DUTIES OF BROKER DEALERS AS TO TRANSFERRED-IN SECURITIES: DEFEATING THE "SOME OTHER DUDE DID IT" DEFENSE

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I. INTRODUCTION

At some point, the claimants' securities arbitration practitioner will likely encounter a case where the client's broker moves from one broker/dealer to another, bringing the client's account – and the securities portfolio in it – to the new firm. The new firm has an obvious financial incentive for the arriving broker to maintain as many of his existing accounts as possible. As noted in a 2007 FINRA Notice to Members:

> It is not uncommon for an individual registered representative or a group of representatives with an established customer base to terminate their association with one firm in favor of another. In such instances, one of the principal interests of the acquiring firm is ensuring that the newly associated representatives retain as much as possible of the customer base they serviced.[2]

But in its zeal to obtain those precious new accounts, the firm may not realize – or may overlook – the fact that the new account contains: securities that are not suitable for the client (or perhaps for almost any client), a portfolio that is grossly over-concentrated, or other issues that give rise to potential liability for breach of fiduciary duty, fraud, negligence, or violations of industry rules and standards. This article examines the issue of the new firm's potential liability for misconduct associated with securities that were purchased at a prior firm and transferred in to the second firm.

The practitioner can bet that any brokerage firm inevitably will disavow responsibility for securities that were purchased at the previous brokerage firm. Essentially the argument goes like this, usually yelled at high volume in an offended tone of voice: "It wasn't me! Some other dude did it!" But the

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2. NASD Notice to Members 07-06 (2007).

issue is hardly as in favor of the brokerage firm as they would make you believe.

To the contrary, a "toolkit" of common law legal principles and securities industry rules establishes that – under the right fact and sometimes depending on the applicable State law -- the second firm may be liable for the suitability, or lack thereof, of securities purchased in the prior account. These legal resources include: common law on fiduciary duties of financial advisors and brokerage firms; common law on liability for "hold" recommendations; FINRA Rules, Notices to Members, and Regulatory Notices that have broadened the concept of "investment advice" to include recommendations to maintain a portfolio or not to sell any securities; and firms' own policies and procedures regarding the review of new brokers and their new accounts.

This article discusses authorities and arguments that practitioners can use to surmount the "Some Other Dude" defense and persuade opposing counsel and arbitration panels that the new firm does indeed bear responsibility for transferred-in securities.

II. COMMON LAW THEORIES SUPPORTING LIABILITY FOR TRANSFERRED-IN SECURITIES

A. *Fiduciary Duties Owed by Brokerage Firms Under Common Law*

A good starting point in analyzing this issue is the concept of fiduciary duty.

Under certain States' laws, brokerage firms have a fiduciary duty to their customers. For example, a series of California appellate decisions dating at least back to the 1960's have long established the fiduciary duty of stock brokers.

> With respect to stockbrokers it is recognized, "The duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity." (Meyer, The Law of Stockbrokers and Stock Exchanges (1931) p. 253. *See also id.*, §§ 39-40, pp. 249-253; and *Walsh v. Hooker Fay* (1963) 212 Cal.App.2d 450, 452 [28 Cal.Rptr. 16].)[3]

3. *Twomey v. Mitchum, Jones Templeton, Inc.*, 69 Cal. Rptr. 222, 236 (Ct. App. 1968).

"[T]he relationship between a stockbroker and his or her customer is fiduciary in nature."[4] "California imposes a fiduciary duty on every broker-customer relationship."[5]

> [S]ecurities brokers who have assisted a fiduciary or a trustee in speculating with trust funds and deceiving the beneficiaries of an investment trust as to the financial stability of the trust are directly liable to the beneficiaries themselves both for breach of the ***brokers'*** fiduciary duties, and for aiding and abetting the trustee's breach in order to further the brokers' own economic interests. (*Duffy* v. *Cavalier* (1989) 215 Cal.App.3d 1517, 1533; Rest.2d Trusts, § 326, pp. 124-125; 4 Scott on Trusts, *supra,* § 326.2, pp. 296-298; Bogert on Trusts, *supra,* § 901, pp. 315-318; cf. *Pierce* v. *Lyman, supra,*1 Cal.App.4th at pp. 1103-1106.)[6]

Federal courts applying State law similarly have recognized that stockbrokers and brokerage firms hold fiduciary duties to their customers. As the Eleventh Circuit Court of Appeals noted:

