Brokerage Firms' Liability When They Fail To Warn About Bad Brokers

By Silver Law Group
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How do bad brokers continue to go from one firm to the next and continue to fleece clients? The answer is as simple as it is unpleasant: brokerage firms fail to disclose material information. Firms fail to warn existing customers, the broker's future customers, the broker's future employers, and regulators about a departing broker's misconduct.[2] Why do firms do this, knowing that the broker might continue the misconduct unabated and undetected, at least for awhile, at a new firm with old and new clients? According to at least one industry trade publication, the answer is: the threat of legal action by the former broker,[3] arbitrations brought by clients, bad public relations, and questions from regulators.[4]

The author represented many investor victims of the now-infamous Gary Gross, the financial advisor who served as the focus of *The Failure Chain*, an article in Registered Rep Magazine.[5] According to the article, even "regulators acknowledge there is actually a problem with the current system."[6]

A brokerage firm's failure to warn by staying silent, or worse, by outright misrepresentation, about a departing broker can, and often does, lead to liability when the broker continues his misdeeds at a new firm with existing and new clients. Firms expose themselves to liability when they fail to do the following two things to protect clients and others from broker misdeeds: (1) use phone calls, letters, or e-mail's to affirmatively warn existing clients about a broker's questionable conduct, and (2) file accurate Uniform Termination Notice for Securities Industry Registration ("Form U-5") with the Financial Industry Regulatory Authority ("FINRA") Central Records Depository ("CRD") so that potential clients and employers alike can access the information on FINRA's "broker check" website.[7]

Form U-5's

When a registered representative's association with a member firm terminates, the member firm is required, within thirty days of the termination, to electronically file a Form U-5 with FINRA and with the state securities regulators for states where the representative is registered.[8] This Form U-5 filing requirement aims to warn FINRA, state securities regulators, and the investing public about potential misconduct by registered representatives.[9] For this reason, "[a]ccurate and forthright responses on the Form U-5 are critical[,]"[10] and, in some states, *e.g.*, Florida, state law mandates accurate and forthright Form U-5 disclosures.[11]

We focus here on Form U-5 responses mandated upon a "full termination," which Form U-5's general instructions define as "the termination of registration with all self-regulatory organizations and all jurisdictions."[12] When a "full termination" occurs, reporting members choose from the following explanations in Form U-5's section 3 to explain the reason for the full termination:

- Voluntary;
- Deceased;
- Permitted to resign;
- Discharged; or
- Other.

If the reporting member selects "permitted to resign," "discharged," or "other," that member must also explain the circumstances of the termination.[13] Only a voluntary termination or the broker's death allows for no explanation regarding the circumstances of the broker's association terminating with the member firm. Further, upon a full termination, be it voluntary or otherwise, Form U-5 also requires answers to the following disclosure questions:[14]

- Question 7A: Investigation Disclosure;
- Question 7B: Internal Review Disclosure;
- Question 7C: Criminal Disclosure;
- Question 7D: Regulatory Action Disclosure;
- Question 7E: Customer Complaint/Arbitration/Civil Litigation Disclosure;
- Question 7F: Termination Disclosure.

A "yes" answer to any of these disclosure questions requires a detailed explanation on Form U-5's disclosure reporting page ("DRP").[15] Frequently, however, these Form U-5 disclosures and explanations are incomplete or inaccurate. Unless potential customers, potential employers, and regulators have access to complete and accurate Form U-5 disclosures, substantial investor losses can result because the investors and regulators have no way to discover and avoid potential problem brokers.[16]

Enforcement actions can also result from a member firm's systematic failure to make accurate Form U-5 disclosures. For example, in July 2004, the NASD (n/k/a FINRA) fined Morgan Stanley "$2.2 million for more than 1,800 late disclosures of reportable information about its brokers" and temporarily suspended Morgan Stanley from registering new brokers.[17] According to the NASD's press release, "[t]he late reports concerned, among other things, customer complaints and disciplinary actions by regulators."[18]

Types of Investor Claims When Broker-Dealers Fail To Warn: Legacy Claims & Non-Legacy Claims

The investors' claims can be divided into two basic categories: (1) legacy claims, and (2) non-legacy claims. Legacy claims are those brought by investors who *were* customers of the former firm that failed to make adequate disclosures to its customers about a departing broker's misconduct—either by direct customer contact or by adequate Form U-5 disclosures. Non-legacy claims are those brought by investors who were *not* customers of the former firm that made inadequate disclosures, but who became customers of the terminated broker *after* that broker went to another firm. In some cases, liability attached to firms several years and several firms *after* the broker left his former firm and after that firm filed (and later, failed to correct) an inaccurate Form U-5.[19]

In the case of legacy claims, the courts tend to base liability either on a breached fiduciary duty or on some type of negligence, *e.g.*, negligent hiring or negligent supervision. In the case of non-legacy claims, the courts tend to find liability for negligence *per se*.

