

**I**n this time of stock market volatility and economic uncertainty, securities brokers, like mortgage brokers and other financial professionals, find themselves faced with increased liability exposure. According to statistics published by the Financial Industry Regulatory Authority (FINRA), claims against securities professionals through November 2008 were up 48 percent compared with the prior year.<sup>1</sup> It is increasingly important for securities brokers, like other professionals, to be aware of their duties and responsibilities to their customers under Texas law. This article outlines those duties and responsibilities, and how violations of those duties and responsibilities can give rise to liability in Texas.

# Liability in Texas

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ILLUSTRATION BY RYAN DAY

## **What is a Securities Broker?**

A securities broker, commonly referred to as a stockbroker, is one who trades securities on behalf of customers in exchange for a fee, known as a commission.<sup>2</sup> A security can include a share of stock, a bond, or a limited partnership interest, among other types of investments.<sup>3</sup> A securities broker who also provides investment advice and exercises discretionary authority in making investment decisions for a customer is known under Texas law as an investment advisor.<sup>4</sup> In both cases, a person must be properly licensed by both the federal regulatory authorities and the Texas State Securities Board.<sup>5</sup> However, the distinction between acting as a securities broker and an investment advisor is more than a formality; it can make a significant difference when evaluating the scope of a broker's duties to his customers under Texas law.

## **Types of Claims Against Securities Brokers**

Most claims asserted against securities brokers are subject to binding arbitration.<sup>6</sup> Texas courts strongly favor the enforcement of arbitration agreements between securities brokers and

their customers.<sup>7</sup> For purposes of evaluating the potential liability Texas securities brokers face, it is instructive to review the types of claims that are commonly asserted against securities brokers in arbitrations filed under the auspices of FINRA, the primary clearinghouse for such disputes. According to statistics published by FINRA, the most common claims against securities brokers, in descending order, are (1) breach of fiduciary duty, (2) misrepresentation/omission of facts, (3) breach of contract, (4) negligence, (5) unsuitability, (6) failure to supervise, (7) unauthorized trading, and (8) churning.<sup>8</sup>

### ***Breach of Fiduciary Duty***

The single most common claim against securities brokers is breach of fiduciary duty.<sup>9</sup> Under Texas law, the nature and scope of a securities broker's fiduciary duties to the customer are "fact-based" and "will vary, depending on the relationship between the broker and the investor."<sup>10</sup> More specifically, the nature of a broker's fiduciary obligations to the customer will depend primarily on the type of services being performed by the broker (i.e., whether the stockbroker is acting as a "mere



order-taker" or acting in a broader capacity as investment advisor to the customer).<sup>11</sup>

The fiduciary obligations owed by a securities broker to a customer will often depend on the amount of discretion a broker has over a customer's account. For example, in the context of a non-discretionary account, in which the broker may only execute trades at the specific instruction of the customer, "the [broker's] fiduciary duty is very narrow — primarily not to make unauthorized trades."<sup>12</sup> On the other hand, in the context of discretionary accounts, in which the broker has been given express authority by the customer to make trades without specific prior instruction, Texas courts have held that the broker will owe the client a broader set of fiduciary obligations.<sup>13</sup> In such circumstances, Texas courts have held that a broker's fiduciary duties include the following: (1) to only recommend securities suitable for the customer;<sup>14</sup> (2) to provide the customer with all information relevant to the affairs the customer instructed to the broker;<sup>15</sup> (3) to execute orders fairly, with a duty to disclose markups and markdowns and other pricing events;<sup>16</sup> (4) to segregate the customer's funds, including proceeds of sales, and to provide accounting to the customer;<sup>17</sup> and (5) to not "churn" the account (engage in excessive trading for the purpose of driving up commissions).<sup>18</sup>

Other, broader fiduciary obligations recognized by Texas courts include requiring the broker to put the customer's interests above his own, to make reasonable use of the confidence that his clients place in him, to act in utmost good faith and exercise the most scrupulous honesty toward the clients, and to fully and fairly disclose all important information to the clients concerning the transaction.<sup>19</sup> Failure to comply with any of these obligations can, in the appropriate context, expose a broker to a claim for breach of fiduciary duty under Texas law.