> The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor. *Thompson v. Smith Barney, Harris Upham Co., Inc.,*709 F.2d 1413, 1418 (11th Cir. 1983); *Dupuy v. Dupuy,* 551 F.2d 1005, 1015 (5th Cir. 1977). *See also* RESTATEMENT (2d) of Agency § 425 (agents employed to make, manage, or advise on investments have fiduciary obligation).[7]

The Eighth Circuit Court of Appeals similarly held that brokers are fiduciaries to their clients:

> Securities brokers . . . at Merrill Lynch are licensed professionals holding themselves out as trained and experienced to render a specialized service. Like the clients of real estate agents, securities customers rely on the agent's expertise and expect the agent to act in their best interests. Because we see no significant difference between real estate brokers and securities brokers, we believe that if confronted

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4. *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 751 (Ct. App. 1989).

5. *Petro-Diamond Inc. v. SCB & Associates, LLC*, 122 F. Supp. 3d 949, 959 (C.D. Cal. 2015).

6. City of Atascadero v. Merrill Lynch, 80 Cal. Rptr. 329, 355 (Ct. App. 1998) (Emphasis in original.)

7. Gochnauer v. A.G. Edwards Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987). The *Gochnauer* court was applying Florida common law. But its conclusion references the Restatement of Agency, which is designed to be a distillation of general common law.

> with the question, the South Dakota Supreme Court would find that securities brokers are fiduciaries that owe their customers a duty of utmost good faith, integrity, and loyalty.[8]

The Eighth Circuit was interpreting South Dakota law. It expressly relied on the reasoning contained is two South Dakota state court cases, one of them dating back to 1910, holding that real estate agents and brokers are fiduciaries.[9]

As in California, Florida, and South Dakota, financial advisors and broker/dealers are also fiduciaries as a matter of law in Missouri. As one Missouri court concluded:

> This fiduciary duty includes at least these obligations: to manage the account as directed by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies.[10]

Not surprisingly, none of these cases differentiate between securities recommended by the current firm versus securities recommended by the customer's prior brokerage firm. Indeed, such a distinction appears antithetical to the very concept of a fiduciary duty. Thus, to the extent that a firm that accepts a customer's new account and the securities transferred in has a fiduciary duty, it cannot evade that duty simply because the securities were purchased in a prior account.

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8. Davis v. Merrill Lynch*,* 906 F.2d 1206, 1215 (8th Cir. 1990).

9. *See* Durand v. Preston, 128 N.W. 129, 131 (1910) (holding that real estate agents and brokers are fiduciaries); Hurney v. Locke, 308 N.W.2d 764, 768 (1981) (confirming the reasoning in *Durand*, and holding real estate brokers are "licensed professionals holding themselves out as trained and experienced to render a specialized service . . . clients rely on the agent's expertise and expect the agent to act in their best interests").

10. A.G. Edwards & Sons, Inc. v. Drew, 978 S.W.2d 386 (Mo. Ct. App. 1998). *See also* State ex rel. PaineWebber, Inc. Voorhees, 891 S.W.2d 126 (Mo. 1995); *Edwards & Sons, Inc.* 801 S.W.2d 746 (Mo. Ct. App. 1990); Leuzinger v. Merrill Lynch, 396 S.W. 570 (Mo. 1965) (ruling that as part of this fiduciary duty, if a broker "knows of facts and circumstances" that would lead "an ordinary careful and diligent person" to believe harm was going to befall his customer, then "a duty to inform would arise.").

B. *Duties Attaching to "Hold" Recommendations Under Common Law*

Another body of common law that practitioners should consider are cases establishing the new firm's responsibility for recommending that a customer "hold" securities that were recommended by and purchased through a prior brokerage firm.

A good starting point here is the general tort law regarding misrepresentations that induce the recipient to ***refrain from*** acting in reliance on the misrepresentations. The Restatement of Torts notes as follows:

> ***One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to*** act or to ***refrain from action in reliance upon it***, is subject to liability to the other in deceit for the pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.[11]

Numerous cases have applied these principles to the securities industry to hold that brokerage firms have a legal duty to their customers for "hold" recommendations made by the firm. This includes California common law:

> California law should allow a holder's action for fraud or negligent misrepresentation. California has long acknowledged that if the effect of a misrepresentation is to induce forbearance-to induce persons not to take action- and those persons are damaged as a result, they have a cause of action for fraud or negligent misrepresentation. We are not persuaded to create an exception to this rule when the forbearance is to refrain from selling stock. This conclusion does not expand the tort of common law fraud, but simply applies long-established legal principles to the factual setting of misrepresentations that induce stockholders to hold on to their stock.[12]

This also includes Florida common law:

> The federal and Florida securities laws only apply to the purchase or sale of securities and not to representations intended to induce a stockholder to retain their securities. *Riley v. Merrill Lynch, Pierce, Fenner Smith, Inc.*, 292 F.3d 1334, 1343 (11th Cir. 2002) ("[W]hile 'holding' claims are not actionable under federal securities laws, they may well be actionable under

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11. Restatement (Second) Torts § 525 (1977) (emphasis added). *See also* Restatement (Second) Torts § 531 (1977); 37 Am. Jur.2d Fraud and Deceit § 243 ("A person is entitled to damages resulting ***from inaction*** where an untrue statement is made with the intent to induce that person ***to refrain from acting***, so long as it can be demonstrated that the false statement produced the inaction.") (Citation omitted, emphasis added.)

12. Small v. Fritz Cos., 132 Cal. Rptr. 2d 490, 492 (2003).

> state laws."); *Ward v. Atlantic Sec. Bank*, 777 So.2d 1144, 1147 (Fla. 3d DCA 2001) (assuming that Florida Securities Investors Protection Act, § 517.011, *et. seq*., Florida Statutes, like analogous federal securities laws, would not cover holding claims because they are not "in connection with the offer, sale, or purchase of any investment or security."). ***State common law recognizes such a claim, in fraud and negligent misrepresentation, called a "holding claim."*** (Emphasis added.)[13]

To the extent that a brokerage firm has liability for "hold" recommendations, there is no rational principle for limiting liability to the firm in which the securities were purchased. Put another way, a firm should not be absolved from liability for a hold recommendation merely because that recommendation relates to securities that were purchased at a prior broker dealer.[14]

III. RELEVANT FINRA NOTICES TO MEMBERS, RULES, AND REGULATORY NOTICES

In addition to the common law addressing brokerage firms' fiduciary duties and their duties attaching to "hold" recommendations, FINRA rules and notices also provide authority for firms' legal responsibilities for hold recommendations as to securities purchased at a customer's prior firm.

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13. Rogers v. Cisco Systems, Inc., 268 F.Supp.2d 1305, 1311, n.13 (N.D. Fla. 2003).

14. Be aware, however, that the United States Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), held that "holders" of securities were not entitled to sue under Section 10(b) of the Exchange Act. *Id*. at 749. The Court described several policy reasons that it concluded weighed against a claim that would rely largely on a plaintiff's "oral version of a series of occurrences." *Id.* at 742. Because a "holder" claim is not "verifiable by documentation" and depends entirely on "oral recollection," the Court concluded that a "holder" cause of action may encourage frivolous and "vexatious litigation" that is difficult to resolve on the merits without a trial. *Id*. at 742-43. Permitting "holder" claims would "throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony" about largely conjectural and speculative damages. *Id*.

A. *NASD Notice to Members 07-06: Firm's Duty to "Learn the Nature of the New Representative's Business"*

A good starting point for FINRA guidance on this issue is NASD Notice to Members 07-06, which addresses firms' duties when taking on new brokers and the new brokers' existing customers.

Notice To Members 07-06 specifically addresses new customers whose accounts contain proprietary or other securities products, including mutual funds or variable products, which may be difficult to service at the new firm, for a variety of reasons:

> Registered representatives with an established customer base may, from time to time, change their association from one firm to another and may wish to bring with them customer assets, including mutual funds and variable products. In some cases these mutual funds or variable products may be held directly with the product issuer or they may be proprietary to the representative's prior firm and the sponsor may not permit them to be transferred into the customer's account at the new firm. Even nonproprietary products may not be freely transferable if the sponsor does not have a dealer or servicing agreement with the new firm.[15]

Although Notice To Members 07-06 focuses on a firm's duty to review proprietary products contained in a new broker's accounts, by its own terms it applies the new firms' due diligence requirements more broadly. Notice To Members 07-06 reaffirms firms' duty to investigate a newly hired broker's book of business, noting: "When conducting due diligence concerning a prospective new registered representative, the new firm should seek to learn the nature of the representative's business."[16]

Similarly, FINRA Rule 2090 provides: "Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[17]

These rules contain no product-based limitation on the duty to understand a new representative's book of business. Thus, Notice To Members 07-06 and Rule 2090 provide a robust avenue to introduce a firm's obligations to carefully review a new client's incoming portfolio. Further, these resources

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15. NASD Notice to Members 07-06 (2007).

16. *Id* at 3.

17. FINRA Rule 2090 (2012).

"set the table" for additional FINRA rules and regulatory notices, discussed below, which address hold recommendations more specifically.