Negligence *per se* claims are not all that different from the garden variety negligence claims like negligent supervision. The key difference between negligent supervision, for example, and some negligence *per se* claim is the basis of the defendant's duty to the injured party. The basis for the duty to plaintiffs in a negligent-supervision case is some relationship between the wrongdoer and his victim that pre-dates the harm. In a negligence *per se* claim, the basis of the duty is either a criminal statute, civil statute, or regulation; there need not be any pre-existing relationship between the wrongdoer and his victim.[20]

Legacy Claims When Broker-Dealers Breach Their Fiduciary Duty To Warn To Existing Clients

Broker-dealers are fiduciaries to existing clients.[21] Who is (and who is not) a client for purposes of the fiduciary duty to warn is a broad concept. In some cases, the clients need not even maintain accounts with the broker-dealer for the broker-dealer to owe fiduciary duties. In those cases, the broker-dealer bears fiduciary duties simply because the plaintiffs or claimants were customers of broker-dealer's registered representative, even though those plaintiffs or claimants might never have "had a formal account with [the broker-dealer]."[22]

Fiduciary status, however attained, triggers heightened duties running from the broker-dealer to the client, including a heightened duty to warn about a departing broker's misdeeds. To fulfill that fiduciary duty to warn, a broker-dealer must take affirmative action to warn clients. The broker-dealer cannot wait for the client to request information about a departing broker whom the client wants to follow to that broker's next firm. Rather, the broker-dealer must act to "'disclose material information'" because doing so "'is the core of a fiduciary's responsibility.'"[23]

Unless the broker-dealer, *i.e.*, the fiduciary, takes this affirmative step of being proactive and warning existing clients, the clients, as "beneficiar[ies] may have no reason to suspect that [they] should make inquiry into what may appear to be a routine matter."[24] In contemporary terms, unless broker-dealers contact existing clients to warn those clients about a departing broker's misconduct, those existing clients might have no reason to log onto FINRA's broker check site and look up a newly-filed Form U-5 for their broker before following that broker to a new firm.

Speaking in the abstract about a broker-dealer's obligation to disclose material information is not helpful absent giving some content to just what kind of information might be material, and thus, required to be disclosed to existing clients. *Glaziers & Glassworkers Union Local No. 252 Annuity Fund* ("*Glaziers*"),[25] provides useful guidance about the limits of what is (and what is not) material information for purposes of a broker-dealer's fiduciary duty to warn.

***Glaziers* Indicates The Extent of Broker-Dealers' Disclosure Obligations—What Information Qualifies As Material?**

In *Glaziers*, broker-dealer Janney Montgomery ("Janney") discovered that one of its brokers altered a cashier's check that the broker used to make a required payment into a partnership investment personal to the broker. No client accounts or monies were affected by the broker's purported misconduct. Nor was there any suggestion that the broker had done anything that harmed any client. The matter involved only the broker's personal investment affairs. Nevertheless, upon discovering the broker's misconduct, Janney told the broker that it would fire him. The broker resigned the next day and ultimately opened his own broker-dealer, where the client, a pension fund for glassworkers, followed. Some time *after* the client followed the broker to his new firm, the broker stole several million dollars from the client and wound up in prison. The client then sued Janney and others to recover its losses.[26]

When the broker resigned from Janney, Janney filed a Form U-5 and provided the NASD (n/k/a FINRA) with what seemed to be an accurate and detailed account of the circumstances surrounding the broker's resignation.[27] The only direct communication that Janney had with the client after the broker resigned was that, after Janney assigned a new account executive to the client's account, the new executive sent the client a letter introducing himself to the client and saying nothing more than the previous broker "had resigned as a Janney representative." The letter made no reference to Janney's

Form U-5 filing. The letter said nothing about the broker's altering a cashier's check. Rather, Janney left its client with the impression that the broker's resignation was routine.[28]

Janney tried (and failed) to defend its failure to warn an existing client about the departing broker's questionable conduct. To that end, Janney challenged the materiality of the information not disclosed because, among other reasons, the broker's actions "did not appear to involve any client's accounts."[29] The appellate panel rejected Janney's argument that such information, as a matter of law, is immaterial, and thus, need not be disclosed. Instead, the panel concluded an issue of fact existed over the materiality of (and need to disclose) information that "called [the broker's] character and integrity into question."[30] The panel did so even though that information related solely to the broker's personal financial affairs.[31]

In rejecting Janney's argument about immateriality, *Glaziers* noted the stark contrast between the "detailed narrative" that Janney gave the NASD on a Form U-5 and what Janney said to the client. The court also noted that the concealed information was compelling enough for Janney to fire the broker. One point *Glaziers* did not touch on—probably because the parties did not raise the point—is that information required to be disclosed on a public filing with self-regulatory organizations and state securities regulators might well be material as a matter of law without further analysis.[32]

So, if *Glaziers* is any guide, information indicating that clients could question a broker's integrity regarding financial dealings –even when those dealings do not affect clients—would seem to be material. If that kind of information is material, then, it stands to reason that any information indicating problematic handling of clients' financial matters is certainly material and should be disclosed to existing clients.

