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THE WORST IS OVER—PROBABLY

May 1, 2005 12:00 PM, By Richard Roth

If legal filings are a leading indicator of the amount of trouble a particular industry is in, the securities industry can start to breathe a bit easier

According to the NASD, the number of new case filings dropped by 8 percent, to 8,201, in 2004. This is, of course, good news for Wall Street.

The NYSE has experienced a similar slowdown. It had been averaging more than 250 new cases filed per quarter in the first nine months of 2004, but that number dropped to 172 in the final quarter of 2004. For the first time since 2001, the annual total of new cases numbered less than 1,000.

Since the beginning of the research conflict-of-interest scandals that eroded investor confidence in such venerable firms as Merrill Lynch and Smith Barney, Wall Street and Main Street have been looking eagerly to the day when the cloud of trouble would lift. Of course, subsequent scandals only increased that cloud's density, but there is now good reason to believe in a more permanent clearing of the air.

SECOND WIND

Of course, the industry thought it was in the clear once before. In 2003, many had hoped the flood of litigation had peaked when investor class-action suits against Merrill Lynch, Goldman Sachs, CSFB and Morgan Stanley were dismissed. These hopes were bolstered by the $1.4 billion settlements Eliot Spitzer extracted from the firms involved in the research scandals.

A new spate of scandals involving mutual funds and hedge funds has moved into the forefront of the securities industry's consciousness. The good news about these scandals for retail brokerage firms is that they are not primary offenders in these new scandals — hence the litigation respite.

The last time the industry could point to a decline in the number of arbitration cases filed was 2000. Even then, the slowdown was insignificant. In 2000, 5,558 arbitrations were filed, compared to 5,608 in 1999. Before that you have to reach back to 1996 to see a year-over-year decrease in the number of arbitrations filed.

In 1997, 5,631 arbitrations were filed, compared to 6,058 in 1996. Remember 1997? The markets were performing well. People were making money and, of course, not complaining in court (or, for that matter, at cocktail parties).

It now appears that investors' wounds may be healed from the tech wreck, even if portfolios may not have fully recovered. Certainly, the statute of limitations is running out for most tech-wreck cases. Additionally, Judge Dennis Jacobs' decision this January to dismiss two class-action suits against Merrill Lynch analysts might well be the death knell for fraud-on-the-market suits against wirehouses. (Judge Milton Pollack, one of the judges who dismissed the original class-action suits against the wirehouses, noted that finding in favor of the plaintiffs would have the effect of turning “the federal securities laws into a scheme of cost-free speculator's insurance.”)

Spitzer's shift in focus in all likelihood is a reflection of public attitudes, signaling that the average investor, along with the markets, has digested the excesses of the past and accepted the damages. Indeed, judging from firms' willingness to accept the terms and safeguards mandated by the global settlement agreement and their evident desire not to risk the loss in investor confidence and the accompanying costs of litigation, the tech-wreck scandals might well be behind us now.

BRIGHT HORIZON

Taking our cues from that old chestnut, “The market never lies,” there may be more good news ahead for the industry. This conclusion is based on trends that can be seen in the labor market surrounding Wall Street itself — especially if you consider the labor markets to be lagging indicators. Specifically, firms tend to begin to fire only after the need to pare down head count is painfully evident. Likewise, they only add headcount when the sure need for more bodies already exists.

Take Merrill as an example. The Wall Street giant cut 23,500 jobs between 2000 and 2003, with heavy-duty layoffs coming only after it was evident the market crash was no blip on the radar screen. Now Merrill is hiring aggressively, if a little more cautiously.

Consider also the statistics offered by BrokerHunter.com, a Web site for retail brokers. The site recently published data showing that early in 2004, employment in the securities industry began picking up, bucking a trend that had been decidedly negative since early 2001. BrokerHunter's survey of wirehouses, independents, insurance companies and registered investment advisors showed that two-thirds of those responding planned to hire brokers and support staff. Of those responding to the survey, over 73 percent indicated they would be hiring more people than last year.

Firms would not be adding personnel if the litigation threat remained a hot one. Still, we're not fully out of the woods yet. The investigations into mutual fund abuses do not all directly affect financial advisors, but they are certainly a distraction, and they are almost sure to result in additions to the already heavy compliance burdens of the average advisor.

It's clear then that brokerage firms and retail brokers alike will be glad when the all-clear has sounded and Wall Street can stop looking over its shoulder and get back to work. That day cannot come soon enough, for serving advisory clients in this environment requires the full attention of those who serve them.

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