B. *FINRA Rule 2111(a): "Investment Strategy" Includes Explicit Recommendations to Hold a Security*

FINRA Rule 2111(a), the current "suitability" rule, requires firms and registered representatives to carefully consider their recommendations not merely in terms of specific transactions, but also in terms of "investment strategies."

> A member or an associated person ***must have a reasonable basis to believe that a recommended*** transaction or ***investment strategy involving a security or securities is suitable for the customer***, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.[18]

The Supplementary Material to Rule 2111 expressly states that the term "investment strategy" "is to be interpreted broadly" and includes "an explicit recommendation to hold a security or securities":

> .03 Recommended Strategies. ***The phrase "investment strategy involving a security or securities"*** used in this Rule is to be interpreted broadly and ***would include, among other things, an explicit recommendation to hold a security or securities***.[19]

Taken together, these components of Rule 2111 establish that "an explicit recommendation to hold a security or securities" is an "investment strategy" for which a firm "must have a reasonable basis to believe . . . is suitable for the customer."

C. *FINRA Regulatory Notice 12-25: "Overly Concentrated Positions"*

The further implications of FINRA Rule 2111 are discussed in FINRA Regulatory Notice 12-25:

> The new rule [FINRA Rule 2111], moreover, imposes broader obligations on firms and associated persons regarding recommendations of investment strategies involving a security or

18. FINRA Rule 2111(a) (2012) (Emphasis added).

19. Supplementary Material to Rule 2111 (2012) at Section .03 (Emphasis added).

> securities. Not only does the new rule now explicitly cover recommended investment strategies involving a security or securities, but it also states that the term "investment strategy" is to be interpreted "broadly" and includes recommendations to "hold" a security or securities.[20]

The backup materials to Regulatory Notice 12-25 elaborate on the firm's duties with respect to hold recommendations. They expressly address the situation of a hold recommendation that is given with respect to securities purchased at a prior firm and transferred into the account, and particularly the circumstances of an over-concentrated position(s):

> Where a broker did not recommend the original purchase of a security but explicitly recommends that the customer subsequently hold that security, the new suitability rule would apply. However, as stated above and discussed in greater detail below, a firm may take a risk-based approach to evidencing compliance with the rule. A hold recommendation involving shares of a blue chip stock ordinarily would not present the type of risk, absent unusual facts, that would require a detailed analysis or documentation. ***Where the hold recommendation involves an overly concentrated position in a security, however, documentation usually would be necessary, even if the broker did not originally recommend the purchase of the security***.[21]

As is clear from the discussion in Regulatory Notice 12-25, FINRA rules and guidance have evolved to conclude without ambiguity that firms have express obligations for securities transferred into an account, even though the firm had no role in recommending the purchase of the securities.

Finally, at the risk of stating the obvious but lest the point escape the attention of the arbitration panel, the practitioner should be sure to drive home the point that the "documentation" referred to above -- in the phrase "documentation usually would be necessary" – means meaningful analysis of a customer's portfolio, and not merely paper generation confirming that the firm has reviewed the incoming portfolio.

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20. FINRA Regulatory Notice 12-25 (2012).

21. FINRA Regulatory Notice 12-25 (2012), Response to Question 11 (Emphasis added).

D. *FINRA Regulatory Notice 12-55: "Investment Advice" Includes Advice Not to "Sell Any Securities" or "Make Any Changes to the Account"*

Like NASD Notice to Members 07-06 and FINRA Rule 2111(a), FINRA Regulatory Notice 12-55 and its backup materials also discuss the term "investment strategy":

> [T]he term ["investment strategy"] would capture ***an explicit recommendation to hold a security or securities or to continue to use an investment strategy involving a security or securities***. The rule would apply, for example, when a registered representative meets (or otherwise communicates) with a customer during a quarterly or annual investment review and ***explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio*** or to continue to use an investment strategy.[22]

The Response to Question 7 in Notice 12-55 is significant because it defines "investment strategy" as including when the broker or firm "***continues to use an investment strategy*** involving a security or securities" (emphasis added) or "***advises the customer not to sell any securities in or make any changes to the account or portfolio*** . . . ." (Emphasis added.) This discussion makes clear that the "investment strategy" concept – i.e., the "know your customer" suitability duty -- applies not only to a recommendation to hold a ***specific security***. Rather, the firm has a suitability duty for an implicit approval of transferred-in securities as part of ongoing portfolio advice, even where the firm or broker did not provide an explicit "hold" recommendation as to a specific security or securities.