As noted earlier, firms often try to excuse their failure to warn existing clients, saying that the firms fear a libel action by former brokers. In fact, in *Glaziers*, a senior Janney executive so testified at his deposition.[33] *Glaziers* correctly rejected that argument because, "fear of being sued, and a concern for its own well being"[34] is no excuse for a fiduciary to not disclose material information to its beneficiary when that "beneficiary needs to know [the information] for [the beneficiary's] protection[.]"[35]

Recent Decisions Reaffirm A Broker-Dealer's Fiduciary Duty To Warn Existing Clients

Glaziers, however, does not stand alone. Judges and arbitrators continue to hold firms accountable when firms breach their fiduciary duty to warn existing clients about a departing broker's misdeeds. Two recent decisions exemplify this continuing trend: *Episcopal Diocese of Central Fla. v. Prudential Securities* ("*Episcopal Diocese*")[36] and *Jenks v. SII Investments, Inc.* ("*Jenks*").[37]

Episcopal Diocese

In *Episcopal Diocese*, the broker was "permitted to resign." As in *Glaziers*, the broker-dealer mailed the client a benignly worded letter that said nothing about "any improprieties or . . . [the broker's being] . . . fired."[38] And as in *Glaziers*, the client actually sustained its losses *after* the client transferred its account to the broker's new firm.[39] The client sued, arguing that "Prudential had a duty to warn [the client] that [the broker] had a significant regulatory history, that he was terminated for cause, and the Prudential failed to properly supervise [the broker's] trading activities.[40] The client argued that Prudential's failure to warn violated Prudential's fiduciary duty. The court agreed, saying

that "[a]t the time the accounts were transferred, Prudential owed the Diocese a continuing fiduciary duty of care by virtue of Prudential's prior history of managing the Diocese's accounts."

Jenks

In *Jenks*, the broker was fired outright, but the broker-dealer said nothing to the client, not even a benignly worded letter—nothing except silence. However, the broker-dealer did file a Form U-5, which was inaccurate and misleading. Instead of telling regulators and the investing public that the broker was filed for "sending out unauthorized sales literature, disobeying rules, and customer complaints, the broker-dealer said that the broker had been "permitted to resign."

By its silence, the broker-dealer allowed the client to believe the broker's benign (and false) explanation that his move to another firm was "something [the broker] had been planning for quite some time and that it was an upward move[.]"[41] As in both *Glaziers* and *Episcopal Diocese*, the client suffered no losses until *after* the broker had moved to a new firm. Interestingly, in *Jenks*, the client did not even purchase the losing securities until *after* the broker had started with a new firm. Neither the delay in purchase nor delay in suffering the loss, however, prevented the court from first denying the broker-dealer's motion to enjoin arbitration. Then later, neither prevented the court from confirming the arbitration award for claimant.

The court focused on two key facts: (1) the broker recommended the losing investments before he was fired from the first broker-dealer, and (2) when it fired the broker, the broker-dealer failed to warn the client that the broker was not "moving upward," but instead, was fired.[42]

The themes common to *Glaziers*, *Episcopal Diocese*, and *Jenks* and the broker-dealers' liability seem clear: (1) all failed to warn existing clients that the departing broker had engaged in some sort of misconduct (in two cases, *Glaziers* and *Episcopal Diocese*, the broker-dealers sent letters to the clients that misled the clients about the true reasons for the broker's moving to a new firm), (2) the clients suffered losses *after* they followed the broker to a new firm, and (3) the clients' complaint or statements of claim emphasized the existence of the broker-dealers' fiduciary duty to warn and their breach of that duty.

Legacy Claims When Broker-Dealers File Inaccurate Form U-5's

Jenks

The *Jenks* federal opinion confirming the arbitration award shows how, in legacy claims, unfocused discussions about inaccurate Form U-5 filings dull the fiduciary duty arguments central to powerful and successful legacy claims—claims where, as in *Jenks*, *Glaziers*, and *Episcopal Diocese*—the clients possessed some kind of relationship to the broker-dealer before the offending broker carried the clients off to a new firm, where the clients suffered heavy losses. Jenks's thorough and well-crafted statement of claim referred only once to the broker-dealer's filing an inaccurate Form U-5, and it did so with a passing reference in a footnote.[43] The bulk of Jenks's statement of claim focused on torts like fiduciary breaches and negligence, which was the basis of the arbitration panel's $400,000-plus award to Jenks. But somehow, when considering whether to affirm the arbitration award, the federal district court got sidetracked into discussing the broker-dealer's inaccurate Form U-5 filing.

The court's discussion of the Form U-5 issue appears to be pure dicta as it added nothing to the fiduciary or common law negligence claims, which made up the bulk of the statement of claim. The opinions themselves make clear that the Form U-5's played a tangential role, at best. Discussing the broker-dealer's inaccurate Form U-5 filing, the court noted as follows:

> In May 2001, [the broker-dealer] fired [the broker] for sending out Unauthorized sales literature, disobeying rules, and customer complaints. But [the broker-dealer] told the regulators and the investing public something different in its U-5—it had "permitted him to resign." Instead of telling all that it fired [the broker].[44]

Then, the court noted that "Jenks knew none of this."[45] That should come as no surprise because as *Glaziers* reasoned: absent some statement from the fiduciary who does know, the beneficiary who does not know has no reason to make inquiries of the broker-dealer,[46] or of FINRA's broker-check website.

In fact, over a year passed after Jenks purchased the losing securities before Jenks knew anything was amiss, and Jenks learned something was amiss only when the broker-dealer called her not to disclose anything about the former broker, but to solicit business. The call ended with the broker-dealer asking Jenks if she still had investments with its former broker, and specifically, in the losing securities that became the subject of the arbitration. When Jenks answered, "Yes," the broker-dealer said, "You're in big trouble. [The broker's] in jail." Then, the broker-dealer hung up.[47] Clearly, Jenks did not check (and had no reason to check) the broker-dealer's inaccurate Form U-5 filing until sometime after the broker-dealer's late and misguided phone call.