### **Misrepresentation/Omission of Facts**

Under federal securities laws, a securities broker may be liable to a customer for making a misrepresentation or omission of material fact with the intent to deceive, manipulate, or defraud the customer, or in reckless disregard of a customer's

investment objectives or best interests.<sup>20</sup> Similarly, under the Texas Securities Act, a securities broker may be civilly liable for committing an "untruth or omission" in the buying or selling of securities.<sup>21</sup> "Untruth or omission" is defined in the act as "an untrue statement of material fact or an omission to state a material fact necessary in order to make the statements made, in the circumstances under which they are made, not misleading."<sup>22</sup> Penalties for violation of this provision of the Texas Securities Act include rescission of the sale or purchase of the security, as well as an award of costs and attorney's fees.<sup>23</sup>

The Texas Securities Act also extends civil liability for a broker's "untruths or omissions" to the broker's "control persons and aiders."<sup>24</sup> A control person is defined as one who "directly or indirectly controls the seller or buyer of the security."<sup>25</sup> A control person is jointly and severally liable for any damages caused by the "untruth or omission" of the broker, unless the control person is able to show that "he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist."<sup>26</sup> An aider, by contrast, is one "who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids" a broker's misrepresentation or omission.<sup>27</sup> As with a control person, an aider can be jointly and severally liable for the broker's conduct.<sup>28</sup>

In addition to the remedies under the Texas Securities Act, a broker who misrepresents the truth can also be liable to the customer for civil fraud or negligent misrepresentation.<sup>29</sup> A broker could also be potentially liable for damages under the Texas Deceptive Trade Practices – Consumer Protection Act (DTPA), which gives consumers a private cause of action for "false, misleading, or deceptive acts or practices."<sup>30</sup> However, the extent of a broker's potential liability under the DTPA is limited by two factors. First, "professional services," which are defined as those services "the essence of which is the providing of advice, judgment, opinion, or similar professional skill," are exempted from the DTPA in most instances.<sup>31</sup> Arguably, a broker, by providing professional services to the customer, would fall within this provision. Second, at least one Texas court has held that an investor did not qualify as a "consumer" under the DTPA because the securities in question were not "goods or services" as defined by that statute.<sup>32</sup>

### **Breach of Contract**

Although breach of contract is listed as one of the most common claims asserted against securities brokers in FINRA arbitrations, the viability of such a cause of action against securities brokers in Texas is doubtful. The author was unable to find a single reported Texas case in which a securities broker was held liable on a breach of contract theory.<sup>33</sup> This is probably the result of two factors: (1) most brokers do not have written contracts with their customers clearly spelling out their duties and responsibilities; and (2) in Texas, actions against

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professional service providers sound in negligence, not contract.<sup>34</sup> Thus, in the absence of a specific written contract that sets forth legal duties and obligations of the broker other than those that exist under common law, in this author's opinion, a securities broker cannot be liable for a cause of action for breach of contract under Texas law.

### **Negligence**

To establish a claim for negligence against a securities broker in Texas, as in any claim for professional negligence, the customer must establish (1) an existence of a duty, (2) a breach of the duty, and (3) damages that were proximately caused by such a breach.<sup>35</sup> The threshold inquiry — whether a duty exists — is a question of law for the court to decide.<sup>36</sup> As with the fiduciary duties discussed above, the general duties and obligations owed by a securities broker to his customer will primarily depend on the nature of their relationship, i.e., whether the account is discretionary or non-discretionary.<sup>37</sup> In non-discretionary accounts, Texas courts have held that a broker's sole duty is to execute a customer's order as instructed; or, if the order is refused, to give prompt notice of same to the customer.<sup>38</sup> In the context of discretionary accounts, in addition to the fiduciary obligations itemized above, at least one Texas

court has recognized the following additional duties owed by a broker to the customer:

- (1) To manage the account in a manner directly comporting with the needs and objectives of the customer, as stated in the authorization papers or as apparent from the customer's investment and trading history;
- (2) To keep informed regarding the changes in the market that affect his customer's interest and act responsively to protect those interests;
- (3) To keep his customer informed as to each completed transaction;
- (4) To explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged.<sup>39</sup>

Thus, as with the fiduciary obligations owed by securities brokers to their customers under Texas law, the extent to which a broker may also be liable for a claim of negligence will largely depend on the nature and extent of the broker's relationship with the customer.

