

# New York Law Journal

ALM Properties, Inc.

Page printed from: [New York Law Journal](#)

[Back to Article](#)

---

## Negligent Referrals to Rogue Stockbrokers

David A. Weintraub

New York Law Journal

11-21-2012

Can an attorney be liable for the negligent referral of a client to a "rogue stockbroker," or in the Thanksgiving spirit, a turkey broker?<sup>1</sup> If an attorney chooses to refer a client to a broker,<sup>2</sup> what are the best practices prior to making the referral?<sup>3</sup> Given the absence of New York case law addressing an attorney's liability for the negligent referral to a "rogue broker,"<sup>4</sup> best practices dictate that at a minimum, an attorney should exercise reasonable care in investigating the broker's background. The attorney must also be extraordinarily careful regarding the nature of the referral to the broker. Initially, it may be best to determine if the person one is referring to is a stockbroker and/or an investment advisor. Generally, stockbrokers charge commissions per transaction, whereas investment advisors charge fees based on percentages of assets under management. Some individuals are both stockbrokers and investment advisors.

The tort of "negligent referral" arises most often in the context of an attorney's liability for a negligent referral to another attorney,<sup>5</sup> or a physician's referral to another physician.<sup>6</sup> It is conceivable, however, that an attorney could be sued for referring a client to a stockbroker who commits misconduct. 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). The logical extension of this cause of action would lead to the potential of liability for the negligent referral to stockbrokers, accountants, or other professionals. Given the potential for liability, it only makes sense to engage in minimal due diligence before referring to a stockbroker.

### The Broker's CRD

At a minimum, before referring to a stockbroker an attorney should review all publicly available information regarding the stockbroker's background. The single most important document to review is the broker's Central Registration Depository report, or CRD. The CRD details the broker's employment history, including all reportable events. A broker's reportable events include customer complaints, arbitrations, regulatory investigations, bankruptcies and certain criminal matters. Because this information is publicly available, and easily accessed, a failure to review the information could easily be deemed negligent.

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 for purposes of FINRA's public database. Importantly, the "Z" records remain publicly available through other databases, as discussed below.

### Obtaining the CRD

Obtaining a CRD is easy, and free. After obtaining the broker's CRD number from FINRA's website, <http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm>, one can download a redacted version of the CRD. The redacted version of the CRD differs in several respects from an unredacted version. First, the redacted version does not provide the name of the investors who have complained about the broker. Second, the redacted version will not reflect bankruptcies that occurred more than 10 years ago.

Third, the redacted version will not reflect whether the broker ever failed licensing exams. If a broker has failed an examination, perhaps multiple times, an investor might hesitate in trusting that broker to understand and explain an especially complex product. The easiest way to obtain an unredacted CRD is through the Florida Office of Financial Regulation. One can send an email to [electronic\\_licensing@fldfs.com](mailto:electronic_licensing@fldfs.com). In the email, request the broker's entire CRD, including a full legacy report. Please note that the Florida Office of Financial Regulation will only provide the CRD 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.

### 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 the broker's conduct is at issue.<sup>7</sup> Once deemed reportable, the event should appear on the CRD.

It is important to note that prior to FINRA's issuance of [Regulatory Notice 09-23](#) in May 2009, there existed a requirement that the broker be a named defendant in order to create a reportable event. If the broker was not a named defendant, he would not have had a reportable event even if accused of fraud, churning or theft. If not deemed a reportable event, the event would not have appeared on the CRD. Because of these since rescinded reporting rules, it is impossible to determine with certainty the precise number of complaints in which a 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, in addition to those appearing on the CRD. Hopefully, the broker will be truthful.

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 broker. Having numerous complaints is not as far fetched as one would think, even with first tier firms. However, before removing the broker from one's 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 better to be informed.

