

The Evolving Scope of a Stockbroker's Duties in the Wake of *Holmes v. Grubman*

By S. Lawrence Polk and Xavier O. Carter



S. Lawrence Polk is a partner and the leader of Sutherland's securities litigation practice group and represents broker-dealers, banks and accountants in the areas of securities litigation, securities arbitration, professional liability litigation, commercial litigation and U.S. Securities and Exchange Commission (SEC) enforcement actions.



Xavier O. Carter is an associate in Sutherland's Litigation Practice Group.

Introduction

Investment professionals sometimes owe heightened duties to their clients. The scope of those duties is determined by the nature of the relationship between the stockbroker or adviser and his or her client. At one extreme, where the broker has a power of attorney and makes investment decisions on behalf of the client, a fiduciary relationship usually follows. At the other extreme, where a client places orders independent of a broker, such as in an online brokerage account, courts generally find an arms'-length relationship. Federal and state courts have struggled to define the nature and scope of duties that apply to the varied investment relationships that lie between these two extremes. This article evaluates the nature of the duty based on the relationship between the client and the adviser or broker, and the various sources for interpreting the scope of a heightened duty, if any, that may apply to this relationship. The article then considers a recent holding by the Supreme Court of Georgia in *Holmes v. Grubman* and its impact on the scope of a stockbroker's duties under Georgia law.

I. The Traditional Framework for a Stockbroker's Duties

If a heightened or even a fiduciary duty is found to exist, an investment professional may be held to a higher level of conduct than is typically found in commercial transactions. *Black's Law Dictionary* defines a "fiduciary duty" as:

A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another).¹

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Many courts are reluctant to impose the full panoply of fiduciary duties except in situations involving true investment advisers or brokers exercising full “discretion” on behalf of a client.

A. The Investment Adviser

Investment advisers almost always are deemed to be fiduciaries. These are persons who receive a fee to render advice about investments, or who, for compensation and as a part of their regular business, generate analyses and reports concerning securities.² The U.S. Supreme Court has held that Congress, through the Investment Advisers Act of 1940 (Advisers Act), recognized “the delicate fiduciary nature of an investment advisory relationship.”³ Because of this “federal fiduciary duty,” investment advisers have “an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading clients.”⁴ The U.S. Securities and Exchange Commission (SEC) is authorized to bring enforcement actions under the Advisers Act and to ensure that advisers fulfill their fiduciary obligations under the Advisers Act.⁵

B. Retail Stockbrokers

The Advisers Act creates an exception for “any broker or dealer whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation” for those services.⁶ Nonetheless, depending on the particulars of a given investment relationship, a heightened or even a fiduciary duty may exist between a broker and his customer. For example, customers who pay a flat fee to their brokerage firm based upon the amount of assets at the firm, as opposed to paying commissions tied to particular transactions, may be deemed to be in a fiduciary relationship with their stockbroker.⁷

One situation where brokers have a fiduciary duty to their customers involves “discretionary” client accounts, whereby the client gives the broker prior authorization to engage in transactions on the client’s behalf, without requiring specific authorization for any given transaction. Courts have consistently found that a fiduciary duty to the client is inherent in this sort of relationship.⁸ A minority of courts, primarily in California, have extended that reasoning to situations where the broker has

“de facto” control over the account,⁹ such as in extreme circumstances where the investor invariably follows the broker’s recommendation, or where the investor is incapacitated.¹⁰

In “non-discretionary” investment relationships, where the client retains authority over all investment decisions and the broker is not permitted to engage in transactions without the investor’s authorization, courts typically find no fiduciary relationship,¹¹ or that only limited duties exist.¹² Non-discretionary investment relationships generally take one of two forms. When the broker acts as merely an “order taker,” most courts find that no heightened relationship exists but that the broker has a duty to execute the order as requested.¹³ In other non-discretionary account relationships in which the broker makes recommendations concerning the purchase or sale of securities, the broker “is obliged to give honest and complete information” with respect to that recommendation.¹⁴ The latter relationship is governed by what is called the “suitability rule,” an industry standard that is sometimes confused with but is not a fiduciary duty. In either case, most courts find that the broker’s duty to the client, whatever the scope, ends after each transaction is completed.¹⁵