### **Unsuitability**

Under both securities industry rules and Texas law, one of the primary duties owed by a securities broker to a customer, at least in the context of a discretionary account, is to manage a customer's account in accordance with the needs and objectives of the customer, as stated in the customer's account papers or as apparent from the customer's investment and trading history.<sup>40</sup> This is often referred to as the "know your customer" rule.<sup>41</sup> In particular, National Association of Securities Dealers (NASD) Rule of Conduct 2310 states that "[i]n recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."<sup>42</sup>

In determining the suitability of an investment for a customer, a broker is required to consider the following factors:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by the broker in making recommendations to the customer.<sup>43</sup>

Failure to recommend suitable investments can expose a securities broker managing a discretionary account to liability under Texas law and applicable securities industry rules.<sup>44</sup>

### **Failure to Supervise**

Under Texas law, supervising organizations, known as broker-dealers, can be liable for failing to properly supervise their registered representatives who fail to comply with their obligations to their customers. As noted above, under the Texas Securities Act, one who "directly or indirectly controls" a broker can



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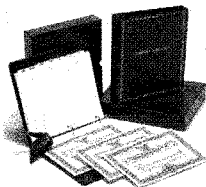
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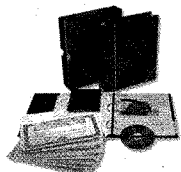
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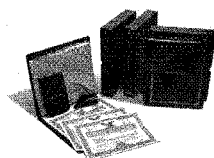
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be liable for the broker's misrepresentation or omission of fact.<sup>45</sup> Additionally, under securities industry rules, member organizations can be liable for failing to properly supervise their registered representatives.<sup>46</sup> Some of the enumerated supervisory duties imposed on member organizations under applicable industry rules include the following:

- (1) Establishment and maintenance of written procedures to ensure compliance with applicable company and industry rules;
- (2) Designation of regional supervisors, called offices of supervisory jurisdiction (OSJ), to oversee individual brokers;
- (3) Undertaking reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities; and
- (4) Conducting audits of the individual brokers, on at least an annual basis, to review the broker's compliance with company and industry rules and regulations.<sup>47</sup>

Failure to comply with these supervisory obligations can lead to a member organization's *respondeat superior* liability for wrongful conduct of the individual broker.<sup>48</sup>

### Unauthorized Trading

As stated above, in a non-discretionary account, a broker may only execute orders that are specifically instructed by the customer.<sup>49</sup> Thus, if a securities broker executes a trade in a non-discretionary account without express authorization from a customer, the broker can be liable for unauthorized trading.<sup>50</sup> In a discretionary account, on the other hand, a broker has much broader discretion to execute trades and is not required to obtain customer consent to each specific transaction.<sup>51</sup> Thus, establishing an unauthorized trading claim is much more difficult in the context of a discretionary account than in a non-discretionary account. Further, a customer's failure to object to repeated instances of unauthorized trading, when the customer is fully aware of and fails to object to same, can be deemed as an implicit authorization for such trades, which will preclude a customer from later complaining of same.<sup>52</sup>

### Churning

Last in the list of most common claims against securities brokers is "churning." Churning is defined as occurring "when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interests."<sup>53</sup> There are three elements to a churning claim:

- (1) The trading in the account was excessive in light of investment objectives;
- (2) The broker in question exercised control over the trading in the account; and
- (3) The broker acted with the intent to defraud or with willful and reckless disregard for the investor's interests.<sup>54</sup>

Establishment of these three elements can expose a securities broker to liability under federal securities laws, as well as a state law claim for breach of fiduciary duty.<sup>55</sup>

### Conclusion

In this turbulent financial environment, securities brokers and investment advisors face increasing liability exposure from disgruntled customers who have suffered losses with their investments. As the foregoing summary of legal authorities attests, a securities broker's liability can vary greatly depending on the nature and extent of the broker/customer relationship. Accordingly, securities brokers in Texas, as well as their supervisory broker-dealers, would be well served to be familiar with their duties and responsibilities to their customers under Texas law in order to minimize their liability exposure.