How should legacy claimants make use of inaccurate Form U-5 filings? Legacy claimants should consider focusing on the purpose and ability of accurate Form U-5 filings to alert regulators to unlawful conduct, which enables regulators to move against the offending broker. Regulators' action against the offending broker could prevent harm to existing and potential clients, as well as any broker-dealer who might consider hiring the offending broker, after the offending broker has moved on to another firm. *Prymak v. Contemporary Financial Solutions, Inc.* ("*Prymak*")[48] and *Dolin v. Contemporary Financial Solutions, Inc.* ("*Dolin*"),[49] two recent federal decisions illustrate and emphasize this regulatory prevention aspect of Form U-5 filings and how, under a negligence *per se* theory, broker-dealers face liability to existing clients, *i.e.*, to legacy claimants.[50]

Prymak

Prymak presents an all too familiar fact pattern: firm one fires broker for selling away,[51] files an inaccurate Form U-5, and does not warn existing clients about the broker's misconduct. Undaunted, the broker moves on, takes existing clients with him, and continues his misconduct, causing clients, old and new, heavy losses.

Prymak carefully and clearly delineates its analysis between negligence and fiduciary-breach claims, emphasizing that only legacy claimants can bring fiduciary-breach claims.[52] To that end, *Prymak* found "Defendants owed no duty to protection those Plaintiffs who were *not* clients . . . while [the broker] was in Defendants' employ."[53] *Prymak* did so because the case involved over sixty named plaintiffs, some of whom were legacy claimants, and some of whom were not.[54]

Interestingly, however, the legacy plaintiffs in *Prymak* did not allege any fiduciary breach claims. Rather, they stuck with straight common-law negligence claims like negligent supervision. In response, *Prymak* noted that the legacy claimants "may have better pled [their negligence claim] as a breach of fiduciary duty claim."[55]

Analyzing the plaintiffs' negligence *per se* claim, *Prymak* first focused on how an accurate Form U-5 might have alerted state securities regulators and how, having been alerted, regulators could have moved in and stopped the broker's selling away.[56] The court then explained the legal basis for a negligence *per se* claim where broker-dealers file inaccurate Form U-5's. Citing both Arkansas and Colorado state securities statutes and regulations, which require accurate U-5's be filed when a broker leaves a broker-dealer,[57] *Prymak* held that even though the relevant state securities regulations do not themselves provide for a private statutory cause of action, violation of those statutes may support an action for negligence *per se*.[58]

Prymak so held because the court concluded that plaintiffs were "members of the class the Colorado and Arkansas securities acts were intended to protect[,] and that [plaintiffs] suffered the kind of injuries the [a]cts were enacted to prevent."[59] Citing the Colorado Securities Act's purpose as one "to protect investors," and stating that "[i]t is clear to this court that the [U-5] reporting provisions of the Colorado and Arkansas securities acts are intended to protect the investing public from the perpetration of fraudulent . . . schemes" like the one perpetrated against the *Prymak* plaintiffs.[60]

In *Prymak*, the negligence *per se* claims worked for some legacy claimants because some of those claimants bought the unregistered securities from the broker *after* the broker had left the broker-dealer that filed an inaccurate Form U-5. That fact put the legacy claimants in the same causation position as the non-legacy claims: "[I]f Defendants had . . . truthfully reported to state and federal regulatory authorities, these authorities would have taken all necessary action to promptly prohibit [the broker] from selling [unregistered securities.]"[61]

For these reasons, *Prymak* held that legacy and non-legacy alike plaintiffs stated a cause of action for negligence *per se* against the broker-dealer that filed an inaccurate Form U-5.

Non-Legacy Claims For Negligence *Per Se*
When Broker-Dealers File Inaccurate Form U-5's

Two coinciding circumstances usually lead to non-legacy claims, *i.e.*, arbitrations (or suits) against a broker's current *and* former firms, even though the investor had no business relationship at all with the broker's former firm. *First*, their broker's bad practices, *e.g.*, selling away, cause the investor to suffer heavy losses at the current firm. *Second*, the investor discovers that the broker's former employer knew or should have know about the broker's bad practices but chose to file an inaccurate Form U-5 when the broker terminated from his former firm.[62] *Palmer v. Shearson Lehman Hutton, Inc.* ("*Palmer*")[63] and *Twiss v. Kury* ("*Twiss*"),[64] two court decisions, and at least one current arbitration highlight this issue.[65]

Palmer

Palmer involved only non-legacy claimants, who were "allegedly defrauded by [the broker] *several years after* [the defendant broker-dealer] had terminated [the broker's] employment and while [the broker] was registered . . . with subsequent dealers."[66] But because these non-legacy claimants alleged negligence *per se*, the defendant broker-dealer faced liability for the very same reasons as the

broker-dealer had in *Prymak*. *Palmer*'s facts are extraordinary in several respects and thus warrant some review.