II. Sources of Law Interpreting the Scope of Stockbrokers’ Duties to Their Customers

A. Federal Courts as a Source for Interpreting the Scope of the Duty

Federal courts, applying state common law, have developed a general framework for the scope of brokers’ duties. That scope, in turn, depends largely on the specifics of a given broker-investor relationship.

i. Non-Discretionary Brokerage Accounts

Federal courts often hold that a fiduciary relationship does not necessarily exist between brokers and their clients,¹⁶ finding that “[i]n a non-discretionary account each transaction is viewed singly.”¹⁷ While the nature of the duty owed for any particular account will depend on the specific facts, and whether the transaction is recommended

by the broker, “the scope of any duties owed by the broker will generally be confined to executing the investor’s order.”¹⁸ In executing client orders in non-discretionary accounts, brokers are charged with the duties of “diligence and competence”¹⁹ and must complete transactions “in a manner best suited to serve the [client’s] interests.”²⁰ Brokers may execute orders only after receiving proper authorization from the client.²¹

Once the broker diligently and competently consummates the transaction on the client’s behalf, most courts find that “the broker’s responsibility to his customer ceases” and the broker “has no continuing duty” to the customer with respect to that transaction.²² The broker is not required to “keep abreast of financial information which may affect his customer’s portfolio or to inform his customer of developments which could influence his investments.”²³

Despite the fact that investors in non-discretionary accounts retain authority on all investment decisions, brokers may perform services beyond simply receiving and processing transactions on the client’s behalf. Brokers in non-discretionary accounts often provide transaction-based advice or make investment recommendations to their customers. As brokers involve themselves more intimately with clients and take on more advisory roles on investment decisions, the scope of the broker’s duties to the client expands and may become heightened. In addition to executing the client’s transaction diligently and competently, brokers who make investment recommendations are also “obliged to give honest and complete information,”²⁴ including “the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have”²⁵ and “the duty not to misrepresent any fact material to the transaction.”²⁶ Brokers should make recommendations only after developing a sufficient understanding of the nature and risks involved with a given transaction.²⁷ They must also describe to their client the risks involved and the potential implications of recommended transactions.²⁸

Even where brokers demonstrate a greater level of involvement in their clients’ financial decisions by providing recommendations in non-discretionary accounts, courts have consistently reiterated that whatever duty a broker owes ends once the transaction has been completed.²⁹ The broker’s advice to the client “triggers no ongoing duty” to the client

and the client “has no legal claim on the broker’s ongoing attention.”³⁰

ii. Discretionary Brokerage Accounts

Federal case law involving discretionary accounts generally finds that the investment professional is a fiduciary, unless the parties provide otherwise by contract.³¹ In a recent opinion, the Eleventh Circuit Court of Appeals held that whether a stockbroker owes a fiduciary duty “is determined by the substantive agreement of the parties. It is not determined by labels placed on the relationship.”³² If there is a fiduciary relationship, brokers exercising discretion must manage client accounts in a manner consistent with the client’s needs and objectives, as they have been communicated to the broker by the client.³³ Brokers must also keep informed of market changes that might affect the client’s interests and affirmatively act to protect those interests.³⁴ Finally, they must keep the customer informed of all completed transactions, and must explain the “practical impact and potential risks” of transactions and investment strategies in which they are engaged on the client’s behalf.³⁵

A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer’s client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another).

Brokers in extreme circumstances may also effectively gain control of technically non-discretionary accounts in such a way that courts will impute to them the fiduciary duties associated with discretionary accounts. Courts will consider several factors to determine whether a broker has in fact “usurped” authority over the account. Chief among these considerations will be the “age, education, intelli-

gence and investment experience of the customer.”³⁶ Finally, courts will find that the broker has usurped control over the account where the broker has engaged in unauthorized transactions.³⁷

B. State Common Law as a Source for Interpreting the Scope of the Fiduciary Duty

State courts are in conflict over whether brokers owe clients a heightened or a fiduciary duty and, if so, the scope of that duty.³⁸ While courts seem to agree that brokers that exercise discretion in investment account decisions are in a fiduciary relationship with their client, the majority of states that have addressed the issue have not found a fiduciary duty in non-discretionary accounts.

