

## **Rogue Stockbrokers and the Duty to Warn**

Does an attorney have liability for the negligent referral of a client to a “rogue stockbroker”? If an attorney chooses to refer a client to a stockbroker, what are the best practices prior to making the referral?<sup>1</sup>

Given the absence of Nebraska case law regarding an attorney’s liability for the negligent referral of a client to a “rogue stockbroker”<sup>2</sup>, best practices dictate that at a minimum, an attorney should exercise reasonable care in investigating the stockbroker’s background.<sup>3</sup> The attorney should also be extraordinarily careful regarding the nature of the referral to the stockbroker. While the tort of “negligent referral” arises most often in the context of an attorney’s liability for a negligent referral to another attorney, it is conceivable that an attorney could be sued for referring a client to a “rogue stockbroker”. The tort of “negligent referral” is thoroughly considered in the article, Temkin, *Can Negligent Referral to Another Attorney Constitute Legal Malpractice?*, 17 Touro L. Rev. 639 (2001). Given that the answer to this question is a definite “maybe”, it only makes sense to engage in minimal due diligence before referring to a stockbroker.

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<sup>1</sup>This article does not address an attorney’s best practices when referring to certified financial planners, trust officers or bank investment departments. These entities are distinct and warrant different considerations.

<sup>2</sup> The phrase “rogue stockbroker” is not defined. However, in a 1996 speech, Mary L. Schapiro, the current Chairman and CEO of NASD, stated, “we are focusing on innovative ways to deal with the problem of rogue brokers, heightened supervision of these brokers, and inadequate supervision of all brokers by firms.” The NASD’s effort culminated in Notice to Members 03-49. Unfortunately, the proposed amendments to NASD Rule 3010 were not enacted in their proposed form.

<sup>3</sup> In *Noris vs. Silver*, 701 So.2d 1238, 1241 (Fla. 3d DCA 1997), the court affirmed the dismissal of a negligent referral claim where there was no suggestion that the referring attorney had knowledge of “facts that would indicate” that the negligent attorney would commit malpractice.

### ***The Stockbroker's CRD***

The easiest due diligence in which an attorney can engage is obtaining the stockbroker's regulatory record. The Central Registration Depository Record, more commonly known as the CRD, details the stockbroker's employment history, including all reportable events. Because a stockbroker's reportable events include customer complaints, arbitrations in which the stockbroker is individually named, regulatory investigations, bankruptcies and certain criminal matters, the information is clearly valuable. In addition to reportable events, the CRD also identifies the broker's licenses, the dates that the broker passed or failed various exams, the broker's scores on exams, as well as the broker's "Z" record. The "Z" record includes events that at one time may have been regarded as reportable, but are no longer considered publicly disclosable.

### ***Obtaining the CRD***

Obtaining a complete CRD is easy, and free. After obtaining the broker's CRD number from the National Association of Securities Dealers's website, [http://www.nasd.com/InvestorInformation/InvestorProtection/NASDW\\_005882](http://www.nasd.com/InvestorInformation/InvestorProtection/NASDW_005882), you can send an email to the Florida Division of Securities. In the email, you should request the broker's entire CRD, including a full legacy report. The Florida Division of Securities will only provide the report if the broker is registered in Florida. Given that a high percentage of brokers are registered in Florida, Florida tends to be a useful resource. The email address is

[electronic\\_licensing@fldfs.com](mailto:electronic_licensing@fldfs.com).<sup>4</sup> I strongly recommend that you **not** obtain the CRD through the NASD's website. The NASD will provide you with a severely redacted version of the CRD. The unfiltered CRD will contain information regarding each customer complaint against the broker, including the nature of the claim, the name of the complaining customer, the complaint's final disposition, and the broker's contribution to any settlement or award.

### ***Customer Complaints and Arbitrations***

If a customer submits a complaint letter against a broker and the letter meets certain criteria, the letter will constitute a reportable event. The same is true if a customer initiates an arbitration proceeding *and* identifies the broker as a respondent in the case. Once deemed reportable, the event should appear on the CRD. On the other hand, if a Statement of Claim is filed in arbitration and only the broker's employer is named as a respondent, the Statement of Claim does not create a reportable event. If the broker is not named as a respondent, he will not have a reportable event even if the broker is accused of fraud, churning or theft. If not deemed a reportable event, the event will not appear on the CRD. Accordingly, it is impossible to determine with certainty the precise number of complaints in which the broker has been involved. When deciding whether to refer a client to a stockbroker, it would be prudent to ask the broker if he has been involved in any customer initiated arbitration proceeding, but where the broker was not named as a respondent. Hopefully, the broker will be truthful.