### Notes

1. See <http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm> (last updated 01/12/09).
2. Texas Securities Act (TSA), Tex. Rev. Civ. Stat. Ann. art. 581-4(H) (defining "broker" as a "dealer" who "engages ... in selling, offering for sale or delivery, or soliciting subscriptions to or orders for ... any security or securities ...").
3. TSA, Sec. 4(A).
4. TSA, Sec. 4(N) (defining "investment advisor" as "a person who, for compensation, engages in the business of advising another, either directly or through publications or writings, with respect to the value of securities or to the advisability of investing in, purchasing, or selling securities ..."); see also *Western Reserve Life Assurance Co. of Ohio v. Graben*, 233 S.W.3d 360 (Tex. App. — Fort Worth 2007, no pet.) (distinguishing between broker who is "a mere order-taker" from one who acts as a "financial advisor whom the Clients trust [...] to monitor the performance of their investments and recommend appropriate financial plans to them").
5. TSA, Sec. 12(A) & (B).
6. See FINRA Code of Arbitration Procedure for Customer Disputes, Rule 12200 (requiring all customer disputes to be submitted to arbitration if required by written agreement or requested by customer).
7. See, e.g., *Cantella & Co. v. Goodwin*, 924 S.W.2d 943, 944 (Tex. 1996) (public policy strongly favors arbitration, and so a trial court must presume the matter is subject to arbitration unless the party opposing arbitration proves otherwise); *Prudential Securities, Inc. v. Marshall*, 909 S.W.2d 896, 898 (Tex. 1995) (arbitration of disputes is strongly favored under both federal and state law).
8. [www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm](http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm) (last updated 01/12/09). Other categories of claims against securities brokers include margin and online trading claims.
9. *Id.*
10. *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5th Cir. 1987) (extent of fiduciary duty will depend on the "degree of trust placed in the broker and the intelligence and personality of the customer").
11. See, e.g., *Hand v. Dean Witter Reynolds, Inc.*, 889 S.W.2d 483, 493 n. 5 (Tex. App. — Houston [14th Dist.] 1994, writ denied) (broker is only fiduciaries with respect to matters within the scope of their agency); *Western Reserve*, 233 S.W.3d at 374 (extent of fiduciary duty of broker depends on whether he is acting as "mere order-taker" or financial advisor).
12. *Hand*, 889 S.W.2d at 493, n.5.
13. *Id.*; *Western Reserve*, 233 S.W.3d 360 at 374.
14. *McCoun v. Rea (In re Rea)*, 245 B.R. 77, 89-90 (B.R. N.D. Tex. 2000).
15. *Id.*
16. *Id.*