As with federal common law, brokers are more likely to have heightened duties when they recommend transactions, but the broker's duty typically ends at the close of each transaction and the broker has no continuing duty to provide advice or keep abreast of information which might affect the client's portfolio. As one court noted, “[i]f a broker were under a duty to inform all of its customers of every fact which might bear upon any security held by the customer, the broker simply could not physically perform such a duty.”³⁹

Investment professionals sometimes owe heightened duties to their clients. The scope of those duties is determined by the nature of the relationship between the stockbroker or adviser and his or her client.

While some courts have been reluctant to find that a fiduciary duty exists between brokers and clients,⁴⁰ courts in jurisdictions such as California have been more willing to do so.⁴¹ In *Duffy v. Cavalier*, for instance, the court noted “there is in all cases a fiduciary duty owed by a stockbroker to his or her customers; the *scope* of this duty depends on the specific facts and circumstances presented in a given case.”⁴² This California decision illustrates the point that even if one characterizes a relationship as “fiduciary” in nature, the more

difficult issue is the scope of the agency between broker and client.

III. The *Grubman* Decision and Georgia's Fiduciary Duty for Non-Discretionary Accounts

The Supreme Court of Georgia recently held in *Holmes v. Grubman* that, under Georgia law, investment professionals owe limited “fiduciary” duties to non-discretionary brokerage customers. A close examination of the opinion reveals that the scope of that duty is much more limited than a traditional fiduciary relationship, or even the scope under the federal fiduciary standard.

A. Factual Background

In *Grubman*, investor William K. Holmes owned shares of WorldCom in a non-discretionary brokerage account with Salomon Smith Barney & Co. (SSB).⁴³ Holmes alleged that in June 1999 he verbally ordered his broker to sell 2.1 million shares of WorldCom, then trading at \$92 per share.⁴⁴ Holmes claimed that his broker convinced him not to sell by referring to a recent research report on WorldCom by Jack Grubman, SSB's telecommunications analyst, and that he purchased more shares of WorldCom based on numerous positive recommendations by Grubman.⁴⁵ WorldCom's stock price fell precipitously and in October 2000, Holmes's investments in WorldCom were involuntarily sold to pay margin calls.⁴⁶

In 2003, Holmes filed suit against Grubman, which ultimately was transferred to the U.S. District Court for the Southern District of New York as part of a larger, consolidated action against the defendants.⁴⁷ Holmes alleged, in part, that the defendants owed him a fiduciary duty with respect to his brokerage account.⁴⁸ The district court dismissed his fiduciary duty claim, finding that SSB owed no such duty because Holmes maintained a non-discretionary account.⁴⁹ The district court found that because Holmes retained final control over his investment decisions, SSB could not have exerted the type of “controlling influence” over him necessary to create a fiduciary relationship under Georgia law.⁵⁰ On appeal, the U.S. Court of Appeals for the Second Circuit certified several questions concerning Georgia law to the Supreme

Court of Georgia.⁵¹ The last of these questions was whether, “[u]nder Georgia law . . . a brokerage firm owe[s] a fiduciary duty to the holder of a non-discretionary account?”⁵²

B. The Grubman Court's Interpretation of a Stockbroker's Fiduciary Duty

On review, the *Grubman* Court first affirmed the Georgia Court of Appeals' past holdings that “a stockbroker has limited fiduciary duties towards a customer who holds a non-discretionary account” to “transact business only after receiving prior authorization from the client and the duty not to misrepresent any fact material to the transaction.”⁵³ The *Grubman* Court went on to conclude further:

[F]iduciary duties owed by a broker to a customer with a non-discretionary account are not restricted to the actual execution of transactions. The broker will have a heightened duty, even to the holder of a non-discretionary account, when recommending an investment which the holder has previously rejected or as to which the broker has a conflict of interest.⁵⁴

