break for several months, would restart with my testimony. The broker had been cross-examined first and testified about all the due diligence he relied on to recommend the TIC. The client testified second. Her testimony made it sound like she thought she was buying real estate but was misled as to the risks. An appraisal was offered and a few other broker-dealer witnesses were crossed, all of whom held fast that supervision was proper and due diligence proper. Everyone acknowledged the PPM had been delivered.

   I began my examination addressing the security Reg. D issues, due diligence, and Reasonable Basis suitability. After a short time, a puzzled arbitrator interrupted me and said to me in so many words, that "everyone has already agreed it is a real estate deal, Caveat Emptor!" Deep into the hearing, I was the first one telling the arbitrators and the parties that the TIC was a security subject to the securities acts and not real estate at all. End result: award for Respondent. With proper pleading and focus, the arbitrators would not have been put through days of testimony and months in adjournment only to hear too late the central issue in the case.

5) **One-day testimony**. Cross-examining the broker first unfortunately gives the Respondents the opportunity to set very narrow Reasonable Basis and supervisory standards for the NCI or investment strategy as a matter of primacy in Claimant's case. This real problem is compounded when the Claimant is examined next. It delays the opportunity for timely expert rebuttal potentially by a day or more. In general, when the central issue in the case is the investment or strategy, putting the expert on first establishes the conclusions and analysis as a matter of primacy in the hearing. This tees-up the examination of witnesses in light of those expert conclusions. In most product or strategy cases, putting the expert on first also makes it possible for the Panel to follow your entire case in context of the investment. If you are limited to one day of expert testimony, consider opening with it in these cases.

6) **Consulting v. Testifying Expert**. There are complications with bringing in one expert to both support the litigation and testify. Once identified as the testifying expert, all subsequent communications with counsel relating to the litigation may be discoverable, including outlines, power points, and

strategic discussions. In a case in which I was retained to testify, Respondents sought to obtain production of my notes, research, and communications with Claimant's counsel for the time period following my identification as Claimant's expert. The Chairman denied Respondents' motion *sua sponte*. On day one of the hearing, a last minute a replacement arbitrator, an experienced litigator, was seated as a Panelist. Respondents moved for reconsideration of their motion. Respondents' counsel's argument that such materials were fully discoverable under both state and federal rules resonated with the replacement arbitrator. In turn, the replacement arbitrator convinced the Chairman to reverse his prior decision. I was ordered to produce all my notes and communications with Claimant's counsel from the date I was identified as Claimant's expert. As an aside, the Chairman granted Claimant's counsel request to require the same production from Respondents' expert. Consequently, it might be best to bring on an expert for education and organizational purposes on the products or strategies prior to filing, and certainly before the 20-day exchange.

Attorneys, not just experts and brokers, need to "Know the Investment."