The thread running through these FINRA authorities appears to be that the transferred-in securities may not be legally isolated but rather become part of the portfolio for which the firm and the broker are responsible to provide reasonable and suitable advice.

IV. INTERNAL FIRM DOCUMENTS (ACCOUNT INTAKE FORMS AND POLICIES AND PROCEDURES MANUALS)

Firm policies and procedures manuals also are likely to contain provisions of the firm's/broker's duties with respect to transferred-in securities, including the firm's review of new account and the firm's supervision of the broker with

22. Regulatory Notice 12-55 (2012), Response to Question 7 (Emphasis added).

respect to new accounts. Under the law, internal policies and procedures can be used as evidence of the duty element under negligence claims.[23]

Brokerage firms have policies and procedures for evaluating new accounts to assess the new customer, the customer's existing securities, and whether those securities are appropriate for the customer and the new firm. The standards and obligations reflected in these documents provide an additional layer of responsibility and scrutiny that firms must undertake in evaluating a new customer, including his or her transferred-in securities. An example of this would be transfer of a portfolio of securities concentrated in a single sector (e.g., energy) which remains so concentrated in the new account that it would generate activity reports or otherwise raise "red flags" in the normal course under that firm's policies.

V. FINAL THOUGHTS

To summarize Key points as to brokerage firm liability for transferred-in securities:

1. Under certain states' common law, brokerage firms and their registered representatives have a fiduciary duty to their customers.
2. Under certain states' common law, brokerage firms and their registered representatives may be held liable for "hold" recommendations.
3. FINRA Rule 2111(a) requires a broker to have "a reasonable basis to believe that a recommended transaction ***or investment strategy*** involving a security or securities is suitable for the customer." (Emphasis added.)
4. The "Supplementary Material" to Rule 2111, at Section .03, provides that the term "investment strategy" includes "***an explicit recommendation to hold a security or securities.***" (Emphasis added.)
5. The response to Question 7 in Notice 12-55 indicates that Rule 2111 would apply even where the transferred-in securities are not specifically discussed or mentioned by the broker (i.e., where the broker ***"advises the customer not to sell any securities in or make any changes to the account or portfolio . . . ."***) (Emphasis added.)

Based on these principles and authorities, to the extent that a Claimant can credibly convince an arbitration panel that the new broker recommended that

23. *See, e.g.* Throop v. Bache Halsey Stuart Sheilds, Inc., 650 F.2d 817, 820 (6th.Cir. 1981); Miller v. Smith Barney, Harris Upham & Co., 84 Civ. 4307, 1986 U.S. Dist LEXIS 28787*14-15 (S.D.N.Y. Feb. 27, 1986).

the client hold a transferred-in security, the Claimant may successfully establish the firm's liability relating to that security.

What constitutes a "recommendation to hold" a security? This certainly gives parties another issue to argue over at an arbitration hearing. But even without an express hold recommendation specific to that security, the firm may still be liable for the transferred-in securities where they effectively became part of the broker's recommended "investment strategy" where the broker advises the customer to make no changes in the account or to not sell any securities.

The practitioner should be prepared for the argument that the firm should not be penalized for an "investment strategy" (i.e., advice to "hold" or "do not sell") that, under most circumstances, would not be expected to generate any income for the firm. Do not discount the rhetorical power of this argument. But be prepared to argue that the issue of what is an appropriate portfolio or investment strategy is separate from whether the firm profits from it. In other words, the absence of commission or other income is not a license for the firm to not scrutinize new accounts. This is contrary to the law, contrary to the firms' policies and procedures, and if allowed would be an invitation for firms to breach their fiduciary duties to their new customers.

Finally, the argument for liability on the part of the second firm for transferred-in securities may inevitably be more persuasive where the customer follows the broker to the new firm than where the customer parts ways with the broker and moves to a new firm. From a standpoint of "optics" or perceived equities, the argument may have some weight, similar to the argument that the firm made no money from the purchase of the securities at issue. But legally the duty to review new accounts is that of the firm and cannot be evaded merely because the recommending broker is not affiliated with the new firm. Thus, the argument is a "red herring" and the practitioner needs to push back hard against it.

By using the "toolkit" of common law fiduciary duty and "holders" principles, FINRA rules and other guidance, and the firm's policies and procedures, the claimants' securities practitioner can establish liability for transferred-in securities that are unsuitable, over-concentrated, or otherwise inappropriate for the customer. When the new firm argues that "Some other dude" is at fault, use these tools to tell the firm: "***You're*** the dude, dude!"