C. The Potential Effect of the Grubman Holding

The Court's holding in *Grubman* is significant in that, for the first time, the Supreme Court of Georgia explicitly recognized a fiduciary duty for brokers in non-discretionary accounts. The ruling, however, does not appear to expand significantly the scope of a broker's duties. The Court specifically approved of the Court of Appeals' usage of federal precedent in establishing the “limited fiduciary

duties” already recognized.⁵⁵ The Court also cited to *Leib* and the *Law of Securities Regulation* in recognizing additional “heightened” duties.⁵⁶ Both of those sources note the limited fiduciary duties generally owed investors who retain authority on their non-discretionary accounts.⁵⁷ The *Leib* decision in particular lists six duties brokers owe clients on non-discretionary accounts.⁵⁸ Each of the duties the *Grubman* Court specifically recognized, with the exception of the “heightened duty . . . when recommending an investment which the holder has previously rejected,” directly correlates with the duties outlined by the *Leib* court.⁵⁹

Conclusion

While the *Grubman* Court made a broad pronouncement that stockbrokers have limited fiduciary duties to holders of non-discretionary accounts, the more difficult issue is the scope of those duties, especially for unsolicited transactions where the stockbroker made no recommendation or took any other action to encourage or discourage the transaction, or for transactions effected entirely by the customer, such as in an online account. It is important to note that the *Leib* court and other courts recognize additional duties for brokers when the broker makes recommendations in a non-discretionary account.⁶⁰ With respect to unsolicited transactions by non-discretionary account investors, courts have consistently found that a broker's only duty is “an added degree of responsibility to carry out pre-existing, agreed-upon tasks properly.”⁶¹ Future appellate courts will be asked to elaborate on the scope of duties owed to customers who make their own investment decisions, or who merely utilize a stockbroker as an order taker.

ENDNOTES

¹ BLACK'S LAW DICTIONARY 581 (9th ed. 2009), duty (parentheticals in original).

² 15 U.S.C.A. § 80b-2(a)(11) (2006).

³ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92, 84 S. Ct. 275, 282-83 (1963) (citation omitted).

⁴ Id. at 194 n.43, 84 S. Ct. at 284 n.43 (citations and internal quotations omitted).

⁵ See Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 14, 100 S. Ct. 242, 244 (1979) (finding that no private right exists to enforce violations of § 206 of the Advisers Act).

⁶ 15 U.S.C.A. § 80b-2(a)(11)(C).

⁷ In 2007, Section 202 of the Advisers Act was interpreted to provide that a fiduciary relationship applies to most fee-based brokerage accounts, as well as investment advisory accounts. Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

⁸ Hill v. Bache Halsey Stuart Shields, Inc., 790 F.2d 817 (10th Cir. 1986).

⁹ Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1532, 264 Cal. Rptr. 740 (1989) (finding broker owed client fiduciary duty when client was an unsophisticated investor and invariably accepted the broker's recommendations).

¹⁰ Beckstrom v. Parnell, 730 So. 2d 942, 949 (La.

Ct. App. 1998).

¹¹ Shamsi v. Dean Witter Reynolds, Inc., 743 F. Supp. 87, 92 (D. Mass. 1989) (“As a general matter, the existence of a stockbroker-customer relationship does not constitute a fiduciary relationship in Massachusetts.”).

¹² Limbaugh v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 732 F.2d 859, 862 (11th Cir. 1984) (“duty owed by the broker was simply to execute the order”).

¹³ Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999).

¹⁴ de Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302 (2d Cir. 2002).