From 1978 until 1984, the broker in *Palmer* managed E.F. Hutton's branch office in Pensacola, Florida. Sometime in early 1983, the broker's supervisor discovered that the broker was selling away by "tak[ing] money from several . . . customers in exchange for personal and corporate promissory notes. E.F. Hutton asked the broker for a list of all such customers. Upon receiving the list, E.F. Hutton "sent letters to all of these people, asking them to acknowledge that Hutton was not obliged on [the broker's] promissory notes—a somewhat back-handed fulfilling of E.F. Hutton's fiduciary duty to warn, at least as to as the customers who invested in the promissory notes. (*Palmer* does not indicate if E.F. Hutton contacted all of the broker's then-customers.)[67]

E.F. Hutton asked for and got the offending broker's resignation in January 1984. But the Form U-5 that E.F. Hutton filed said that the broker had "*voluntarily resigned*,"[68] obviating the requirement that E.F. Hutton provide any explanation on the Form U-5 regarding the circumstances surrounding the broker's leaving. E.F. Hutton's response also relieved the firm of answering any of the disclosure questions in section seven, including Question 7F's termination disclosure and Question 7B internal review disclosure. E.F. Hutton did not correct the Form U-5. This left the broker an unblemished record, and thus free to join another top-tier broker-dealer, which the broker did. He joined Prudential Bache.[69]

The broker stayed a Prudential Bache a little over a year, leaving in March 1985 to join yet another firm, Associated Planners Securities Corporation ("Associated") where, in 1986, he met Luther and Marlene Young (the "Young's), two *Palmer* plaintiffs. Shortly before leaving Associated in April 1987, the broker sold the Young's a $50,000 promissory note made out by the broker's own outside business activity, Kury Financial.[70]

By this time, in April 1987, the broker is over three years and two firms removed from E.F. Hutton. In April 1987, the broker left Associated and joined Capital Equities Corporation ("Capital") a month later. In December 1987, at Capital—almost *four years and three firms removed* from E.F. Hutton—that the broker met Joan Palmer ("Palmer"), the named plaintiff in *Palmer*. The broker sold Palmer a $20,000 promissory note from Kury Financial.[71]

The promissory notes were nothing more than a Ponzi scheme and provided the broker with a lavish lifestyle. Florida's Department of Banking and Finance opened an investigation in May 1988 and permanently revoked the broker's license in April 1989.

In March of 1989, the Young's and Palmer sued E.F. Hutton and others. E.F. Hutton convinced the trial court that it owed no legal duty of any kind to either the Young's or Palmer. Consequently, the trial court entered summary judgment for E.F. Hutton. On appeal, the Young's and Palmer argued that E.F. Hutton had "a common law duty to take sufficient precautions at that time to ensure that other prospective investors were protected[.]"[72] The appellate court disagreed.

The appellate court ruled that E.F. Hutton owed no common law duty to the Young's or Palmer for two reasons. First, E.F. Hutton had no ability to control the broker years after the broker had left its employ. Second, neither the Young's nor Palmer had any association with either E.F. Hutton or its broker while the broker was employed by E.F. Hutton. For those reasons, the appellate court concluded, there could be no common law duty under Florida law to protect the Young's or Palmer. Not so, however, with the plaintiffs' claim for negligence *per se*.

Citing Florida's state securities laws, which like Colorado's and Arkansas's in *Prymak*, *supra*., require the filing of an accurate Form U-5 when a broker leaves a firm, the appellate court ruled that "[t]he statutory provisions clearly imposed on Hutton, at the time [the broker] left its employ, a legal obligation to report the fact of [the broker's] termination to the Department [of Banking and Finance] and to accurately state the reason for such termination[.]"[73] The appellate court continued that "had Hutton properly reported its termination of [the broker] and the reasons for such termination, the Department would not have allowed[the broker] to re-register as an associated person and permit [the broker] to continue in the securities business without first instituting an investigation into whether [the broker's] re-registration should be denied, suspended, or revoked."[74]

Thus, as *Prymak* and *Dolin* would later do, *Palmer* relied upon the purpose state securities reporting regulations, *i.e*., protection of the investing public at large, to upon the negligence *per se* claim of non-legacy plaintiffs.

Twiss

Like *Dolin*, *Twiss* is the mirror image of an earlier decision—*Palmer*—with the same facts and legal theories. *Twiss* bears some mention in the text for two reasons: (1) in *Twiss*, Hutton argued that the inaccurate Form U-5 did not matter because the investors "never inquired with regulatory authorities before making loans to [the broker]," an argument the court rejected,[75] and (2) the *Twiss* plaintiffs put into evidence a letter from the Assistant Director of Florida's Division of Securities that laid the blame squarely at E.F. Hutton's door by saying the division would have acted and likely prevented harm to non-legacy plaintiffs if E.F. Hutton had only told the truth in its Form U-5.[76]

Like *Palmer*, *Twiss* reversed judgment on the investors' claim for negligence *per se.*

Conclusion

Legacy claims should focus upon a firm's fiduciary duty to warn existing customers. Fiduciary-breach claims need not cite inaccurate Form U-5 filings. Inaccurate or accurate Form U-5 filings have (or should have) nothing to do with whether a firm satisfied its fiduciary obligations to warn existing customers. This is so because FINRA's broker-check and the U-5 reporting system is not designed for existing customers. Rather, it stands as a due diligence tool for potential customers and potential employers. Oftentimes, however, legacy claims can involve a firm's failure to warn existing customers *and* a firm's failure to make accurate Form U-5 disclosures.

