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Broker-Dealer Duties in 2016

John R. Fahy

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Various politicians, regulators and securities industry members have been lately tussling on the Department of Labor's proposal to treat securities brokers and dealers as ERISA fiduciaries² and the SEC's specific authority under the Dodd-Frank Act to impose fiduciary duties upon securities brokers and dealers.³ One item lost in the regulatory cacophony is what duties does a broker-dealer already have to a customer? The ongoing public discussions of the Department of Labor's ERISA fiduciary proposal or the SEC's authority under the Dodd-Frank Act to impose fiduciary duties on broker-dealers really have not delved into these issues. But, here is a little known fact. According to an extra-legal FINRA interpretation, broker-dealers are already subject to a "best interests" standard under the Suitability Rule (as of the 2012 rule revisions) – which means that they are already subject to a general fiduciary duty. Broker-dealers also were always subject to common law fiduciary obligations as agents. Plus, broker-dealers have a myriad of other specific duties.

Broker-dealer regulation is highly prescriptive. Broker-dealers have multiple specific duties to their clients.

Fiduciary Duty of Agent to Principal

Customers sign customer agreements with their broker-dealer. Those agreements appoint the broker-dealer to be the customer's special agent for buying and selling securities. While there are common law agency duties, those duties are typically specifically defined by the contract.

Where the relationship of principal and agent is shown, the principal is entitled to the best efforts and unbiased judgment of the agent. . . . A broker is a special agent and has the same duty toward his employer as a special agent has toward his principal. . . . A broker's contract of employment calls for the utmost good faith on the part of the broker and he is bound to disclose to his employer all material facts within his knowledge affecting any

¹ John R. Fahy, jfahy@whitakerchalk.com, (817) 878-0547. John R. Fahy is a member of Whitaker Chalk Swindle & Schwartz PLLC in Fort Worth where he has practiced securities law since 2006. He chairs the Securities Committee of the State Bar of Texas Business Law Section and is a Council Member for the Business Law Section. Previously, he worked for the U.S. Securities and Exchange Commission's Fort Worth Regional Office, managed the Texas State Securities Board's Houston office, and served as general counsel for two registered broker-dealers. He also previously held the Series 7, 24 and 66 licenses. He earned his J.D. and Master degrees from the University of Texas – Austin and his B.A. from Yale.

² Employee Benefit Security Administration Proposed Rule "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Retirement Investment Advice" Federal Register Volume 80, Number 75 (Monday, April 20, 2015) Pages 21928-21960 [FR Doc No: 2015-08831]

³ 15 USC §78o(k); *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Section 913(g).

transaction. The broker may become liable to his principal for any negligent or other wrongful act done by him where his principal suffers damage.⁴

The agent owes the customer a duty of good faith, reasonable care and skill in performing the agent's duties. Under Texas law, the broker-dealer has a duty to inform the customer what it knows, but does not have a duty to report what it did not know or conduct inquiries.⁵

The broker-dealer's agency duty is most obviously seen when directly or indirectly executing a trade order. The customer places the order, which can be limit or market and will identify a security and the amount of securities, and the broker-dealer goes out into the market and executes the order. Alternatively, the broker-dealer can fill the order from inventory as a principal transaction, which brings with its own special regulatory concerns. If the order is "Not Held," then the broker-dealer must promptly execute the ordered trade. If the order is "Held" then the broker-dealer has time and price discretion to work the purchase or sale of securities piecemeal in an effort to not make the market more volatile because of the trade execution.

A corollary to the duty of agent's common law duty of good faith is FINRA Rule 2010 which requires the broker-dealer to "observe high standards of commercial honor and just and equitable principles of trade."⁶

Know Your Customer

FINRA Rule 2090 requires broker-dealers to know their customers – that is they are required, in opening and maintaining each account, to know and retain the "essential facts" concerning every customer and every person authorized to act for the customer. The "essential facts" required include: (1) effectively service the customer's account; (2) carry out special handling instructions; (3) understand the authority of each person acting on behalf of the customer; and (4) comply with applicable laws, regulations and rule.⁷

This means using "reasonable efforts" to obtain customer identifiers and information about their assets, income, risk tolerances, retirement plans, obligations, family status and spending habits. FINRA stated that know-your-customer compliance is a continuing obligation, and not merely tied to the time of the account opening. FINRA did not delineate any specific time frames for revisiting the know-your-customer information.⁸ But a SEC rule requires broker-dealers to maintain certain account

⁴ *Rauscher Pierce Refsnes, Inc. v. Great Southwest Savings, F.A.* 923 S.W.2d 112, 115-116 (Tex. App. – Houston [14th Court of Appeals] 1996) (citations omitted); see also *Barnsdall Oil Co. v. Willis*, 152 F. 2d 824, 828 (5th Cir. 1946).

⁵ *Banner Life Insurance Co. v. Pacheco*, 154 S.W.3d 822 (Tex. App. – Houston [14th Court of Appeals] 2005).

⁶ FINRA Rule 2010.

⁷ FINRA Rule 2090; Supplementary Material, FINRA Rule 2090.01.

⁸ FINRA NTM 11-02, FN 5.

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