17. *Id.*
18. *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981).
19. *Western Reserve*, 233 S.W.2d at 374 (citing Comm. on Pattern Jury Charges, State Bar of Tex., Texas Pattern Jury Charges: Fiduciary Duty PJC 104.2 (2003)); *but see Edward D. Jones v. Fletcher*, 975 S.W.2d 539, 545 (Tex. 1998) (holding that stockbroker's fiduciary obligation to customer does not include duty to ascertain client's mental competence).
20. *See, e.g.*, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) and S.E.C. Rule 10b-5 (17 C.F.R. §10b-5) (making actionable broker's misrepresentation or omission of material fact or scheme to defraud when made with intent to deceive, manipulate, or defraud or in reckless disregard of customer's investment objectives and/or best interests).
21. TSA, Sec. 33(A) & (B).
22. *Id.*
23. *Id.*, Sec. 33(D).
24. *Id.*, Sec. 33(F).
25. *Id.*, Sec. 33(F)(1).
26. *Id.*
27. *Id.*, Sec. 33(F)(2).
28. *Id.*, *see also Sterling Trust Co. v. Adderley*, 168 S.W.3d 835 (Tex. 2004) (holding that, to be liable under TSA, an "aider" must be subjectively aware of the primary violator's improper activity, though showing actual knowledge of the exact misrepresentations is not required).
29. *Western Reserve*, 233 S.W.3d at 375-76 (outlining elements of fraud against broker and stating that the "gist of fraud is successfully using cunning, deception, or artifice to cheat another to the other's injury"); *Hand*, 889 S.W.2d at 489 n. 2 (outlining elements of actionable negligent misrepresentation claim against securities broker).
30. Tex. Bus. & Com. Code Ann. (hereinafter "DTPA") §17.46 (Vernon 1987).
31. *Id.*
32. *Hand*, 889 S.W.2d at 496-500 (holding that customer who complained that broker who failed to timely execute an order for purchase of a commodity contract was not "consumer" under the statute because a commodity contract is not a "good" under the statute, and the broker did not provide "services"); *see also* DTPA §17.45(4) (Vernon 1987) (defining "consumer" as one who "acquires by purchase or lease, any goods or services").
33. *But see Romano v. Dempsey-Tegeler & Co.*, 540 S.W.2d 538 (Tex. Civ. App. — Houston [14th Dist.] 1976, writ ref'd n.r.e.) (holding trial court erred by refusing to submit jury issue on breach of contract).
34. *See, e.g., Bray v. Jordan*, 796 S.W.2d 296, 298 (Tex. App. — El Paso 1990, no writ) (holding claim for professional negligence against attorney sounded in tort, not contract).
35. *Hand*, 889 S.W.2d at 491 (negligence claim requires showing breach of duty by broker that proximately causes damages to the customer).
36. *Id.*
37. *Western Reserve*, 233 S.W.3d at 374; *Hand*, 889 S.W.2d at 492-93.
38. *Hand*, 889 S.W.2d at 494 ("Generally, while a broker has a duty to execute a customer's order to liquidate the existing positions, he has no duty to accept an order to open new positions unless he accepts the agency. The only duty that arises, if a broker refuses to accept the agency, is that the broker must give prompt notice that the order is refused") (citations omitted).
39. *Anton v. Merrill Lynch*, 36 S.W.3d 251, 257-58 (Tex. App. — Austin 2001, pet. denied) (citing *Leib v. Merrill Lynch, Pierce, Fenner & Smith*, 461 F.Supp. 951 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981) and *McCown v. Rea (In re Rea)*, 245 B.R. 77, 90 (Bankr. N.D. Tex. 2000)).
40. *Anton*, 36 S.W.3d at 257-58 (listing among duties owed by broker in discretionary account to "manage the account directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history").
41. *See Edward D. Jones v. Fletcher*, 975 S.W.2d at 545 (citing NYSE Rule 405 that requires members to "[u]se due diligence to learn the essential facts relative to every customer").
42. NASD Rule of Conduct 2310(a).
43. *Id.*, subsec. (b).
44. *Anton*, 36 S.W.3d at 257-58; *In re Rea*, 245 B.R. at 89-90.

45. TSA, Sec. 33(F)(1).
46. *See* NASD Rule of Conduct 3010.
47. *Id.*
48. *Id.*
49. *Hand*, 889 S.W.2d at 492.
50. *Id.* at 493 n. 5 (in non-discretionary account, "the fiduciary duty owed to the customer is very narrow — primarily not to make unauthorized trades").
51. *Id.*
52. *See, e.g., Ferguson v. Francis I. DuPont & Co.*, 369 F.Supp. 1099 (N.D. Tex. 1974) (customer's knowledge of but failure to object to repeated unauthorized trades by broker over several years constituted implicit authorization and constituted bar to claim under securities laws).
53. *Miley*, 637 F.2d at 324.
54. *Id.* (citing numerous authorities).
55. *Id.*



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