Existing customers can (and should) rely upon the firms' fiduciary duty to directly contact existing customers and inform them about a departing broker's misdeeds. Absent that direct contact, existing customers might have no reason to even log onto broker-check or to otherwise ask about the circumstances surrounding their broker's leaving his current firm. Further, conflating a fiduciary's duty to warn with whether a firm filed an accurate Form U-5 invites firms to argue that they can satisfy their fiduciary duty to warn by filing an accurate Form U-5.

Nevertheless, legacy claimants can make use of facts and arguments concerning inaccurate Form U-5 filings by alleging negligence *per se* and by arguing that state regulators were unable to move against the offending broker and prevent harm to existing clients. But given the strength and simplicity of fiduciary breach liability for failure to warn existing clients, it might well be that negligence *per se* arguments are superfluous and unnecessary for existing clients, *i.e*., legacy claimants.

Not strictly enforcing fiduciary duties to warn in legacy claim cases promotes a perverse result: broker-dealer fiduciaries might end up providing more accurate and thorough information to strangers via FINRA's broker-check than they provide to their clients—the beneficiaries of the broker-dealers' fiduciary duties.

Non-legacy claims should focus on negligence *per se* as a basis for liability when firms fail to make accurate disclosures on the Form U-5. This makes sense because no direct relationship exists between the firm and non-legacy claimants. Firms' only obligations to non-legacy claimants, *i.e.*, the investing public, is set forth by FINRA rules, exchanges rules, and state securities regulations, which require accurate Form U-5 filings so potential customers and potential employers can judge which broker they should engage.

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[2] The purpose of this article is to inform the reader about possible avenues of recovery in broker-dealer disputes. However, nothing herein is meant to indicate that other potential legal theories or arguments should be foreclosed.

[3] In *Glaziers & Glass Workers Union Local No. 252 Annuity Fund v. Newbridge Securities, Inc.*, 93 F.3d 1171 (3rd Cir. 1996) ("*Glaziers*"), a decision regarding a broker-dealer's obligations to warn existing clients about a bad broker who leaves the firm, a broker-dealer argued that "it had 'acted prudently in not volunteering to customers unproven allegations and innuendo, which might have been false." *Id.* at 1177. That argument failed.

[4] *See generally* John Churchill, *The Failure Chain*, Registered Rep Magazine (Apr. 1, 2008) (available at: http://www.registeredrep.com/mag/finance_failure_chain_0409/9ndex.html).

[5] *Id.*

[6] *Id.* at 1.

[7] http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm. It is critical to note that "broker-check" is designed as a due diligence resource for a broker's potential clients and future employers. Given that and a broker-dealer's fiduciary duty to affirmatively warn existing clients about broker misconduct, the authors do not believe that a broker-dealer satisfies its fiduciary obligations to existing clients simply by making an accurate Form U-5 filing. Rather, we believe more is required to satisfy fiduciary obligations to beneficiaries than is required to satisfy duties to the public at large.

[8] *See* FINRA By-Laws, Art. V § 3(a) (2008); New York Stock Exch. R. 345.17(a) (2008); Philadelphia Stock Exch. R. 604(b) (2008); Chicago Bd. of Options Exch. R. 9.2, 9.3 (b) (2008); American Stock Exch. R. 340.01 (2008); and FINRA R. 3070(d) (2008) and *see also*, *e.g.*, FLA. STAT. § 517.12(11)(b) (2008) (requiring broker-dealers and others "to promptly file with the department . . . notice as to the termination of employment of any associated person registered for such dealer . . in this state and shall also furnish the reason or reasons for such termination"); FLA. ADMIN. CODE R. 69W-600.008 (2008) (specifying that dealers must file Form U-5); MICH. COMP. L. § 451.601(b) (2008) (similar to Florida's requirement);

MICH. ADMIN. CODE R. 451.602.2(2) (2008) ("A notice of agent termination shall contain the information specified in U-5.").

[9] *See*, *e.g.*, *Rosenberg v. Metlife, Inc.*, 866 N.E. 2d 439, 444-45 (N.Y. Ct. App. 2007) (explaining the design and import of Form U-5 as "[t]he public interests implicated by the filing of Forms U-5 are significant.").

[10] *Rosenberg*, 866 N.E. 2d at 444-45.

[11] *See SII Investments v. Jenks*, 2006 WL 2092639, at *4 (M.D. Fla. Jul. 27, 2006) (Florida Administrative Code § 69W-600.008, "when read in conjunction with" Florida statutes, "imposed a legal duty on a [broker-dealer] to accurately report in a U-5 the grounds for terminating an agent") (citing *Twiss v. Kury*, 25 F.3d 1551 (11th Cir. 1994) and *Palmer v. Shearson Lehman Hutton, Inc.*, 622 So.2d 1085 (Fla. 1st DCA 1993)).

[12] Instr. Rev. Form U-5 (10/2005) (available at: http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p015113.pdf).

[13] *See Twiss*, 25 F.3d at 1553 n.4 ("There are five options that an employer may choose as the reason for termination on a Form U-5 . . . If either the 'permitted to resign,' 'discharged,' or 'other' reason is given, the employer must furnish details for that answer.'"); Instr. Rev. Form U-5 (10/2005) at 3 ("If 'Permitted to Resign,' 'Discharged,' or 'Other,' is checked, provide an explanation in the space provided.").