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<sup>4</sup> The Nebraska Department of Banking and Finance, <http://www.ndbf.org/consumers/consedu.shtml>, charges \$1.50 per page for this report.

If the broker has several customer complaints or arbitration proceedings on his or her record, it may be difficult to make a good faith referral to that broker. One may even conclude that the individual is a “rogue stockbroker”. Having numerous complaints is not as far fetched as one would think, even with first tier firms. However, before removing the broker from your referral list, there is no harm in discussing the events with the broker. Sometimes reasonable explanations exist. It is always possible that the claims brought against a particular broker were frivolous, the broker prevailed at arbitration, or the claims were settled for nuisance amounts. Regardless of one’s decision whether to continue to refer to a particular individual, it is always better to be informed.

### ***State Registration***

The unfiltered CRD will also contain information regarding the states in which the broker has applied for registration. If the CRD states “T\_NOREG”, I view this as a “red flag”. This information often means that a particular state has requested that the broker withdraw his or her application. Alternatively, a state may have requested additional information regarding a prior event and the broker prefers not to provide the information. In these situations, most brokers prefer that their application be withdrawn, as opposed to having it denied. The NASD’s redacted version of the CRD will not reflect any of the states where the broker was terminated without registration. The unfiltered version, available from many state regulators, will contain this information.

### ***Pending Regulatory Investigations***

A pending regulatory investigation also represents a reportable event. A regulatory investigation is distinct from a regulatory inquiry, which is not reportable. An investigation is generally considered the second stage of an inquiry – the regulator has preliminarily determined that the broker’s conduct warrants a more thorough look. Because an investigation may result in charges being brought against a broker, the event is considered reportable.

### ***Bankruptcies***

Bankruptcies are also reportable. While there are numerous reasons why a person may file for bankruptcy, an attorney may be reluctant to recommend a stockbroker when, arguably, the broker could not manage his or her own finances. Bankruptcies are reflected on both the NASD’s redacted CRD, and the unfiltered CRD’s available from state regulators.

### ***Education***

Attorneys may also take note of a stockbroker’s education. There is no requirement that stockbrokers graduate from college. Obtaining a Series 7 license requires approximately 6 weeks of reasonably intense studying, passing an exam, and submitting to a background check. That is all. The securities industry also has minimal continuing education requirements. Once an individual passes the Series 7, success or failure will depend in significant part upon one’s salesmanship skills. Obtaining employment at a first tier firm will likewise depend upon little more than a manager’s belief that one can generate client assets

(sell), and a reasonable presentation. Having a criminal background may block employment at some firms, but not all. Only certain felonies rise to the level of statutory disqualifications. Misdemeanors such as passing bad checks, do not.

### ***Employment History***

Attorneys may also take note of a stockbroker's employment background. This information, not reflected on the NASD's redacted CRD, may indicate that the 45 year old stockbroker who appears to be "seasoned" in the securities industry, has actually been selling used cars for the past 20 years.

### ***Is The Firm Genuinely Full Service?***

In referring a valued client to a stockbroker, the attorney may also wish to consider the individual broker's sophistication and whether the brokerage firm under consideration offers the types of products that you may believe are appropriate for your client. If, for example, you are referring a client with a \$10 million net worth consisting primarily of one concentrated stock position, it may be important to know whether the prospective stockbroker is permitted to offer or recommend hedging strategies. Some firms do not offer these products and services. At least one firm with a significant presence in Omaha holds itself out as a "full service" firm. In reality, brokers at this firm are not permitted to offer any type of hedging strategies. They are not given access to exchange funds, prepaid variable forwards, collars, or other related products. Given that the brokers employed by this firm are not likely to advise clients that these products exist elsewhere, the client has lost access to investments that might be

appropriate. When a firm's advertising materials reflect that the firm is "full service", do not necessarily believe the fluff.

***Conclusion***

Rather than focusing on whether Nebraska courts would recognize the tort of "negligent referral", I recommend spending a few minutes investigating the background of the stockbroker under consideration. If the attorney is considering engaging in a more formal referral program with a stockbroker, such as those that are offered to many estate planning attorneys, it is that much more important to exercise due diligence before referring a client. This is especially important given the strong likelihood that our clients will use the professionals that we recommend.