### State Registration

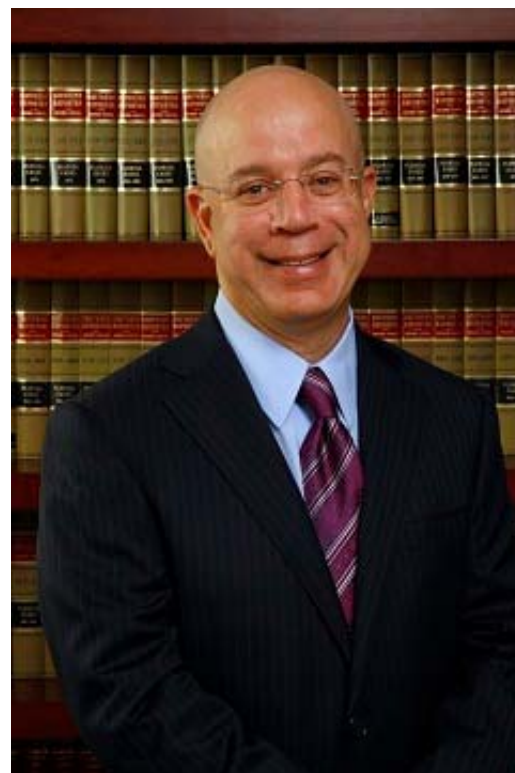
The unredacted CRD will also contain information regarding the states in which the broker has applied for registration. If the CRD states "T\_NOREG," this may be seen as a "red flag." This information often means that a particular state has requested that the broker withdraw his or her application. Alternatively, a state may have requested additional information regarding a prior event and the broker has elected not to provide the information.

When the broker has voluntarily withdrawn an application, the decision may have been based on a fear that the application would have been denied. A formal denial would look far worse on a CRD than a voluntary withdrawal. FINRA's redacted version of the CRD will not identify those states where the broker was terminated without registration. The unredacted version will contain this information.

### Pending Regulatory Probe

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



David A. Weintraub

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 stockbroker could not manage his or her own finances. Bankruptcies are reflected on both FINRA's redacted CRD, and the unredacted CRDs available from state regulators. However, if the bankruptcy is more than 10 years old, it no longer appears on the redacted CRD.

### 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 six 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.

### Employment History

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

### A Genuinely Full Service Firm?

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

### Insurance Issue

Most major securities firms are self-insured. That is, they do not have errors and omissions coverage except perhaps for extraordinarily large claims, i.e., in excess of \$50 million. Many smaller firms purchase insurance, or require their employees to purchase it, as a matter of course. Given that one may never let a contractor into one's home without proving that they are insured, it is reasonable to ask a stockbroker whether they have insurance.

### Conclusion

Rather than focusing on whether New York courts would recognize the tort of "negligent referral" in the stockbroker context, the safer path is 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 broker, 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. And remember, nobody wants their clients to be gobbled by a turkey broker.

**David A. Weintraub** is a securities attorney with offices in Plantation, Fla., and New York City.

### Endnotes:

1. See *De La Bere v. Pearson, Limited*, 1 KB 280 (1907).
2. Under New York law, a stockbroker, or someone holding a Series 7 FINRA license, is referred to as a "salesman." See NY CLS Gen. Bus. §359-e (2012). FINRA refers to the same Series 7 licensed individual as a "representative." See FINRA Rule 1031(b). For statute of limitations purposes, stockbrokers and financial advisors are not "professionals." *Ironshore Insurance Ltd. v. Western Asset Management Company*, 2012 U.S. Dist. LEXIS 76818 (S.D.N.Y. May 30, 2012).
3. This article does not address an attorney's best practices when referring to investment advisors, certified financial planners, or trust officers, unless those individuals also maintain Series 7 licenses. These entities are distinct and warrant different considerations.
4. The phrase "rogue stockbroker" is not defined. However, in a 1996 speech, Mary L. Schapiro, the current chairperson of the Securities and Exchange Commission, 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."

5. In [Tormo v. Yormark](#), 398 F.Supp. 1159 (D.N.J. 1975) the court considered whether a New York attorney could be liable for the negligent referral to a New Jersey attorney who eventually stole the client's money. The court held that the attorney could not be liable, as he had confirmed that the New Jersey attorney was licensed. The referring attorney had failed to learn that the New Jersey attorney was under indictment at the time of the referral. The court stated that "it would be unfair to require a New York practitioner referring a case to New Jersey counsel to know facts concerning him which are notorious only within New Jersey." It is important to recognize that *Tormo* was decided in 1975, decades before the Internet and the proliferation of vast publicly available databases. Query whether the result would be the same today.

6. [Jung Xu vs. Karpov](#), 2008 NY Slip Op 52107U, 21 Misc.3d 1120A; 873 N.Y.S.2d 512; 2008 N.Y. Misc. LEXIS 6155 (2008).

7. A complaint letter is reportable if the customer alleges (1) damages of \$5,000 or more, and (2) that the broker was involved in one or more sales practice violations. See FINRA Form U-4.