[14] Instructions Rev. Form U-5 (10/2005) at 1, 4.

[15] Instructions Rev. Form U-5 (10/2005) at 4.

[16] *See*, *e.g.*, Bruce Kelly, *Busted Brokers Continue Bilking Clients At New Firms*, Investment News (Dec. 7, 2008) (available at: http://www.investmentnews.com/article/20081207/REG/312089972).

[17] *See* NASD News Release, *NASD Fines Morgan Stanley $2.2 million for Late Reporting, Firm Temporarily Suspended from Registering New Brokers* (NASD July 29, 2004) (available at: http://www.finra.org/Newsroom/NewsReleases/2004/p010891).

[18] *Id.* and *see also* FINRA Notices December 2007, *FINRA Fines UBS Financial Services $370,000 For Late Reporting, Failure To Report Broker Information* at 22-23 (available at: http://www.finra.org/web/groups/Industry/@ip/@reg/@notice/documents/Notices/P037801.pdf).

[19] *See generally Twiss v. Kury*, 25 F.3d 1551 (11th Cir. 1994); *Episcopal Diocese of Central Fla. v. Prudential Sec., Inc.*, Case No. 5D05-248, slip op. (Fla. 5th DCA Dec. 30, 2005) (slip op. available at http:// http://www.5dca.org/Opinions/Opin2005/122605/5D05-248.op.pdf), *opinion withdrawn and superseded on other grounds*, 925 So. 2d 1112 (Fla. 5th DCA 2006) (fiduciary duty to warn applied even though plaintiff suffered damages after contracts with Prudential were terminated and after accounts were transferred to new broker).

[20] *See*, *e.g.*, *Prymak v. Contemporary Fin. Solutions, Inc.*, 2007 WL 4250020, at *8 (D. Colo. Nov. 29, 2007) ("'Negligence *per se* serves to establish the existence of the defendant's breach of a legally cognizable duty owed to the plaintiff' by adopting a standard of care from a statute or ordinance.") (citation omitted).

[21] *See*, *e.g.*, *Episcopal Diocese of Central Fla.*, Case No. 5D05-248, slip op. at 6 ("At the time the accounts were transferred, Prudential owed the Diocese a continuing fiduciary duty of care by virtue of Prudential's prior history of managing the Diocese's accounts."); *Glaziers*, 93 F.3d at 1182 (Broker-dealers who are fiduciaries have "a duty to disclose to the [client] any material information which [the broker-dealer] knew, and which the [client] did not know, but need to know for [the client's] own protection. * * * The well established obligations endemic in the law of trusts requires nothing less."); *Jenks v. SII Investments, Inc.*, NASD Case No. 05-00373, Award at 3 (NASD Oct. 21, 2005) ("Respondent is liable on the claims of breach of fiduciary duty[.]") (available on PACER at https://ecf.flmd.uscourts.gov/doc1/04711556508).

[22] *Dolin v. Contemporary Fin. Solutions, Inc.*, 2009 WL 890689, at*4 (D. Colo. Mar. 31, 2009) (Court found fiduciary duty running from broker-dealer to claimant/plaintiff even though claimant/plaintiff never had a formal account with broker-dealer.).

[23] *Glaziers*, 93 F.3d at 1182 (quoting *Bixler v. Central Pa. Teamsters Health & Welfare Fund*, 12 F.3d 1292, 1300 (3rd Cir. 1993)).

[24] *Glaziers*, 93 F.3d at 1181.

[25] 93 F.3d 1171 (3rd Cir. 1996).

[26] *See id.* at 1175-77 (*Glaziers*' factual account).

[27] *See id.* at 1176 (quoting Janney's Form U-5 explanation).

[28] *See id.* at 1176-77.

[29] *Id.* at 1182.

[30] *Id.*

[31] *Id.*

[32] *Accord Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 641 n.17 (3d Cir. 1990) ("Disclosures mandated by law are presumably material."); *In re Goodyear Tire & Rubber Co. Sec. Litig.*, 1993 WL 130381, at *6 (E.D. Pa. Apr. 22, 1993) (same).

[33] *Glaziers*, 93 F.3d at 1181.

[34] *Id.*

[35] *Glaziers*, 93 F.3d at 1181 (quoting RESTATEMENT (SECOND) OF TRUSTS § 173, comment d (1959)).

[36] Case No. 5D05-248, slip op. (Fla. 5th DCA Dec. 30, 2005) (slip op. available at http:// http://www.5dca.org/Opinions/Opin2005/122605/5D05-248.op.pdf).

[37] 370 F. Supp. 2d 1213 (M.D. Fla. 2005) (order denying broker-dealer's motion for preliminary injunction to stay arbitration); 2006 WL 2092639 (M.D. Fla. Jul. 27, 2006) (magistrate's report & recommendation denying broker-dealer's motion to vacate arbitration award).

[38] *Episcopal Diocese*, slip op. at 3.

[39] *See id.*

[40] *Episcopal Diocese*, slip op. at 3.

[41] *Jenks*, 370 F. Supp. 2d at 1215.

[42] 370 F. Supp. 2d at 1219 ("Furthermore, the Court finds Jenks' argument ore persuasive—that her purchases of [the losing security] grew out of and were a natural consequence of [the broker's] recommendation, made while [the broker] was still associated with [the first broker-dealer.]")