- ¹⁵ Id.; FINRA Rule 2310.
- ¹⁶ *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981); *see also* de Kwiatkowski, 306 F.3d at 1302.
- ¹⁷ *Leib*, 461 F. Supp. at 952.
- ¹⁸ *Martinez Tapia v. Chase Manhattan Bank, N.A.*, 149 F.3d 404, 412 (5th Cir. 1998).
- ¹⁹ de Kwiatkowski, 306 F.3d at 1302.
- ²⁰ *Leib*, 461 F. Supp. at 953.
- ²¹ Id.
- ²² Id.
- ²³ Id.
- ²⁴ de Kwiatkowski, 306 F.3d at 1302.
- ²⁵ *Leib*, 461 F. Supp. at 953.
- ²⁶ Id.
- ²⁷ Id.
- ²⁸ Id.
- ²⁹ de Kwiatkowski, 306 F.3d at 1302 (citing *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d at 536 (finding a broker's fiduciary duty is limited to the "narrow task of consummating the transaction requested"), and *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940-41 (2d Cir. 1998) (finding that in a non-discretionary account, "the broker's duties are quite limited" including the duty to obtain client's authorization before making trades and to execute requested trades)).
- ³⁰ de Kwiatkowski, 306 F.3d at 1302.
- ³¹ *Leib*, 461 F. Supp. at 953.
- ³² *SMF Holdings, Ltd., v. Banc of America Securities, LLC*, No. 07-11178, at 12 (11th Cir. filed March 25, 2010).
- ³³ Id.
- ³⁴ Id.
- ³⁵ Id.
- ³⁶ Id. at 954.
- ³⁷ Id.
- ³⁸ HAZEN, LAW OF SECURITIES REGULATION § 14.15 [2] (6th ed. & Supp. 2010).
- ³⁹ *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273, 280 (Miss. 1991).
- ⁴⁰ *Shamsi*, 743 F. Supp. at 92 ("As a general matter, the existence of a stockbroker-customer relationship does not constitute a fiduciary relationship in Massachusetts."), *relying on* *Vogelaar v. H. L. Robbins & Co.*, 348 Mass. 787, 204 N.E.2d 461 (1965).
- ⁴¹ *Duffy*, 215 Cal. App. 3d at 1531-32, 264 Cal. Rptr. 740 (finding a fiduciary relationship when an unsophisticated investor holding a non-discretionary account routinely followed the broker's recommendations); *see also* *Beckstrom*, 730 So. 2d at 951-52 (relying heavily on *Leib*, 461 F. Supp. at 953-54 to define parameters of fiduciary relationship for non-discretionary accounts, but finding that broker owed a fiduciary duty to elderly patient whose health deteriorated and who told the broker that he desired less control over his account).
- ⁴² *Duffy*, 215 Cal. App. 3d at 1536 n.10, 264 Cal. Rptr. 740.
- ⁴³ *Holmes v. Grubman*, No. SO9Q1585, ___ S.E.2d ___, 2010 WL 424225, at *1 (Ga. Feb. 8, 2010).
- ⁴⁴ Id.
- ⁴⁵ Id.
- ⁴⁶ Id.
- ⁴⁷ *Holmes v. Grubman* (In re WorldCom, Inc. Sec. Litig.), 456 F. Supp. 2d 508, 510 (S.D.N.Y. 2006).
- ⁴⁸ Id. at 517.
- ⁴⁹ Id. at 517-18.
- ⁵⁰ Id. at 517.
- ⁵¹ *Grubman*, 2010 WL 424225, at *1.
- ⁵² Id.
- ⁵³ Id. at *6 (citing *Glisson v. Freeman*, 243 Ga. App. 92, 99, 532 S.E.2d 442, 449 (2000)).
- ⁵⁴ Id.
- ⁵⁵ Id.
- ⁵⁶ Id.
- ⁵⁷ *See* *Leib*, 461 F. Supp. at 953; HAZEN, *supra* note 37, § 14.15[2].
- ⁵⁸ *Leib*, 461 F. Supp. at 953.
- ⁵⁹ *See* *Grubman*, 2010 WL 424225, at *6.
- ⁶⁰ *Leib*, 461 F. Supp. at 953; *see also* de Kwiatkowski, 306 F.3d at 1302 (finding an obligation to give "honest and complete information when recommending a purchase or sale").
- ⁶¹ *Hill*, 790 F.2d at 825; *see also* *Limbaugh*, 732 F.2d at 862 ("duty owed by the broker was simply to execute the order").

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