[43] *See Jenks v. SII Investments, Inc.*, NASD Case No. 05-00373, Statement of Claim at 8 n.3 (NASD filed Feb. 1, 2005) (available on PACER at: https://ecf.flmd.uscourts.gov/doc1/04712976919).

[44] *Jenks*, 2006 WL 2092639, at *2.

[45] *Id.*

[46] *See Glaziers*, 93 F.3d at 1181.

[47] *Jenks*, 2006 WL 2092639, at *2.

[48] 2007 WL 4250020 (D. Colo. Nov. 29, 2007).

[49] 2009 WL 890689 (D. Colo. Mar. 31, 2009).

[50] *Dolin* involved only two legacy claimants. It cites and relies heavily upon *Prymak*. Discussion of *Dolin* would be repetitive given the extensive discussion of *Prymak*. *Dolin* will not be extensively analyzed or discussed in this article. It is mentioned and cited only to provide the reader with an additional research resource.

[51] "'Selling away' is 'a term of art in the securities field used when a registered representative sells securities not approved for sale by the employer' and is a sub-set of theories of recovery falling under 'failure to supervise.'" *Drag v. Southtrust Bank*, 2005 WL 1883241, at *5 n.1 (W.D.N.C. Aug. 4, 2005) (quoting *New Life Brokerage Services, Inc. v. Cal-Surance Associates, Inc.*, 222 F. Supp. 2d 94, 99 (D. Me. 2002)). *E.g.*, *Prymak v. Contemporary Financial Solutions, Inc.*, 2007 WL 4250020 (D. Colo. Nov. 29, 2007) (selling away case that led to liability for inaccurate Form U-5 filings).

[52] *See Prymak*, 2007 WL 4250020, at *12.

[53] *Prymak*, 2007 WL 4250020, at *14 (italics in original).

[54] Even though *Prymak* was "a securities fraud case," 2007 WL 4250020, at *1, and even though *Prymak* was based upon state-law causes of action for more than fifty plaintiffs, *Prymak* did not trigger federal pre-emption under the Securities Litigation Uniform Standards Act ("SLUSA"), 15 U.S.C. § 78bb(f)(1)(A), because the securities sold were unregistered, non-exempt securities that were not listed on any national exchange. Consequently, the securities were not "covered securities" under SLUSA, and thus, not pre-empted by SLUSA. *See Merrill Lynch v. Dabit*, 547 U.S. 71, 84, 126 S. Ct. 1503, 1512 (2006) ("A covered security' is one traded nationally and listed on a regulated national exchange.").

[55] *Prymak*, 2007 WL 4250020, at *13 n.5.

[56] *Prymak*, 2007 WL 4250020, at *4.

[57] *Prymak*, 2007 WL 4250020, at **6-7 (explaining requirements of Colorado and Arkansas state securities regulations).

[58] *Prymak*, 2007 WL 4250020, at *10 ("Thus, my finding that the state securities laws at issue do not provide Plaintiffs with a private right of action is not determinative of [Plaintiffs'] negligence *per se* claim.").

[59] *Prymak*, 2007 WL 4250020, at *9.

[60] *Prymak*, 2007 WL 4250020, at *9.

[61] *Prymak*, 2007 WL 4250020, at *4.

[62] *See*, *e.g.*, *Palmer v. Shearson Lehman Hutton, Inc.*, 622 So.2d 1085 (Fla. 1st DCA 1993).

[63] 622 So.2d 1085 (Fla. 1st DCA 1993).

[64] 25 F.3d 1551 (11th Cir. 1994) (applying Florida and relying heavily on *Palmer*, *supra.*).

[65] Currently, Blum & Silver, LLP represents about 200 investor claimants in a massive Ponzi scheme selling away case in the Midwest. The case involves both legacy and non-legacy claimants.

[66] 622 So.2d at 1086 (emphasis added).

[67] *See Palmer*, 622 So.2d at 1087.

[68] *Palmer*, 622 So.2d at 1088 (italics in original).

[69] *Palmer*, 622 So. 2d at 1088.

[70] *See Palmer*, 622 So.2d at 1088.

[71] *See id.*

[72] *Palmer*, 622 So.2d at 1089.

[73] *Palmer*, 622 So.2d at 1090.

[74] *Palmer*, 622 So.2d at 1092.

[75] *Twiss*, 25 F.3d at 1557.

[76] *Twiss*, 25 F.3d at 1557 n.18 (quoting letter from Division of Securities).

Brokerage Firms' Liability When They Fail To Warn About Bad Brokers

About The Author

Scott L. Silver manages the south Florida firm of Silver Law Group which focuses on representing investors in claims against stockbrokers, investment banks, securities firms, commodities firms, and other members of the financial services industry. For more than twenty years, Mr. Silver has represented claimants nationwide in a host of forums, including arbitrations before FINRA, the NFA, and the AAA, as well as in courts nationwide. In so doing, Mr. Silver has recovered numerous multi-million dollar awards and settlements for claimants. Amongst other accolades, Mr. Silver serves as the Co-Chairman of the Securities and Financial Fraud Group of the American Association of Justice. Mr. Silver is admitted to practice in Florida and in New York and represents investors nationwide.

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